Half Yearly Report on Management of Foreign Exchange Reserves

April, 2013 – September, 2013

Reserve Bank of India

Department of External Investments and Operations (DEIO)
Central Office, Mumbai

Report on Management of Foreign Exchange Reserves

Contents

Developments during the Half Year ended September, 2013

I.1 Introduction

The Reserve Bank of India publishes half-yearly reports on management of foreign exchange reserves for bringing about more transparency and enhancing the level of disclosure. These reports are prepared half yearly with reference to the position as on end-March and end-September each year. The present report (21st in the series) is with reference to the position as on end-September, 2013.

The report is divided into two parts: Part I gives the developments regarding movement of reserves and information on the external liabilities *vis-à-vis* the foreign exchange reserves, Financial Transaction Plan (FTP) of the IMF, adequacy of reserves, *etc.* during the half-year under review. Objectives of reserve management, statutory provisions, risk management practices, information on transparency and disclosure practices followed by the RBI with regard to reserve management are covered in Part II.

Part- I

I.2 Movement of Reserves

The reserves stood at USD 292.0 billion as at end-March, 2013. During the half year under review, it came down to USD 275.5 billion at the end of August, 2013 after which it increased to USD 277.2 billion at the end-September, 2013 (Table 1 & Chart 1).

Although both US dollar and Euro are intervention currencies and the Foreign Currency Assets (FCA) are maintained in major currencies like US dollar, Euro, Pound Sterling, Japanese Yen etc., the foreign exchange reserves are denominated and expressed in US dollar only. Movements in the FCA occur mainly on account of purchases and sales of foreign exchange by RBI in the foreign exchange market, income arising out of the deployment of the foreign exchange reserves, external aid receipts of the Central Government and the effects of revaluation of the assets.

Table 1 : Movement in Foreign Exchange Reserves (USD Million)

Month End	FCA	Gold	SDR	RTP	Forex Reserves
March-13	259,726	25,692	4,327 *(2,887)*	2,301	292,046
April-13	263,322	23 974	4,356 *(2,887)*	2,240	293,892
May-13	258,509	22,836	4,327 *(2,887)*	2,225	287,897
June-13	254,367	21,556	4,342 *(2,887)*	2,189	282,454
July-13	250,276	20,747	4,369 *(2,887)*	2,180	277,572
August-13	247,402	21,724	4,375 *(2,887)*	1,990	275,491
September-13	248,847	21,765	4,429 *(2,887)*	2,192	277,233

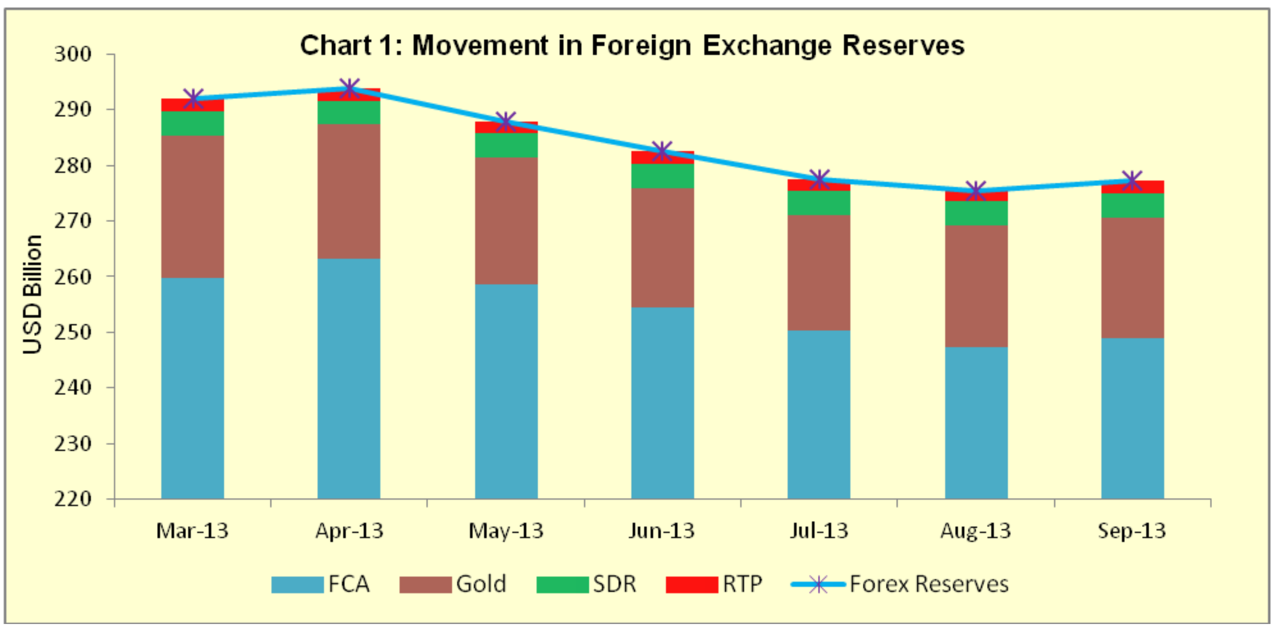
Notes:

(i) *FCA (Foreign Currency Assets): FCAs are maintained as a multi-currency portfolio comprising major currencies, such as, US dollar, Euro, Pound sterling, Japanese yen, etc. and are valued in terms of US dollars.*

(ii) *FCA excludes investment in foreign currency denominated bonds issued by IIFC (UK) and foreign currency received under SAARC SWAP arrangement.*

(iii) *SDR (Special Drawing Rights): Values in SDR have been indicated in parentheses.*

(iv) *RTP refers to the Reserve Tranche Position in the IMF.*



I.3 Forward Liability

The net forward liability of the Reserve Bank in domestic foreign exchange market stood at USD 9,581 million as at the end of September, 2013.

I.4. External Liabilities vis-à-vis Foreign Exchange Reserves

India's International Investment Position (IIP), which is a summary record of the stock of country's external financial assets and liabilities, as at end-September, 2013 is furnished in Table 2.

Table 2: International Investment Position of India	(USD Billion)
Item	**Sept-13 (P)**
A. Total External Assets	**436.7**
1. Direct Investment	120.1
2. Portfolio Investment	1.4
3. Other Investment	38
4. Foreign Exchange Reserves	277.2
B. Total External Liabilities	**732.9**
1. Direct Investment	216.9
2. Portfolio Investment	169.2
3. Other Investment	346.8
Net IIP (A-B)@	**-296.2**

P : Provisional

@ Difference, if any, is due to rounding off.

The net IIP as at end-September, 2013 was negative at USD 296.2 billion, implying that our external liabilities are more than the external assets. The net IIP as at end-September, 2012[1] and end-March, 2013[2] was USD (-) 286.1 billion and USD (-) 317.6 billion respectively.

[1] Partially Revised F***igures***
[2] ***As at '1' above***

I.5 Adequacy of Reserves

Adequacy of reserves has emerged as an important parameter in gauging the ability to absorb external shocks. With the changing profile of capital flows, the traditional approach of assessing reserve adequacy in terms of import cover has been broadened to include a number of parameters which take into account the size, composition and risk profiles of various types of capital flows as well as the types of external shocks to which the economy is vulnerable. The High Level Committee on Balance of Payments, which was chaired by Dr. C. Rangarajan, erstwhile Governor of the Reserve Bank of India, had suggested that, while determining the adequacy of reserves, due attention should be paid to payment obligations, in addition to the traditional measure of import cover of 3 to 4 months. In 1997, the Report of the Committee on Capital Account Convertibility under the Chairmanship of Shri S.S. Tarapore, erstwhile Deputy Governor of the Reserve Bank of India, suggested alternative measures of adequacy of reserves which, in addition to trade-based indicators, also included money-based and debt-based indicators. Similar views have been held by the Committee on Fuller Capital Account Convertibility (Chairman: Shri S.S. Tarapore, July 2006).

One popular measure of reserve adequacy requires that the usable foreign exchange reserves should exceed scheduled amortisation of foreign currency debts (assuming no rollovers) during the following year. In 2011, IMF has developed a new reserve adequacy metric for emerging market economies (EMs) and low income countries (LICs) that builds on various possible drains on reserves. Sources of such risk would include external liabilities as well as current account variables and some measure of potential capital flight.

At the end of September, 2013, the import cover declined to 6.6 months from 7.0 months at end-March, 2013. The ratio of short-term debt[3] to the foreign exchange reserves which was 33.1 per cent at end-March, 2013 increased to 34.2 per cent at end-September, 2013. The ratio of volatile capital flows (defined to include cumulative portfolio inflows and short-term debt) to the reserves increased from 94.3 per cent as at end-March, 2013 to 97.3 per cent as at end-September, 2013.

I.6. Management of Gold Reserves

The Reserve Bank held 557.8 tonnes of gold, of which 265.5 tonnes are held abroad in safe custody with the Bank of England and the Bank for International Settlements. It forms about 7.9 per cent of the total foreign exchange reserves in value terms (USD) as on September 27, 2013.

I.7 Investment Pattern and Earnings of the Foreign Currency Assets

The foreign currency assets are invested in multi-currency, multi-asset portfolios as per the existing norms, which are similar to the best international practices followed in this regard. As at end-September, 2013, out of the total foreign currency assets of USD 248.8 billion, USD 155.7 billion was invested in securities, USD 86.6 billion was deposited with other central banks, BIS and the IMF and remaining USD 6.6 billion comprised deposits with foreign commercial banks and funds placed with the External Asset Managers (EAMs) **(**Table 3**).**

[3]Redefined from 2005-06 by including suppliers' credit upto 180 days and FII investments in the Government of India Treasury Bills and other instruments and further in March, 2007 by including external debt liabilities of the banking system and the investments in the Government Treasury bills by foreign central banks and international institutions.

Table 3 : Deployment Pattern of Foreign Currency Assets	(USD Million)	
	As at End-March-13	As at End-September-13
Foreign Currency Assets *	**259,726**	**248,847**
(a) Securities	152,525	155,659
(b) Deposits with other central banks, BIS & IMF	101,687	86,586
(c) Deposits with foreign commercial banks / funds placed with EAMs	5,514	6,602

* FCA excludes investments in foreign currency denominated bonds issued by IIFC (UK) and foreign currency received under SAARC SWAP arrangement.

The rate of earnings on foreign currency assets, which was 1.47 per cent during July 2011- June 2012, decreased marginally to 1.45 per cent during the year July 2012- June 2013.

I.8 Other Related Aspects

I.8.1 Financial Transaction Plan (FTP) of the IMF

During April – September, 2013, there were two Purchase transactions for US$ 216.1 million. There were four repurchase transactions during the period April - September, 2013 amounting to USD 328.1 million.

I.8.2 Investments under Note Purchase Agreement (NPA) and New Arrangements to Borrow (NAB) with IMF

The IMF's amended and expanded New Arrangements to Borrow (NAB) became effective on March 11, 2011. India has committed to provide resources up to SDR 8,740.8 million to the IMF under this arrangement. Under the NAB, the Government of India is the participant while the RBI holds the NAB notes. The RBI has subscribed to notes equivalent to SDR 1123.2 million under the NAB till end-September, 2013.

In order to enhance the resources available to the IMF for crisis prevention and resolution through a new round of bilateral borrowing, the Note Purchase Agreement 2012 (NPA 2012) was signed between the IMF and the RBI on September 19, 2013 under which the RBI has agreed to purchase SDR denominated Notes for an amount up to the equivalent of USD 10 billion.

I.8.3 Bilateral Swap Arrangement between India and Japan

RBI had entered into a bilateral currency swap arrangement (BSA) with Bank of Japan for an amount of USD 3 billion on June 29, 2008 for a period of 3 years. After expiry of the arrangement in 2011, the agreement was renewed on December 4, 2012 for a period of 3 years with enhancement of the amount of swap from USD 3 billion to USD 15 billion.

Subsequently in September 2013, the Indian and Japanese Governments decided to increase the swap amount from USD 15 billion to USD 50 billion. Accordingly, an amendment agreement has been signed by RBI and BOJ.

I.8.4 Investment in bonds issued by IIFC (UK)

The Reserve Bank has agreed to invest up to an amount, the aggregate of which shall not exceed USD 5 billion, in the bonds, issued by the India Infrastructure Finance Company (UK) Limited. As at end-September, 2013, the amount invested stood at USD 950 million.

Part-II

Objectives of Reserve Management, Legal framework, Risk Management Practices, Transparency and Disclosure.

II.1. Objectives of Reserves Management

The guiding objectives of foreign exchange reserves management in India are similar to those of many central banks in the world. The demands placed on the foreign exchange reserves may vary widely depending upon a variety of factors including the exchange rate regime adopted by the country, the extent of openness of the economy, the size of the external sector in a country's GDP and the nature of markets operating in the country. While liquidity and safety constitute the twin objectives of reserves management in India, return optimisation becomes an embedded strategy within this framework.

II.2. Legal Framework and Policies

The Reserve Bank of India Act, 1934 provides the overarching legal framework for deployment of reserves in different foreign currency assets (FCA) and gold within the broad parameters of currencies, instruments, issuers and counterparties. The essential legal framework for reserves management is provided in sub-sections 17 (6A), 17(12), 17(12A), 17(13) and 33 (6) of the above Act. In brief, the law broadly permits the following investment categories:

(i) deposits with other central banks and the Bank for International Settlements (BIS);

(ii) deposits with overseas branches of commercial banks;

(iii) debt instruments representing sovereign/sovereign-guaranteed liability with residual maturity for the debt papers not exceeding 10 years;

(iv) other instruments / institutions as approved by the Central Board of the Reserve Bank in accordance with the provisions of the Act; and

(v) dealing in certain types of derivatives.

II.3 Risk Management

The broad strategy for reserve management including currency composition and investment policy is decided in consultation with the Government of India. The risk management functions are aimed at ensuring development of sound governance structure in line with the best international practices, improved accountability, a culture of risk awareness across all operations, efficient allocation of resources and development of in-house skills and expertise. The risks attendant on deployment of reserves, viz., credit risk, market risk, liquidity risk and operational risk and the systems employed to manage these risks are detailed in the following paragraphs.

II.3.1 Credit Risk

The Reserve Bank has been sensitive to the credit risk it faces on the investment of foreign exchange reserves in the international markets. The Reserve Bank's investments in bonds/treasury bills represent debt obligations of highly rated sovereigns, central bank and supranational entities. Further, deposits are placed with central banks, the Bank for International Settlements (BIS) and foreign branches of commercial banks.

RBI has framed requisite guidelines stipulating criteria for selection of issuers/counterparties with a view to enhancing the safety and liquidity aspects of the reserves. The Reserve Bank continues to apply stringent criteria for selection of counterparties. Credit exposure vis-à-vis sanctioned limit in respect of approved counterparties is monitored continuously. Developments regarding counterparties are constantly under watch. The basic objective of such an on-going exercise is to assess whether any counterparty's credit quality is under potential threat.

II.3.2 Market Risk

Market risk for a multi-currency portfolio represents the potential change in valuations that result from movements in financial market prices, for example, changes in interest rates, foreign exchange rates, equity prices and commodity prices. The major sources of market risk for central banks are currency risk, interest rate risk and movement in gold prices. Gains/losses on valuation of FCA and gold due to movements in the exchange rates and/or price of gold are booked under a balance sheet head named the Currency and Gold Revaluation Account (CGRA).The balances in CGRA provide a buffer against exchange rate/gold price fluctuations which in recent times have shown sharp volatility. Foreign dated securities are valued at market prices prevailing on the last business day of each month and the appreciation/depreciation arising therefrom is transferred to the Investment Revaluation Account (IRA). The balances in IRA is meant to provide cushion against changes in security price over the holding period.

II.3.2.1 Currency Risk

Currency risk arises due to movements in exchange rates. Decisions are taken regarding the long-term exposure on different currencies depending on the likely movements in exchange rate and other considerations in the medium and long-term (e.g., maintenance of major portion of reserves in the intervention currency, benefit of diversification, etc.). The decision making procedure is supported by reviews of the strategy on a regular basis.

II.3.2.2 Interest Rate Risk

The crucial aspect of the management of interest rate risk is to protect the value of the investments as much as possible from adverse impact of interest rate movements. The interest rate sensitivity of the portfolio is identified in terms of benchmark duration and the permitted deviation from the benchmark.

II.3.2.3 Liquidity Risk

Liquidity risk involves the risk of not being able to sell an instrument or close a position when required without facing significant costs. The reserves need to have a high level of liquidity at all times in order to be able to meet any unforeseen and emergency needs. Any adverse development has to be met with reserves and, hence, the need for a highly liquid portfolio is a necessary constraint in the investment strategy. The choice of instruments determines the liquidity of the portfolio. For example, in some markets, treasury securities could be liquidated in large volumes without much distortion of the price in the market and, thus, can be considered as liquid. Except fixed deposits with the BIS, overseas branches of commercial banks and central banks and securities issued by supranationals, almost all other types of investments are highly liquid instruments which could be converted into cash at short notice. The Reserve Bank closely monitors the portion of the reserves, which could be converted into cash at a very short notice, to meet any unforeseen / emergent needs.

II.3.3 Operational Risk and Control System

In tune with the global trend, considerable attention is paid to strengthen the operational risk control arrangements. Key operational procedures are documented. Internally, there is total separation of the front office and back office functions and the internal control systems ensure several checks at the stages of deal capture, deal processing and settlement. The deal processing and settlement system including generation of payment instructions is also subject to internal control guidelines based on the principle of one point data entry. There is a system of concurrent audit for monitoring compliance in respect of all the internal control guidelines. Further, reconciliation of accounts is done regularly. In addition to internal annual inspection and statutory audit of accounts by external auditors, there is also a system of audit of the dealing room operations by external auditors. There is a comprehensive reporting mechanism covering significant areas of activity / operations relating to reserve management. These are provided to the senior management periodically, *viz.*, on daily, weekly, monthly, quarterly, half-yearly and yearly intervals, depending on the type and sensitivity of information. The Reserve Bank uses SWIFT as the messaging platform to settle its trades and send financial messages to its counterparties, banks with whom nostro accounts are maintained, custodians of securities and other business partners.

II.4 Transparency and Disclosures

The Reserve Bank has been making available in the public domain data relating to foreign exchange reserves, its operations in foreign exchange market, position of the country’s external assets and liabilities and earnings from deployment of foreign currency assets and gold through periodic press releases of its Weekly Statistical Supplements, Monthly Bulletins, Annual Reports, etc. The Reserve Bank's approach with regard to transparency and disclosure closely follows international best practices in this regard. The Reserve Bank is among the 71 central banks across the globe which have adopted the Special Data Dissemination Standards (SDDS) template of the IMF for publication of the detailed data on foreign exchange reserves. Such data are made available on monthly basis on the Reserve Bank's website.

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