Government Budgets, Banking and Auditors: What is New?*

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I am thankful to the organisers for persuading me to address this gathering since the event has provoked me to think deeper on a subject of mutual interest. In fact, having agreed to give a talk, the search for an appropriate subject commenced. It has to be futuristic as demanded by the organisers. It ought to be of general interest and at the same time relevant to a gathering of Chartered Accountants. Of course, it can not but be an area of concern to the Reserve Bank of India. Above all, the subject should be one in which I have some comparative advantage over others. After considerable deliberation and consultations, the subject chosen is "Government Budgets, Banking and Auditors: What is New".

International Concern

Let us start with Government Budgets. Till a few years ago, budgets of Central Government and State Governments were entirely a matter of domestic concern. In recent years, the Government budgets, and in particular, revenue and fiscal deficits have become matters of global concern also. The international credit agencies look at the fisc, which affects borrowings by our corporates.

The foreign investors look at our Budgets in deciding to bring money in or take it out. The investors' sentiments affect stock markets and consequently to some extent, the exchange rate also. Some analysts argue that this international focus on our Budgets is occurring only because we are seeking foreign savings, but that is not true. Countries in European region, which include Germany, France and Italy have been mandated to keep the fiscal deficit below 3 per cent of Gross Domestic Product.

There is since last year a Group of 20 countries of which India is a member and the G-20 is closely involved in addressing issues concerning international financial stability. Transparency in fiscal matters is an important item on their agenda. Our Government budgets, and in particular, deficits are a matter of wider economic and international significance now, more than even before and increasingly so in future.

Of particular significance to a central bank is the way the fiscal deficit is financed. Financing of fiscal deficit through a process of monetisation by a central bank except at the discretion of the central bank and at market related terms is frowned upon. The changing role of the Reserve Bank of India in financing fiscal deficits of Government, and consequent implications for monetary policy as well as balance sheet of the Reserve Bank of India thus assumes significance. Well, the moment a balance sheet is mentioned, the auditor's role cannot be far behind.

The way banks are organised and supervised has also ceased to be a matter merely of our domestic concern – especially after the Asian crisis. Most of international financial transactions have to pass through banks and both their stability and efficiency have become areas of concern especially for G-20. The link between our Central Government Budget and our banks is well known. Most of our large banks are wholly or substantially owned by Government and are provided with budgetary support as equity. Banks also hold about sixty per cent of the whole of Government debt, though much of it is to fulfil statutory reserve requirements. The Reserve Bank, besides being a fiscal agent, is also the supervisor of the commercial banks.

In fact, even to allow overseas branches of our banks to operate in other countries, the supervisors of host countries are closely tracking the standards of our supervision and health of our banking system. Of course, in the process of evolution of international standards, the RBI is closely involved. In any case, in the matter of supervision of banks and non-banking finance companies also, the RBI like many other central banks is placing increasing reliance on the professional inputs of auditors.

In brief, there are observable links between Government Budgets and banks with which auditors are associated, and in regard to both, the recent trends indicate changing international as well as domestic dimensions.

Budgets and Banks in the Past : Fiscal Activism

After independence, and as part of planned development, the economic policy in India moved from fiscal neutrality to what may be described as fiscal activism. Such activism meant large developmental expenditures, mainly to finance long-gestation projects requiring long term finance. The Government expected to raise funds at fine rates. A large borrowing programme with a strong preference for low interest rates added to the demand for support from the RBI or increasing monetisation of fiscal deficits.

A little explanation on financing of fiscal deficit is perhaps useful. Fiscal deficit, defined to be on cash basis for this discussion, can be financed either through bond issuance or money creation. Bond financing entails net placement of Government debt in financial markets. Money financing, on the other hand, involves changes in the monetary base arising out of changes in net central bank credit to Government and thus is a combined effect of central bank's contribution to primary issues, open market operations and clean advances. Such financing of the fiscal deficit may be involuntary or voluntary. For example, it is involuntary when a central bank is obliged to extend credit to Government through what has been described as "automatic monetisation". Similarly, Government securities may be placed in captive market by legal stipulations, say on provident funds, insurance and banking. The financing of fiscal deficit may not be at market determined or market related rates but concessional rates if recourse is made to involuntary financing. It should be obvious that each form of financing of fiscal deficit has its own consequences, and does impact on monetary policy and operations of financial sector.

What happened in India till recently? The Reserve Bank had to manage the effects of large scale monetisation through preemption of commercial banks' resources by hiking Statutory Liquidity Ratios and Cash Reserve Ratios well beyond the limits warranted by genuine prudential requirements, while Government also preempted resources from other captive institutions such as provident funds, and nationalised insurance. At one stage, well over one-half of the total resources raised by the banking system was preempted and as much as 15-16 per cent was impounded under the Cash Reserve Ratio at extremely low rates of remuneration. The Reserve Bank also had to ensure successful borrowing of mandated amounts at mandated uniform interest rates, by States and public enterprises as part of the national planning effort. Under these circumstances, the RBI had virtually no choice except to allocate credit and fix interest rates for both deposits and credit, leading to a complex administered interest rate regime with complicated cross-subsidisation. The consequences of such fiscal activities were not as productive as was originally expected.

Consequences of Fiscal Activism

Fiscal activism was expected to result in a virtuous cycle of development. However, while liabilities in terms of public debt were expanding, assets created out of such borrowings failed to yield commensurate results. Such a gap between the cost of borrowing and the return continued to widen over time. This imbalance between returns and cost of borrowing resulted in gradual deterioration into a 'soft budget-constraint', particularly on account of easy monetisation and artificially low cost of debt. Efforts to improve financial returns of investments made by Government did not yield adequate results.

In view of soft-budget constraints, the fiscal deficits persisted, and over a period, deficits on the revenue account surfaced. The automatic monetisation of deficits by the RBI mounted through recourse to issue of *ad hoc* Treasury Bills at low interest rates at much less than half the market related rates. The temporary mismatches between Government receipts and expenditures during the year also became larger over time, since there was no incentive towards efficient cash management.

There were inadequate incentives to State governments to ensure fiscal prudence, since the quantum and terms of borrowing were not related to fiscal promise or performance. Many public enterprises also tended to become beneficiaries of preemption of banks' resources and directed lending.

The effect on the banking system was evident. Preemption of a large proportion of bank deposits and an administered interest rate regime resulted in high cost and low quality of financial intermediation. The spreads between deposit and lending rates of commercial banks increased, while the administered lending rates did not factor in credit risk. About 80 per cent of the total activity in commercial banking was accounted for by public sector banks, almost wholly owned by Government and the Reserve Bank. In the absence of development of financial markets, banks also emerged as the mainstay of financial intermediation. There was simply no competition to banks and among banks either.

The Reserve Bank as regulator of commercial banks used to some extent, regulations to subserve fiscal objectives. The market for Government securities and in fact for debt segment could not be developed since a large part of Government's borrowing was financed through involuntary mechanisms. Monetisation of deficits required the Reserve Bank to seek several rearguard actions affecting the financial system. In fact this fiscal-monetary interface was partly responsible for the macroeconomic imbalances of the 'eighties. The imbalances were evident from persisting revenue deficits, large current account deficits and weaknesses in the financial sector. The economy was thus vulnerable to a crisis, which in fact was triggered by the Gulf war of 1990-91.

Joint Family Approach

In sum, there was a *de facto* joint family balance sheet of Government, the RBI and commercial banks, with transactions between the three segments being governed by plan priorities rather than sound principles of financing inter-institutional transactions. There was a widespread feeling that this joint family approach, which sought to enhance efficiency through co-ordinated approach, actually led to loss of transparency, of accountability and of incentive to measure or seek efficiency. The reform measures since 1992 strive to impart greater integrity and transparency, to the respective balance sheet and audit becomes critical in ensuring the true account and proper financial relationship among the three entities.

Recent Changes

It is necessary to briefly recall the reform measures taken to move away from the joint family approach to the balance sheets of Government, the RBI and commercial banks.

First, the system of issuance of *ad hoc* Treasury Bills and automatic monetisation was replaced with a system of Ways and Means Advances (WMA). The quantum available to Government as WMA to meet temporary mismatches between receipts and expenditure is now annually agreed upon between the Reserve Bank and Government. The interest rate is also agreed upon.

Second, an increasing proportion of the fiscal deficit of the Government is being financed by borrowings at market related rates of interest.

Third, most public enterprises have been moved out of what is described as "approved market borrowing programme" and thus the enterprises are encouraged to borrow from market through voluntary transcriptions. Furthermore, States are also encouraged to access markets on a stand-alone basis for a part of their borrowing programme.

Fourth, there has been a reduction in preemptions of commercial banks' resources from well over one-half to about a third of their resources. Thus, the mandatory component of market financing of Government borrowing has decreased. Valuation of such securities, now is attuned to international best practices to capture market risks appropriately.

Fifth, the administered interest rate regime has been dismantled and there are very few prescriptions of interest rates.

Sixth, a policy decision has been taken by the Reserve Bank to eliminate its long term lending operations to commercial sector and to moderate other forms of monetisation by reducing direct funding of commercial sector.

Seventh, an appropriate legal, institutional and technological framework has been put in place for regulation and development of money, Government securities and forex markets. Both, the primary and secondary segments of Government securities market have exhibited more participants, larger turnover and greater depth.

Eighth, there is diversified ownership of banks, and less than a third of total commercial banking activity is now transacted by wholly owned public sector banks.

Ninth, the Government has decided to reduce its ownership stake further in the banking sector.

To sum up, the Government budget has to recognise the increasing need to convince the financial markets to raise resources to finance its deficit. The Reserve Bank has to ensure adequate supervision over the banking system since banks no longer will enjoy the twin comfort of large Government ownership and huge portfolio of gilt edged securities in their asset-portfolio, at predetermined yields and value .

Further, the non-banking finance companies are emerging as an important segment in financial intermediation and are subject to regulation by the RBI.

Finally, the Reserve Bank has to manage its balance sheet since its assets, liabilities, income, expenses, etc. are generated more out of its own volition and conditions in market, both domestic and forex, than out of Five Year Plan induced actions, or automatic monetisation at the instance of Government.

While one cannot ignore the importance of a consolidated balance sheet approach to finances of public sector, both global concerns and domestic experience make it essential to maintain the sanctity, integrity and well defined legal, commercial and prudential inter relationships among the components' balance sheets. In addition, the risk-containment and internal control systems do become an integral part of financial management in a system related to financial markets and progressive linkages with global developments.

Balance Sheet and Audit arrangements in the RBI

The RBI's balance sheet reflects to a significant degree the effects of economic reforms and in particular, the financial sector reform. In a speech in November 1997, I had detailed the relationship between our central bank's balance sheet and monetary policy, the main features of the RBI's balance sheet, the current issues that have an impact on the RBI's balance sheet in the wake of financial sector reforms and improvements that have been brought about in the management of the RBI's balance sheet in the context of financial sector reforms evidencing a move towards autonomy to the RBI in operating its monetary policy.

In the address today, I will focus on internal audit arrangements in the RBI and efforts being made to enhance the standards of accounting and consideration of code of good practices. As regards audit arrangements, we have had a separate Inspection Department ever since the Bank was set up. The RBI conducts both financial and systems audit. The Bank has introduced concurrent audit. We are in the process of laying down norms for Information Technology audit. Greater emphasis is now being laid on risk based approach to internal audit.

The Bank has also introduced, very recently, control self-assessment audit as an adjunct to internal audit, covering departments sensitive to risk.

The Inspection Department reports to and operates under the direction of the Inspection and Audit Sub-Committee of the Central Board of the Bank.

The statutory audit of the Bank's final accounts is entrusted to firms of Chartered Accountants approved by Government of India. Accounting policies are also disclosed in the annual financial statement.

The Reserve Bank of India has in the last few years considerably enhanced the standards of reporting and disclosure in the annual report, which contains the audited financial statements. The formats, accounting system, practices, procedures and policies were originally designed in line with the practices followed by Bank of England and the basic format has remained. While in principle, most of the underlying international accounting principles applied to other financial institutions can be applied to central banks, the implementation of the principles has to factor in the unique objectives and special responsibilities of central banks. With increasing deregulation and development of financial markets, the operations of the RBI for implementing policy decisions and maintaining stability in markets have also become more sophisticated with use of new instruments to meet the

dynamics of the situation. Therefore, it becomes necessary to review accounting and disclosure policies not only on an ongoing basis but also more formally and specifically by addressing and dealing with the emerging issues in a comprehensive manner. Such a review is being taken up to study the international practices, our own practices and experience, and consider improvements, where needed.

In this connection, it is useful to recognise the code of good practices on transparency in monetary and financial policies. The IMF Code identifies desirable transparency practices for central banks. Part IV of the Code refers to accountability and assurances of integrity by the central bank and one significant good practice is that the central bank should publicly disclose audited financial statements of its operations on a preannounced schedule. Further, the financial statements should be audited by an independent auditor. The Reserve Bank is substantially in compliance with the code though we strive to adopt the code to suit our national requirements while constantly reviewing and improving our practices.

Auditors' Role in NBFCs

The Bank has been placing greater reliance on the role of statutory auditors and has cast a special responsibility on them to report, by exception, to the RBI on the contravention/violations of the RBI regulations coming to their notice during the course of their statutory audit of NBFC. There is a statutory provision for taking assistance of the auditors in carrying out special audits and other specific scrutiny of the accounts of NBFCs as and when considered necessary. In fact, the Reserve Bank has recently conducted 1,400 special audits with the assistance of the chartered accountants for the purpose of considering registration of NBFCs. The auditors are required to submit a special report to the Board of Directions of the company on the violations, if any, of RBI Act/Directions. Institute of Chartered Accountants of India (ICAI) is represented on all the Working Groups and Committee appointed by the Bank for examination of various issues pertaining to NBFC sector and in fact the views of ICAI are taken into consideration while framing regulations and devising supervisory framework for the NBFCs.

Auditors as Supervisory Resource in Banks

In almost all countries, the role of statutory auditors has been seen as that of a watchdog. Traditionally, the statutory auditors are expected to ensure that the final accounts prepared by the banks are in the format laid down by the concerned supervisory authority and reflect 'true and fair' position of the institution.

Over the time, a few developed countries like U.K. have begun utilising the services of the auditors as the supervisory resource and the central banks abroad have started employing external auditors for investigating specific areas of supervisory concern as their agents. The RBI had started utilising the services of external auditors immediately after the irregularities in securities transactions in some of the banks, financial institutions came to light during 1991-92.

The Working Group (January 1995) to Review the System of On-site Supervision Over Banks have recommended utilising the services of the external auditors as supplementary vehicles to the supervisors, keeping in view the limited time and resources available at the latter's disposal.

Apart from their statutory duty to certify the correctness of the final accounts, the statutory auditors of the banks are being requested to examine several items and report to the concerned bank's Top Management/RBI.

From the year 2000-01, the auditors are being requested to verify and comment upon the status of the compliance by the bank in regard to the implementation of various aspects relating to frauds and malpractices in banks and the internal control and inspection/audit system in banks. Further, they have also been advised to look into the bank's functioning in order to reduce transaction cost, inculcate greater use of information technology and better customer service.

The regulatory-resource role played by the auditors is likely to increase manifold, in the days to come as the RBI is moving towards risk based supervision and consolidated supervision. Keeping this in view, the ICAI as well as auditor fraternity will shoulder more and more responsibilities to meet these challenges. But the relationship will have to be clearly defined keeping in view international practices and our requirements.

Relationship between Supervisor and Auditors

The issue of relationship of supervisors with internal and external auditors has been flagged by the Basel Committee on Banking Supervision. They had, in July 2000, circulated a Consultative Paper (available at **www.bis.org**). This is being considered by the Reserve Bank. The paper addresses the delicate balance between the supervisor, external auditor and internal auditor in order to optimise supervision. The central theme of this paper is that internal controls within banking organisations must be supplemented by an effective internal audit function that independently evaluates the control systems within the organisation. External auditors, on the other hand, can provide an important feedback on the effectiveness of this process. Further, supervisors need to satisfy themselves that the weaknesses identified by the auditors are corrected. This calls for effective coordination between the supervisors, external auditor and internal auditor. The Consultative Paper raises four main issues for discussion. First, as regards definition of internal audit, whether advising or consulting function should be the basic or ancillary function of internal audit?

Second, what should be the stance on the whistleblowing function of internal auditors in the context of reporting issues for the internal audit function?

Third, what are the pros and cons of outsourcing of internal audit?

Fourth, should the internal auditor be independent of the external auditing or can internal audit be performed by the external auditor?

The Basel Committee have asked for comments on this paper by November 30, 2000. We would request the gathering to share your thoughts and comments with the RBI as this will help us refine our views on the subject, convey to BIS and apply the considerations in our relationship as supervisor, with the auditors.

Conclusion

It should be very evident that in an increasingly interdependent world of financial flows prone to contagion, Government budgets, banks and central banks have ceased to be matters of domestic concern alone. This concern is equally valid for developed world and emerging economies like India.

In the past, we pursued a policy of fiscal activism which resulted in several unexpected consequences and one of them was what may be called a joint family approach to the balance sheets of Governments, RBI and commercial banks. In the joint family approach, there were overlaps, duplications and above all ill-defined interconnected transactions with inadequate transparency and lack of accountability.

Both global concerns and domestic experience make it essential to maintain the financial or accounting integrity and prudential interrelationships of respective balance sheets without ignoring the importance of consolidated approach to balance sheets in public sector. The reform measures in fiscal and financial sectors, among other things, aim to achieve this.

The ongoing audit arrangements in the RBI also reflect this changed approach. The extensive use of external auditors in RBI's supervision of both banks and non-banks also reflects this change in approach. In all these areas, further progress and greater refinement is being attempted by the RBI, and I will specifically mention two factors of significance.

First, the Reserve Bank is aware that its balance sheet now is very sensitive to the use of indirect and market based policy instruments like the Bank Rate, open market operations and the Liquidity Adjustment Facility operations and to forex developments.

Second, the balance sheets of banks have also become sensitive to developments in financial markets and they need to develop internal control and risk assessment systems. Supervisory concerns can be facilitated by use of auditors, both external and internal, but such use has to be carefully crafted. Your response to the consultative paper of BIS on the subject as soon as possible would be of immense help to us.

In conclusion, I would invite your attention to Governor Jalan's Mid-term Monetary Policy Statement of October 2000 which contains two important relevant messages. First, it is wise for all concerned to have appropriate asset-liability management and risk management systems in place to meet uncertainties inherent in the financial markets, especially in emerging markets including possible changes in monetary measures. Second, the Reserve Bank's current monetary policy stance as mentioned in the statement would be to maintain to the extent possible a stable interest rate environment and to provide appropriate liquidity through its Liquidity Adjustment Facility as necessary.

***	Address by Dr. Y.V. Reddy, Deputy Governor, Reserve Bank of India, at Festival of Thoughts, Annual Conference of the Institute of Chartered Accountants of India, Hyderabad Branch, on November 12, 2000**