Chapter 3

RESERVE BANK OF INDIA: EVOLUTION, FINANCIAL REPORTING AND ACCOUNTING PRACTICES

By

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1. Reserve Bank of India – An Overview

The Reserve Bank of India, the central bank of the country, was established in 1934 under the Reserve Bank of India Act 1934 (II of 1934), which provides the statutory basis of the functioning of the Bank. The Bank commenced operations on 1 April 1935. The initial functions envisaged for the Reserve Bank were to regulate the issue of banknotes, maintain reserves with a view to securing monetary stability and operate the credit and currency system of the country to its advantage.

1.1 Historical Background

Establishment of the Reserve Bank was a long drawn process with the process of legislation beginning in January 1927 and the enactment taking place in March 1934. The evolution of the thorough process may, however, be traced to the efforts to set up a banking institution in 1773 when Warren Hastings, Governor (later Governor-General) of Bengal proposed his ‘Plan’ for a ‘General Bank in Bengal and Bihar’, which was set up in April 1773. This bank had some elements of a central bank as it could act as a Treasury for revenue collections in districts. Apart from facilitating Government revenue collections, the bank could undertake remittances on behalf of merchants, who could also be saved the risk and the expenses involved in making remittances to the depots for manufactured goods. The project was, however, short-lived and the bank closed in 1975, even though it had met the objectives and also made considerable profits (RBI, 1970).

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Beginning 1806 with the Bank of Bengal, the Government established three presidency banks and allowed them to issue notes up to specified limits until 1862, when the Government was given the sole right to issue notes under the Paper Currency Act. These banks were also entrusted with cash balances of the government and public debt management. Soon the need was felt to centralize the government balances in a single bank to increase banking presence across the country. There were prolonged debates, without reaching a conclusion or consensus, on proposals of amalgamation of the three presidency banks and the establishment of a separate central bank. Finally, the three presidency banks were amalgamated in 1921, leading to the formation of the Imperial Bank of India. Essentially a commercial bank, the Imperial Bank, performed certain central banking functions such as banker to the Government and bankers' bank, while the core central banking function of the issuance of currency notes and management of foreign exchange continued to be the responsibility of the Central Government (RBI, 2006).

The experience of the presidency banks brought out some important lessons for the then Government. The managerial and regulatory aspects led to financial difficulties in the Bombay Presidency Bank, making it difficult for the Government to withdraw its cash balances. The Government also realized that keeping large balances with the presidency banks was of no real advantage to trade and market. Withdrawal of large cash balances by the Government could lead to crisis which otherwise might not occur (RBI, 1970). It was, therefore, suggested that the Government should have its reserves in its own custody, which led to the establishment of Government Treasuries. With the establishment of the Imperial Bank, however, Reserve Treasuries were abolished and all treasury balances were kept with the Bank. It was also made the sole banker to the Government in view of the agreement signed between the Government and the Bank. The leading banks in India also kept a major portion of their cash balances, even though there were no explicit statutory requirements for them to do so. Even though the Imperial Bank was assigned a few central banking functions, two main central banking functions viz., regulation of note issuance and management of foreign exchange continued to be performed by the Government. Meanwhile, the International Financial Conference held at Brussels in 1920 and the second conference held in 1922 at Genoa, emphasized the need for establishing a center of issuance in each country.

The recommendations of the Hilton Young Commission, which submitted its Report in 1926, took the central banking philosophy in India close to international thinking. Pointing out the 'inherent weakness' of the Indian system, where the control of currency and credit was in the hands of two different authorities, it recommended the establishment of a central bank, which may be called the Reserve Bank of India, to solely perform central banking functions. Thus, the legislative process of establishing the Reserve Bank began in 1927 with the introduction of the Gold Standard and Reserve Bank of India Bill in the Legislative Assembly with provisions for the Bank to take over the management of the currency from the Governor-General in Council apart from other functions.

1.2 Establishment and Evolution of Reserve Bank of India

The introduction of the Bill in 1927 was followed by a prolonged debate and discussion, after which the Bill was reintroduced in 1933 as The Reserve Bank of India Bill which was passed by Assembly in the same year and by Council of States in 1934. The Reserve Bank was established in 1935 as a shareholders' institution in April 1935. The preamble to the RBI Act 1934, states the objective of RBI is to "regulate the issue of bank notes and the keeping of the reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage". The Bank's functions included (i) issue of currency; (ii) banker to the Government; and, (iii) banker to other banks. After its establishment, it served as the Central Bank of Burma (Myanmar) up to April 1947, even after it seceded from the Indian Union in 1937. After the partition of India, the Reserve Bank served as the Central Bank of Pakistan up to June 1948 when the State Bank of Pakistan commenced operations. The Bank was nationalized in 1949.

The focus and priority attached to various functions by the Reserve Bank have changed over time in line with the economic and financial developments in the country. As in many other countries, matters relating to currency and exchange, such as the question of the monetary standard and the exchange rate, received far more attention than the subject of banking, especially central banking (RBI, 1970). The Bank began its operations by taking over from the Government, the functions that were thus far, performed by the Controller of Currency and from the Imperial Bank of India, the management of Government accounts and public debt. The existing currency offices at Calcutta, Bombay, Madras, Rangoon, Karachi, Lahore and Cawnpore (Kanpur) became branches of the Issue Department.

Soon after independence, the country began pursuing its development aspirations and the Bank was seen playing a crucial in the process, particularly for the agriculture sector. The developmental role of the Bank became more pronounced in the 1960s, when finance began to be considered as a major catalyst for development. Apart from putting in place, a policy framework for sectoral lending such as priority sector lending norms, the Bank also played a crucial role in establishment of development institutions in the country which specialized in sector-specific finance needs as well as finance infrastructure in the country. Some of these included the Deposit Insurance and Credit Guarantee Corporation of India, the Unit Trust of India, the Industrial Development Bank of India, the National Bank of Agriculture and Rural Development and the Discount and Finance House of India.

Exchange rate related issues and price stability began receiving more attention in the 1970s and 1980s. The breakdown of Bretton Woods stable exchange rate and oil shock of 1973-74 posed serious balance of payments problem for the country leading to the enactment of the Foreign Exchange Regulation Act (FERA) 1973, which focused on foreign exchange conservation rather than regulation. Thus, implementation of the FERA and managing scarce foreign exchange reserves received greater attention of the Bank during 1970s.

Beginning the 1980s, managing inflation in the economy emerged as a focus area and the monetary framework put in place was an outcome of global thinking in favor of the Monetarist approach. This period saw a significant expansion of the domestic monetary base due to a large budgetary deficit of the Government and the Reserve Bank's financing of these deficits. The Committee to Review the Working of the Monetary System (Sukhamoy Chakravarty[2], 1985) suggested that monetary targeting should be made in a formal and secure manner whereby the monetary targets are decided on the basis of desired growth in output and the tolerable level of inflation (RBI, 2006).

The policy framework in the Indian economy saw a major shift beginning the 1990s with a move towards liberalization and globalization with commensurate implications for the role of the Reserve Bank in the economy, which warranted a change in its focus areas as well as operational framework. In the changed scenario, the role of financial markets became increasingly important for meeting the financing needs of the commercial sector as well as for policy transmission. Development of the debt market also received special attention from the Bank during the 1990s. Foreign exchange markets received a major thrust with the replacement of FERA 1973 with a new legislation, the Foreign Exchange Management Act (FEMA) 1999, which focused on facilitating external trade and payments and promoted the orderly development and maintenance of the foreign exchange market in India. The Reserve Bank also absorbed short-term liquidity through repo operations during the 1990s. Apart from developing the financial markets, steps were also taken to strengthen the banking system through addressing non-performing loan problems and taking prudential norms close to international standards.

[2] Chairman of the Committee to Review the Working of the Monetary System.

The liquidity framework went through a major shift in the beginning of the 2000s with the implementation of full-fledged Liquidity Adjustment Facility (LAF) in June 2000 with the policy rate representing the interest rate corridor for monetary policy transmission. During the decade, the Reserve Bank discontinued buying government securities in the primary market under the Fiscal Responsibility and Budget Management (FRBM) Act 2003, imparting autonomy and effectiveness to its monetary and liquidity management operations.

Beginning 2005, the Reserve Bank placed a major focus on financial inclusion with several initiatives taken to bring the hitherto excluded population in the ambit of the formal banking and financial sector. Financial inclusion efforts during the 2000s differed from earlier efforts as the focus this time was on individuals, rather than an aggregative approach aimed at sectoral and regional levels. Efforts were also made for the promotion of financial literacy to enable the public to avail banking services on the one hand, and to create awareness about the increasing number of fraudulent activities on the other.

Inflation management saw a paradigm shift beginning 2014, with a change in the anchor from WPI-based inflation to CPI-based inflation and the adoption of a disinflation glide path to reduce the inflation rate to below 6% January 2016. The inflation targeting framework was formalized with the signing of an agreement between the Government and the Reserve Bank in February 2015, to reduce the inflation rate to 4+/-2% by 2017-18 and maintain it at that level thereafter.

To incorporate the evolution of monetary and financial developments in the country, the Reserve Bank felt the need to rearticulate, in contemporary terms, its core purpose as given in the preamble to the RBI Act 1934. The purpose was to delineate the Reserve Bank's strategic objectives and provide a framework and backdrop for the formulation of Reserve Bank policies and the charting of its direction. Accordingly, the Reserve Bank issued its 'Core Purpose, Values and Vision' Statement in April 2015. The Core Purpose is defined as fostering monetary and financial stability conducive to sustainable economic growth and ensuring the development of an efficient and inclusive financial system. The Statement also delineated the shared values that guide organizational decisions and employee actions in pursuit of the Reserve Bank's Core Purpose. Setting a vision for itself, the Bank is committed to pursue public interest and common good as a leading central bank that is recognized for its credible, transparent and proactive policies (RBI, 2015).

2. Balance Sheet Reporting and Accounting Practices

The balance sheet of a central bank is distinct from the balance sheet of any other entity as it reflects linkages of the entire operations within the economy and the rest of the world. Each operation of the central bank such as issuance of currency, foreign exchange operations, liquidity and monetary management are reflected in its balance sheet. The structure and evolution of a central bank’s balance sheet is crucial for understanding its policy goals and their effectiveness (Rule, 2015). The uniqueness of the balance sheet of a monetary authority emanates not only as the source of money creation but also as a description of its relationships with the government on the one hand, and the banking and financial system on the other. Not surprisingly, the information content and health of central banks’ balance sheets are receiving a lot of attention the world over, in an effort to unravel the mystique surrounding the temples of money (Jadhav; Ray; Bose and Sen Gupta, 2003).

There are significant variations in the publication of central banks’ balance sheet in terms of frequency and format standards. The most common place for the publication of the balance sheet for many central banks is in their annual reports. Many central banks, however, also publish their balance sheet at higher frequency on websites and other sources. Some central banks, such as the Bank of England and the Federal Reserve, publish their balance sheets (or parts of their balance sheet) on a weekly basis with minimal lag. Others, such as the national central banks within the euro system and the Hong Kong Monetary Authority publish their balance sheet monthly, again with a minimal lag (Rule, 2015).

The reporting of the balance sheet by the central bank is a major component of transparency, which in turn, makes accountability more effective. There is considerable amount of evidence which indicates that central bank transparency increases the effectiveness of monetary policy and enhances economic and financial performance in several ways. “First, improving the public's understanding of the central bank's objectives and policy strategies reduces economic and financial uncertainty and thereby allows businesses and households to make more-informed decisions. Second, if practitioners in financial markets gain a better understanding of how policy is likely to respond to incoming information, asset prices and bond yields will tend to respond to economic data in ways that further the central bank's policy objectives. For example, if market participants understand that arriving information about the economy increases the likelihood of certain policy actions, then market interest rates will tend to move in a way that reinforces the expected actions, effectively supporting the goals of the central bank. Third, clarity about the central bank's policy objectives and strategy may help anchor the public's long-term inflation expectations, which can substantially improve the efficacy of policy and the overall functioning of the economy. Finally, open discussion of the central bank's analyses and forecasts invites valuable input and feedback from the public" (Bernanke, 2007).

The institutional arrangements in respect of reporting requirements vary across nations with clear legislative stipulations in some while in others by tradition. The accounting policies of central banks also vary, although it has been argued that central banks should follow a uniform accounting policy to enable comparability and better understanding of policy stances. The International Monetary Fund (IMF) introduced safeguards for assessment focusing on external audit, legal structure, financial reporting and internal auditing mechanism. Overall, there are three basic accounting standards, viz., the International Accounting Standards (IAS), US Generally Accepted Accounting Principles (US GAAP) and the European Central Bank GAAP (ECB GAAP) for which central banks could conceivably benchmark. The International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board, include all existing International Accounting Standards (IAS) (Jadhav; Ray; Bose and Sen Gupta, 2003).

Some central banks report a single balance sheet while others such as the Bank of England and the Bank of Thailand prepare separate accounts of the Banking and Issue Departments. The South African Reserve Bank publishes financial statements for the Group (i.e., the Central Bank and its subsidiaries) but the Reserve Bank of India does it separately. Meanwhile, the Reserve Bank of Australia prepares and disseminates consolidated financial statements covering its subsidiary and controlled entities (RBI, 2006).

3. Balance Sheet Reporting by RBI

The Reserve Bank was mandated to prepare separate balance sheet of the Issue Department and Banking Department under the Reserve Bank of India Act 1934. Apart from the Annual Report, the information is also disseminated on a weekly basis through its website and weekly publications.

3.1 Legislative Requirement

The financial statements of the Reserve Bank are based on the provisions of the Reserve Bank of India (RBI) Act 1934 and the notifications issued there under, while the form of presentation conforms to the prescriptions laid down in the Reserve Bank of India General Regulations 1949. Article 53 of the RBI Act 1934 requires the Bank to transmit a weekly account of the Issue Department and Banking Department to the Government. It also mandates the Bank to prepare and transmit to the Government, the annual accounts, together with a report by the Central Board on the working of the Bank throughout the year, within two months from the date on which the annual accounts of the Bank are closed (June 30). The Act (Section 50-52) requires the Central Government to appoint two auditors to examine the annual balances sheet of the Bank.

For better comparability and transparency, a Technical Committee to review the Form of Presentation of the Balance Sheet and Profit & Loss Account[3] had made several recommendations relating to the format and contents of the Balance Sheet and Profit & Loss Account of the Reserve Bank. In response to the recommendations of the Committee following the notification by the Government, the balance sheets of the Issue and Banking Departments for 2014-15 have been merged and each item of asset and liability is shown as line items supported by schedules (RBI, 2015).

3.2 Purpose of Financial Statements

The financial statements of the Reserve Bank are general purpose financial statements, providing information about the manner in which the Reserve Bank obtains its resources and invests in assets as well as the nature and extent of its income and expenditure, in so far as they reflect the efficient and effective management of the Bank, including by its Board, and for the discharge of the responsibilities, in view of the RBI Act 1934 (RBI, 2013).

General purpose financial statements of an entity normally include (i) Balance Sheet; (ii) Profit & Loss Account; (iii) Cash Flow Statement; (iv) Statement of Accounting Policies and Explanatory Notes; and, (v) Consolidated Balance Sheet and a Consolidated Profit & Loss Account. The RBI Act 1934 and Regulations framed thereunder requires RBI to prepare the balance sheet and profit and loss account. Notably, there is no requirement under the RBI Act or Regulations to prepare the Cash Flow Statement, a Statement of Accounting Policies and Explanatory Notes or a Consolidated Balance Sheet and Profit & Loss Account. Nevertheless, in keeping with the need for transparency, major accounting policy and explanatory notes are disseminated in the Annual Report of the Bank.

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[3] Shri Y.H. Malegam, Chairman of Technical Committee I.

3.3 Accounting Policies

Accounting policies followed by the Reserve Bank are not strictly in conformity with the requirements of the International Accounting Standards/International Financial Reporting Standards (IAS/IFRS) as it is felt that complete convergence with the IAS/IFRS may not be desirable. The IAS/IFRS are designed for commercial entities and may not relevant for central banks, particularly from the perspective of materiality and need for adopting more conservative policy by central banks (RBI, 2013). The accounting policies adopted by the Reserve Bank are generally in accordance with the IAS/IFRS with appropriate departures. The accounting policies of the Bank are spelt out in its Annual Report, which are briefly discussed below.

The financial statements of the Reserve Bank are prepared in accordance with the Reserve Bank of India Act 1934 and the notifications issued thereunder and in the form prescribed by the Reserve Bank of India General Regulations 1949. These are based on historical cost except where it is modified to reflect revaluation.

3.3.1 Income and Expenditure

Income and expenditure are recognized on accrual basis except penal interest which is recognized on realization basis. Unclaimed balances outstanding for three under certain accounts are written back to income. Income and expenditure in foreign currency are recorded at the exchange rates prevailing on the last business day of the week/month/year as applicable.

3.3.2 Gold and Foreign Currency Assets and Liabilities

Gold is revalued on the last business day of the month at 90% of the daily average price quoted by the London Bullion Market Association (LBMA) for the month. The value of gold and foreign currency assets (FCA) as well as foreign currency liabilities are converted into rupee value on the basis of the exchange rate as on the last business day of the month. Unrealized gains/ losses are credited/debited to the Currency and Gold Revaluation Account (CGRA).

Foreign securities other than treasury bills and commercial papers and certain “held to maturity” securities are marked to market and appreciation/depreciation is recorded in the Investment Revaluation Account (IRA). Premium or discount on foreign securities is amortized daily. The profit/loss on the sale of foreign currency assets is recognized with respect to the book value.

Forward contracts are valued on a yearly basis and any marked to market gain is credited to the Foreign Exchange Forward Contracts Valuation Account (FCVA) with contra debit to the Revaluation of Forward Contracts Account (RFCA). Loss is debited to the FCVA with contra credit to the Provision for Forward Contracts Valuation Account (PFCVA). The actual gain or loss on maturity of the contract is recognized in the Income Account and the unrealized gains/losses previously recorded in the FCVA, RFCA and PFCVA are reversed. The debit balance in the IRA and FCVA, if any, on June 30, is required to be charged to the Contingency Fund and reversed on the first working day of the following year.

3.3.3 Domestic Investments

Rupee securities are valued at lower of book value or market value (LOBOM). Market prices for non-traded securities are derived on basis of the yield curve as notified by the Fixed Income Money Market and Derivatives Association of India (FIMMDA). Any depreciation is adjusted against the current year’s interest income. Treasury bills and shares are valued at cost. Any change in the accounting policies is explained in the Annual Report of the Bank.

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