Credit Information Review

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October 2001

Mid-term Review of Monetary and Credit Policy : 20001 - 2002

Dr. Bimal Jalan, Governor, in a meeting with Chief Executives of major commercial banks presented the Mid-term Review of Monetary and Credit Policy for 2001-02. After reviewing the domestic and external developments, Governor stated that despite several uncertainties, the fundamentals of the economy, as reflected in moderate inflation, stable and low interest rates, high foreign exchange reserves, large foodgrains stock and competitive advantage of information technology related industries, are strong. He further stated that according to the present indicators, the liquidity in the system will remain adequate to meet all legitimate requirements for credit. He said that unless circumstances change unexpectedly, the Reserve Bank will endeavour to maintain the current interest rate environment.

Domestic Developments

On the domestic front, quoting India Meteorological Department and the Ministry of Agriculture, the Governor stated that the agricultural growth in 2001-02 is expected to be significantly higher than the previous year. On the other hand, the position regarding revival of industrial sector and export growth in the first half of the current year was not favourable. Considering the likely rate of growth in agriculture during the current year, the unfavourable behaviour of industrial and export sectors, taking in view of the global uncertainty, the Governor mentioned that a firm projection of revised growth rate for the year as a whole is difficult.

The Governor stated that the inflation outlook for the year appeared comfortable as agricultural growth prospects remain positive, and foodgrain stocks were very high.

The Governor indicated that the growth rates in money supply and aggregate deposits of scheduled commercial banks in the current financial year were slightly higher than the growth rates observed a year ago. He added that the relative attractiveness of bank deposits had improved and if this deposit growth continued it may pose a challenge to the banking system in deploying resources, particularly in the context of sluggishness in credit and investment demand. The Governor added that late in September and early October, there had been some pick up in non-food bank credit and other resource flows to the commercial sector from the banking system. Commenting on the sources contributing to the reserve money expansion he stated that while net RBI credit to the Central Government showed a modest increase, the RBI's net foreign exchange assets increased significantly. He expected that the reserve money expansion may remain moderate during 2001-02.

He stated that the overall interest rate structure had come down substantially in the last two years and continued to show a softening trend. The prime lending rates (PLRs) of scheduled commercial banks had also softened. As banks were permitted to lend to exporters and their prime customers at sub-PLR rates, the cost of bank borrowings to such corporates had come down even further. Long-term domestic deposit rates of public sector banks declined from 10.50 per cent in March 2001 to 9.25 per cent in October 2001.

HIGHLIGHTS

- RBI cuts Bank Rate by 0.50 percentage point, from 7.0 per cent to 6.50 per cent to touch its lowest since May 1973.
- RBI reduces CRR by 2.0 percentage points from 7.50 per cent to 5.50 per cent, releasing an additional liquidity of Rs.6,000 crore to banks; but removes exemptions available on CRR and links Interest rate paid on eligible CRR balances with Bank Rate increasing it for the present to 6.5 per cent.
- Monetary Policy stance to continue as in the first half of the year.
- In view of global uncertainties, a projection in the range of 5.0 per cent to 6.0 per cent growth rate for 2001-02 considered reasonable for monetary management.
- RBI provides operational flexibility to banks in “Loan System” for credit delivery.
- RBI initiates steps to closely monitor non-SLR investments by banks and FIs.
- RBI Current Account Facility being rationalised.

As announced in the annual policy statement of April 2001, during the first half of the fiscal year, the Reserve Bank continued to provide appropriate liquidity through its repo operations. The interest rate environment also remained fairly soft across maturities as well as various instruments and the yield on 10 year government securities declined by about 100 basis points, between April and mid-October 2001.

External Developments

In the past, several measures had been introduced to ensure timely delivery of credit to exporters at reasonable cost and removal of procedural hassles. The Governor stated that the survey on exporters’ satisfaction had been initiated by the National Council of Applied Economic Research (NCAER), New Delhi.

The Governor pointed out that sometimes a noticeable portion of the corporate foreign currency commitments tend to remain unhedged on the basis of their perceptions of the market and these could impact the overall financial status of the corporates under circumstances of severe uncertainties. Hence, he desired that banks which had large exposures to such corporates should put in place a system for monitoring such unhedged external exposures.

The Reserve Bank would continue with its efforts to simplify procedures, reduce documentation requirements and further liberalise opportunities for productive investment in India by Non Resident Indians (NRIs) and others and by Indian corporates / entities abroad. The Governor welcomed further suggestions from experts, corporates and market participants in these areas through e-mail at helpnri@rbi.org.in

Stance of Monetary Policy for the Second Half of 2001-2002

The Governor proposed to continue with the overall stance of monetary policy announced in the April Statement for the remaining half of the current year and to ensure that all legitimate requirements for credit are met consistent with price stability. Unless circumstances change unexpectedly, RBI will also endeavour to maintain the current interest rate environment.

The Governor, however, cautioned that while all efforts will be made to maintain the current stance of monetary policy, two caveats are necessary in order to ensure that banks and market participants do not take too complacent a view on the current monetary and interest rate environment. First, in their portfolio management, banks, primary dealers (PDs) and other market participants must explicitly take into account that the interest rate environment can change quite dramatically within a very short period of time. The substantial decline in interest rates in the last couple of years has resulted in large gains, realised and unrealised, to holders of medium and long-term securities. It is of utmost importance that these gains are not frittered away or used for illiquid market operations. Second, it needs to be recognised that in view of certain structural characteristics of our financial system, the scope for further softening in lending rates by banks and other financial intermediaries is limited. Among the factors, the Governor mentioned :

- Holders of term deposits in banks generally belong to fixed income groups and expect a reasonable nominal interest rate, in excess of the long-term rate of inflation. This constrains the ability of banks to effect further reduction in their lending rates without affecting their deposit mobilisation and the growth of financial savings over the medium-term.

- The preference for fixed interest rates on term deposits effectively reduced the flexibility that banks have in lowering their lending rates in the short run.

- For public sector banks, the average cost of funds is over 7.0 per cent, combined with non-interest operating expenses of 2.5 to 3.0 per cent of total assets, puts pressure on the required spread over cost of funds. Relatively high overhang of Non-Performing Assets (NPAs) pushes up further the lending rates. It, however, is necessary to continue with the on-going efforts to reduce the impact of these structural constraints on the flexibility of interest rate structure, he added.

Recently, the Government has taken important steps to reduce the prevailing interest rates on contractual savings like Provident Funds and National Saving Schemes. A more sustainable and flexible interest rate regime for contractual savings has also been recommended by the Expert Committee set up by the Government (Chairman: Dr. Y.V. Reddy). (For report of this committee, please visit www.finmin.nie.in). It will also be highly desirable for banks to move over to a variable interest rate structure on longer-term deposits as early as possible. Since interest rates could vary in both directions, depending on the phase of the business cycle and inflationary outlook, a variable interest rate regime on long-term deposits does not necessarily imply lowering of the average interest rate earned by depositors over a period of time (compared with a fixed rate regime, which favours old deposits over new deposits when interest rates are coming down, and *vice versa* when rates are moving in the opposite direction). In addition, banks have to put in their best efforts to reduce their operating costs over time by improving productivity and increasing their volume of lending.

Financial Sector Reforms and Monetary Policy Measures
Recent Financial Market Developments

The Governor indicated that recent events have brought to the fore the need for Boards of banks and financial institutions to exercise proper vigilance and supervision over the functioning of commercial banking and other financial institutions. The Reserve Bank proposes to set up a consultative group of directors of a select group of commercial banks and financial institutions to suggest, for consideration by Government/RBI, measures that should be taken to strengthen the internal supervisory role of Boards.

Monetary Measures

(a) Bank Rate

On the basis of a review of macroeconomic and monetary developments, the Bank Rate is being reduced by 0.50 percentage point from 7.0 per cent to 6.50 per cent with effect from the close of business October 22, 2001. At this level, it is the lowest Bank Rate since May 1973.

(b) Cash Reserve Ratio

- From the present level of 7.5 per cent CRR has been reduced by 200 basis points to 5.50 per cent of net demand and time liabilities. Effective from the fortnight beginning November 3, 2001, CRR will be reduced to 5.75 per cent; and effective fortnight beginning December 29, 2001, the CRR will be reduced further to 5.50 per cent of NDTL.

- At the same time, all the exemptions on the liabilities will be withdrawn except inter-bank liabilities, for the computation of NDTL (for requirement of maintenance of CRR) with effect from fortnight beginning November 3, 2001.

- These changes will facilitate the development of a short term yield curve, develop money market, reduce the regulatory arbitrage between banks and non-banks, enhance the availability of lendable resources with the banks and improve the efficiency of indirect instruments in the conduct of monetary policy.

- The combined impact of these two measures will result in augmenting lendable resources of the banking system by about Rs.8,000 crore (about Rs.6,000 crore effective from November 3, 2001).

- RBI will continue to use the CRR instrument in both directions for liquidity management in addition to other instruments (such as, the LAF.)

(c) Interest on cash balances

- With effect from the fortnight beginning November 3, 2001, the interest paid on eligible cash balances will be at the Bank Rate (i.e., 6.5 per cent).

Liquidity Adjustment Facility - Progress

- In addition to overnight repos, the Reserve Bank will also have the discretion to introduce longer-term repos upto 14-day period as and when required.

Development of Government Securities Market

- The notified amount of 91-day Treasury Bills (TBs) has been increased to Rs.250 crore. It has also been ensured that both the 91-day and 364-day TBs mature on the same day in order to facilitate the availability of adequate fungible stocks of TBs of varying maturities in the secondary market.

- A Negotiated Dealing System (NDS) is being introduced with a view to facilitating electronic bidding in auctions and secondary market transactions in government securities and dissemination of information on trades on a real-time basis.
- The Clearing Corporation of India Limited (CCIL) was registered on April 30, 2001 under the Companies Act, 1956 with the State Bank of India as the chief promoter. The operationalisation of CCIL is expected to commence with a test run in November 2001.
- With the approval of the Government, the new uniform price auction format will be introduced on an experimental basis.
- A scheme of retail participation for government securities on non-competitive basis has been finalised.
- The Reserve Bank has prepared a consultative paper drawing a road map for developing Separate Trading of Registered Interest and Principal of Securities (STRIPS). The consultative paper has been placed on the Bank's website for views / comments.

Review of the Satellite Dealer System

- The Reserve Bank has decided to undertake a review of SD system to examine the scope for establishing a better linkage between SDs and PDs and thereby improving the SD system as an effective distribution channel at a retail level for government securities.

Prudential Measures

(a) Credit Information Bureau

- In order to operationalise the process of collection and dissemination of the data on credit information by the CIB, RBI will constitute a Group drawing representation from CIB, Indian Banks' Association (IBA), select banks and FIs. The Group will examine the possibility of the CIB performing the role of collecting and disseminating information on the list of suit-filed accounts and the list of defaulters, including willful defaulters, which is presently handled by the Reserve Bank.

(b) Non-SLR Investments by Banks and FIs

- In order to contain the risks arising out of non-SLR investment portfolio of banks and Financial institutions (FIs), in particular through the private placement route, it is proposed to issue further prudential guidelines to be observed by banks which will be finalised after further consultation with banks and FIs.
- Banks and FIs have already been advised that effective October 31, 2001, they will be permitted to make fresh investments and hold bonds and debentures, privately placed or otherwise, only in dematerialised form.
- To enable the transparency of the trades including nomenclature of the bonds, amount traded and the price at which traded, banks and FIs could evolve a reporting mechanism and the NSDL/CDSL can in turn disseminate such information to the market. These arrangements would apply uniformly to all bonds issued by corporates, banks, FIs and State and Central Government sponsored institutions directly or as Special Purpose Vehicles (SPVs).
- Overall, any proposals of direct or indirect financing of the Government budgets, directly or through SPVs should be eschewed and proposals should be for specific monitorable projects, particularly in capital-intensive and high-cost sectors, including infrastructure.

Components of financing and returns need to be well defined and assessed.

(c) Transparency and Accounting Standards

As a further step in ensuring transparency and credibility of their financial positions, it has been decided that banks should furnish the following additional disclosures in the 'Notes on Accounts' in their balance sheets, from the year ending March 2002.

- Movement of provisions held towards NPAs and movement of provisions held towards depreciation on investments.
- It has been decided to set up a Working Group comprising representatives of Institute of Chartered Accountants of India (ICAI), banks and RBI to identify the compliance as also gaps in compliance with the accounting standards and recommend steps to eliminate/reduce the gaps.

Settlement of NPAs

Given that the purpose of guidelines on one time settlement of non-performing assets was to provide an opportunity for "one-time settlement" within the specified time period, and sufficient time has already been provided, it is not proposed to extend this scheme. However, the broad framework provided for settlement in the 1995 guidelines will continue to be in place, and banks are free to design and implement their own policies for recovery and write-off incorporating compromise and negotiated settlements with the approval of their boards, particularly for old and unresolved cases falling under the non-performing assets category.

Urban Co-operative Banks
SLR Investments of UCBs: Revised Timeframe

In response to the representations received from federation of urban co-operative banks it is proposed to modify the timeframe for achieving the prescribed levels of SLR holding. The revised timeframe is :

Category of UCBs	Minimum SLR holding in government and other approved securities as per cent of NDTL			
	Present	Earlier proposed for March 31, 2002	Now proposed for March 31, 2002	Now proposed for September 30, 2002
Non-Scheduled UCBs				
1. UCBs with NDTL of Rs.25 crore and above	10.0	15.0	12.5	15.0
2. UCBs with NDTL of less than Rs.25 crore	Nil	10.0	7.5	10.0
Scheduled UCBs	15.0	20.0	17.5	20.0

It is possible that a number of UCBs in any of the categories have already achieved as on October 20, 2001 or were nearer to the target set for end-March or end-September 2002. Such UCBs are advised not to bring down their present level of SLR holding in government and other approved securities as a proportion of their NDTL.

Loans against Shares

In response to representations received from Urban Cooperative Banks (UCBs) and their federations, it is now proposed to allow UCBs to grant loans to individuals against security of shares, subject to the following parameters :

(i) Loans against shares/debentures may be granted to individuals to meet contingencies and personal needs or for subscribing to rights or new issues of shares/debentures or for purchase in the secondary market. Loans against primary/collateral security of shares/debentures will be limited upto Rs.5 lakh, if the security is in physical form, and upto Rs.10 lakh, if the security is in demat form. Aggregate of all such loans should be within the overall ceiling of 20.0 per cent of the owned funds of the bank, and margin of 40.0 per cent should be maintained in all cases of such loans**.**

(ii) It is essential that before accepting shares as security, UCBs should put in place a risk management system. UCBs should also have Audit Committee of their Boards of Directors and all the approved loan proposals should be placed before the Audit Committee at least once in two months. Details of loans sanctioned should be reported to the Board in the subsequent Board meeting. The Management and Audit Committees should ensure that all loans against shares are made only to those individuals who are not in any way connected with any stock-broking activity or stock-broking entity.

(iii) UCBs which have outstanding loans to individuals can renew them upto permissible amounts beyond the contracted date on merits, subject to the above conditions.

(iv) As before, UCBs should ensure that there is no direct investment by them in either primary or secondary market under any circumstances.

Credit Delivery Mechanism

"Loan System" for Delivery of Bank Credit

In the current environment of short-term investment opportunities available to both corporates and banks, banks will have the freedom to change the composition of working capital by increasing the cash credit component beyond 20 per cent, for working capital limits of Rs.10 crore and above, if they so desire.

Legal Reforms

Major legal reforms have been initiated in the banking sector covering areas such as security laws, Negotiable Instruments Act, fraud on banks, regulatory framework of banking, etc., Further progress in regard to various initiatives for legal reforms is given below:

- The Working Group constituted by the Government for suggesting changes in the provisions of Negotiable Instruments Act, 1881, has, *inter alia*, recommended the introduction of truncation of cheques and electronic cheques and suggested appropriate legal amendments. The Working Group on Asset Securitisation has drafted a Bill on Asset Securitisation which is under consideration of the Government. The draft legislation prepared by another Working Group constituted by the Government to examine the vesting of powers with banks and FIs for taking possession and sale of securities without intervention of the courts has been put on the RBI Website in August 2001 seeking comments from the public.

- Proposals regarding amendments to the Reserve Bank of India Act, 1934, Banking Regulation Act, 1949, Government Securities Bill in replacement of the Public Debt Act, 1944, are currently under consideration of the Government.
- For drafting a legislation on Payment Systems in India, an international consultant and an eminent Indian draftsman have been appointed by RBI in consultation with the National Payments Council.
- An Expert Committee on Bank Frauds (Chairman: Dr.N.L. Mitra) submitted its Report to RBI in September 2001 which has been put on the RBI website. The Committee examined and suggested both the preventive and curative aspects of bank frauds. The important recommendations of the Committee include: a need for including financial fraud as a criminal offence and amendments to the Indian Penal Code by including a new chapter on financial fraud; amendments to the Indian Evidence Act to shift the burden of proof on the accused person and special provision in the Code of Criminal Procedure for transferring the properties involved in the financial fraud and confiscating unlawful gains; and preventive measures including the development of Best Code Procedures by banks and FIs. The Report is being examined by the Reserve Bank.

Edited and published by **Alpana Killawala** for the **Reserve Bank of India,** Press Relations Division, Central Office, Shahid Bhagat Singh Marg, Mumbai-400 001 and printed by her at **Alco Corporation**, A-2, 331, Shah & Nahar Ind. Estate, Lower Parel (West), Mumbai - 400 013. **Annual Subscription : Rs. 12, Readers desirous of subscribing may remit the subscription, by way of cheque/DD payable at Mumbai to the Director, DRRP (Sales Section), DRRP, Reserve Bank of India, Amar Building, Sir P. M. Road, P. B. No. 1036, Mumbai - 400 001. Also Available on Internet at www.cir.rbi.org.in**