Chapter II

Policy Developments in Commercial Banking

Introduction

2.1 The global financial landscape has changed significantly during the last one and half years. Several large global financial institutions have either failed or have had to be restructured to avoid failure. The recent financial market turbulence has brought into sharp focus the issue of financial stability. To quell the turmoil in markets, extra-ordinary actions have been initiated by several central banks and governments in advanced countries to mitigate the systemic risks posed by the ongoing financial crisis in an environment of heightened risk aversion. Co-ordinated policy action by central banks and lending by central banks to non-banks are some instances of such policy actions. To restore confidence and facilitate functioning of markets, in a number of countries, governments also drew up comprehensive plans offering guarantees to depositors and assurances to creditors. Further, steps have been taken to deal with distressed assets and provide liquidity, including through bank recapitalisation. These developments highlight the challenge the regulators/governments face to maintain financial stability. The recent liquidity and solvency problems faced by some banks in the US and Europe also suggest that the assumption concerning the ability of some financial intermediaries to generate sufficient liquidity in times of need strikes at the very root of the financial intermediation function performed by them.

2.2 While financial innovations in banking and financial systems help in reducing the cost of financial intermediation significantly, they can pose some serious risk too. This would need strengthening of the regulatory and supervisory frameworks. A major challenge faced by the regulators is, thus, how to adapt capital and liquidity standards to manage the risk posed by financial innovations. The challenge is also to improve the methods for identification, assessment and mitigation of systemic risks, given the increased degree of global financial integration and significant growth in cross-border operations of large financial institutions. It is recognised that regulatory and supervisory failure in advanced economies was one of the causes of the present crisis and countries are moving towards plugging the loopholes and information gaps in financial regulation and supervision and improving the global financial architecture. As part of the ongoing rethinking on international financial architecture, there is a growing recognition that emerging market economies should have a greater role and say in global matters and multilateral institutions and fora (such as the Financial Stability Forum).

2.3 Following the wide-ranging reforms undertaken since the early 1990s, the Indian banking system has become quite robust. The Indian banking industry has largely remained protected from the global financial turbulence. The Reserve Bank has, however, been vigilant about the lessons that have emerged from the global credit crisis. The Reserve Bank has been constantly reviewing and refining its regulatory and supervisory policies to ensure strong capital base, effective risk management and best corporate governance standards in the banking sector. In recent years, the focus has also been on improving credit delivery and customer service and promoting financial inclusion.

2.4 During 2007-08, prudential norms governing issue of letters of comfort by banks were prescribed, the role of credit rating agencies was scrutinised and a more dynamic liquidity management system was operationalised. An important development during the year was the adoption of the Basel II framework by foreign banks operating in India and Indian banks having operational presence outside India. A few changes were also made in the revised capital adequacy framework based on the feedback received, while detailed guidelines relating to Pillar 2 were also issued. It has been the endeavour of the Reserve Bank to put in place safe and efficient payment and settlement systems in the country. In this context, the enactment of the Payments and Settlement Systems Act, 2007 designated the Reserve Bank as the regulator of the payment and settlement systems in the country, thus paving the way for efficient regulation, control, functioning and audit of the systems. Along with measures to conform to the best prudential practices followed internationally, the Reserve Bank also undertook a number of initiatives to facilitate access to credit to the underserved sections/sectors of the economy. Banks have been advised to adopt customer-oriented approach with a view to easing the access to banking facilities for people at large.

2.5 This chapter provides a detailed account of various policy measures undertaken by the Reserve Bank in the Indian commercial banking sector during 2007-08 (July-June) and 2008-09 (up to October 2008). The stance of monetary policy as it evolved during 2007-08 and 2008-09 (up to October 2008), together with monetary policy measures, is presented in Section 2, followed by a review of the measures initiated in the area of credit delivery in Section 3. Section 4 details the various measures initiated to promote financial inclusion. Initiatives taken in the areas of prudential regulation and supervision are detailed in Section 5 and Section 6, respectively. Policy initiatives pertaining to Regional Rural Banks (RRBs) are set out in Section 7. Policy developments in the area of financial markets, *i.e.*, the money market, the Government securities market and the foreign exchange market are covered in Section 8. This is followed by an account of measures initiated in the area of customer service by banks in Section 9. Policy measures relating to the payment and settlement systems and technological developments are outlined in Section 10 and Section 11, respectively. Section 12 details the measures undertaken to strengthen the legal infrastructure.

2. Monetary Policy

2.6 Several challenges such as unprecedented capital flows, turbulent international financial markets and increase in headline inflation and inflationary expectations had a bearing on the conduct of monetary policy during 2007-08. Monetary conditions were impacted by significant shifts and developments in both global and domestic arenas by the year-end as compared with the initial assessment. While aggregate supply capacity expanded, economic activity continued to be mainly demand-driven. Inflation picked up in the fourth quarter of 2007-08 mainly due to supply-side pressures that essentially emanated from global surge in prices of commodities such as foodgrains, crude oil and steel. Several new challenges have emerged in 2008-09 with the global financial system undergoing a crisis of unprecedented dimension. Liquidity in the domestic money and foreign exchange markets was squeezed as knock-on effects of international crisis. While inflation reached multi-year highs in the early part of the year and continues to be above the acceptable level, there has been a moderation in the growth momentum of the economy. Consequently, the task of conduct of monetary policy has become more complex than before.

2.7 The reconstituted Technical Advisory Committee on Monetary Policy (TACMP), with tenure up to January 31, 2009, has strengthened the consultative mechanism for monetary policy in India as important issues are discussed in its meetings held from time to time[1]. TACMP's role is, however, advisory in nature and the responsibility and accountability of decision-making rests with the Reserve Bank. The Committee is headed by the Reserve Bank Governor with the Deputy Governor in charge of monetary policy as Vice Chairman and comprises the other three Deputy Governors, two members of the Central Board of the Reserve Bank and five external members with expertise in the areas of monetary economics, central banking, financial markets and public finance.

2.8 The year 2007-08 began with moderation in global growth, relative to the previous year. In addition, inflationary pressures were evident in terms of the elevated levels of commodity and asset prices. Simultaneously, risks from financial markets had magnified with amplified exchange rate fluctuations and growing uncertainty regarding the timing and extent of global liquidity withdrawals. It was gradually becoming clear that the sub-prime mortgage crisis would pose a grave risk to the world economy. On the domestic front, the outlook remained positive up to the third quarter despite some moderation in the real economy, business confidence and credit offtake, which was already anticipated.

2.9 The stance of monetary policy for 2007-08 was initially conditioned by the pattern of likely evolution of macroeconomic and financial conditions which indicated an environment supportive of sustaining the then prevailing domestic growth momentum and it was considered necessary that monetary policy, while contributing to growth, ensured and maintained price and financial stability (Box II.1). While the conduct of monetary policy reinforced the emphasis on price stability and well-anchored inflation expectations all along, the shifting stance of the policy to greater emphasis on financial stability was notable. Monetary measures were taken in an environment of heightened uncertainty and supply constraints impacting the growth momentum in the domestic economy.

Annual Policy Statement for 2007-08

2.10 The Annual Policy Statement for the year 2007-08 was issued at a time (April 2007) when global growth was strong, with expectation of moderation relative to the previous year. Commodity and asset prices were stoking inflationary pressures across the globe. In the global financial markets, risks remained under-priced and diffused. As a structural change was underway in the Indian economy, there was optimism of a step-up in the growth trajectory. However, there were indications of intensified demand-side as well as supply-side pressures in the form of sustained demand for capital goods and consumer durables, high growth rates of money/credit, wage pressures in some sectors and rising input costs. Against this backdrop, the Statement noted that the overarching policy challenge was to maintain the transition to a higher growth path while containing inflationary pressures.

2.11 The Annual Policy Statement estimated real GDP growth for 2007-08 at around 8.5 per cent and stated that the policy endeavour

[1] In 2008-09 so far, apart from the usual meetings before the Annual Policy Statement for 2008-09 in April 2008, the First Quarter Review in July 2008 and the Mid-term Review in October 2008, an additional TACMP meeting was held on June 23, 2008 to advise the Reserve Bank on suitable policy responses to the sudden hardening of inflation.

Box II.1: Stance of Monetary Policy – April 2007 to October 2008

Annual Policy Statement for 2007-08 (April 2007)

- To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.
- To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.
- To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations and the growth momentum.

First Quarter Review for 2007-08 (July 2007)

- To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.
- To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.
- To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations, financial stability and the growth momentum.

Mid-term Review for 2007-08 (October 2007)

- To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment that supports export and investment demand in the economy so as to enable continuation of the growth momentum.
- To re-emphasise credit quality and orderly conditions in financial markets for securing macroeconomic and, in particular, financial stability while simultaneously pursuing greater credit penetration and financial inclusion.
- To respond swiftly with all possible measures as appropriate to the evolving global and domestic situation impinging on inflation expectations, financial stability and the growth momentum.
- To be in readiness to take recourse to all possible options for maintaining stability and the growth momentum in the economy in view of the unusual heightened global uncertainties, and the unconventional policy responses to the developments in financial markets.

Third Quarter Review for 2007-08 (January 2008)

- To reinforce the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment conducive to continuation of the growth momentum and orderly conditions in financial markets.
- To emphasise credit quality as well as credit delivery, in particular, for employment-intensive sectors, while pursuing financial inclusion.
- To monitor the evolving heightened global uncertainties and domestic situation impinging on inflation expectations, financial stability and growth momentum in order to respond swiftly with both conventional and unconventional measures, as appropriate.

Annual Policy Statement for 2008-09 (April 2008) / First Quarter Review for 2008-09 (July 2008)

- To ensure a monetary and interest rate environment that accords high priority to price stability, well-anchored inflation expectations and orderly conditions in financial markets while being conducive to continuation of the growth momentum.
- To respond swiftly on a continuing basis to the evolving constellation of adverse international developments and to the domestic situation impinging on inflation expectations, financial stability and growth momentum, with both conventional and unconventional measures, as appropriate.
- To emphasise credit quality as well as credit delivery, in particular, for employment-intensive sectors, while pursuing financial inclusion.

Mid-term Review for 2008-09 (October 2008)

- Ensure a monetary and interest rate environment that optimally balances the objectives of financial stability, price stability and well-anchored inflation expectations, and growth.
- Continue with the policy of active demand management of liquidity through appropriate use of all instruments including the CRR, open market operations (OMO), the MSS and the LAF to maintain orderly conditions in financial markets.
- In the context of the uncertain and unsettled global situation and its indirect impact on the domestic economy in general and the financial markets in particular, closely and continuously monitor the situation and respond swiftly and effectively to developments, employing both conventional and unconventional measures.
- Emphasise credit quality and credit delivery, in particular, for employment-intensive sectors, while pursuing financial inclusion.

would be to contain year-on-year inflation close to 5.0 per cent. This was, however, based on the assumption of no further escalation in international crude prices and non-occurrence of domestic/external shocks. It was observed that the Reserve Bank's self-imposed medium-term ceiling on inflation at 5.0 per cent had exerted a beneficial impact on inflation expectations and brought down the socially tolerable rate of inflation. With a view to maintaining self-accelerating growth over the medium-term and taking cognisance of both India's evolving integration with the global economy and societal preferences in this regard, the Statement added that the resolve, going forward, would be to condition policy and perceptions for inflation in the range of 4.0–4.5 per cent. As M3 growth in 2005-06 and 2006-07 was well above the indicative projections, the need to contain monetary expansion in 2007-08 at around 17.0-17.5 per cent, in consonance with the outlook on growth and inflation, was emphasised. In harmony with M3 projections, the growth in aggregate deposits in 2007-08 was placed at around Rs.4,90,000 crore. A gradual deceleration of non-food credit (including investments in bonds/debentures/shares of public sector undertakings and private corporate sector and commercial paper) growth to 24.0-25.0 per cent was projected in 2007-08, as against the average of 29.8 per cent during 2004-07. It was indicated that the policy of withdrawal of semi-durable and durable elements of liquidity through the Market Stabilisation Scheme (MSS) would continue along with other arrangements relating to the operation of the liquidity adjustment facility (LAF). Supplementing the monetary measures taken in March and April 2007, the policy hiked the cash reserve ratio (CRR) that banks were required to maintain by 25 basis points to 6.5 per cent with effect from the fortnight beginning April 28, 2007.

First Quarter Review for 2007-08

2.12 The First Quarter Review, issued in July 2007, retained the projection of real GDP growth and the outlook for inflation for 2007-08 at around 8.5 per cent and 5.0 per cent, respectively, barring domestic or external shocks. There was expectation of return to trend growth in agriculture in the backdrop of the India Meteorological Department's forecast of normal rainfall for the country while growth in industrial and services sectors was expected to be sustained. There were indications that the lagged and cumulative effects of monetary policy actions in conjunction with fiscal and administrative measures for supply management had exerted a salutary effect on inflation expectations. While non-food credit growth had decelerated, the acceleration in money supply and reserve money warranted an appropriate response. The Review noted that the considerable uncertainty in international financial markets and the volatility in equity and currency markets had imparted an additional dimension of uncertainty to the evolution of the international economic environment. With a view to insulating domestic real activity from external shocks, it was indicated that monetary policy in India would continue to be vigilant and pro-active in the context of any accentuation of global uncertainties that posed threats to growth and stability of the domestic economy. While the stance of monetary policy continued to reinforce the emphasis on price stability and well-anchored inflation expectations and thereby sustaining the growth momentum, it was recognised that contextually, financial stability could assume greater importance in the months ahead. The Review stated that the Reserve Bank would continue with its policy of active demand management of liquidity through appropriate use of the CRR stipulations and OMO including the MSS and the LAF, using all policy options at its disposal flexibly, as and when the situation warranted. Accordingly, in response to the then prevailing macroeconomic and overall monetary and liquidity conditions, the second liquidity adjustment facility (SLAF) and the ceiling of Rs.3,000 crore on daily reverse repo under the LAF was withdrawn on August 6, 2007. The CRR was raised by 50 basis points to 7.0 per cent with effect from the fortnight beginning August 4, 2007.

Mid-term Review for 2007-08

2.13 The Mid-term Review of the Annual Policy Statement for 2007-08 (October 2007) was formulated in the context of strong aggregate demand and the economy being mainly driven by the increase in gross fixed investment, while growth in private consumption and exports was relatively modest. The growth in key monetary aggregates such as reserve money and M3 was well above initial projections, on account of higher than expected deposit growth and capital inflows and the drawdown of fiscal cash balances. Although wholesale price index (WPI) inflation had eased considerably, consumer price inflation, particularly for agricultural workers and rural labourers remained high. The Review reiterated that GDP growth and inflation outlook for the year would continue to be as indicated in the Annual Policy Statement for 2007-08. With a view to conditioning inflation expectations in the range of 4.0-4.5 per cent, the Mid-term Review set a medium-term inflation target of 3.0 per cent, consistent with India's broader integration into the global economy.

2.14 The Review also stated that upside threat to inflation emanated not just from domestic liquidity conditions but also from global factors, particularly the high and volatile levels of international crude, food and metal prices. There was a possibility of China's high inflation rate being transmitted to its major trading partners, given the country's dominant position in the global economy. On a review of the then prevailing monetary conditions, it was decided to increase the CRR by 50 basis points to 7.5 per cent with effect from the fortnight beginning November 10, 2007.

Third Quarter Review for 2007-08

2.15 The Third Quarter Review in January 2008 observed that adverse global developments had the potential to overwhelm the softening of inflation in terms of manufactures and primary food articles through the year. The prospects for the domestic economy over the remaining part of 2007-08 were, however, perceived to be consistent with policy expectations. There was a historic build-up in the foreign exchange reserves during 2007-08 and it was noted that the expansion of monetary conditions made liquidity management more complex and challenging. The Review indicated that the aggregate deposit growth in the year was above the Annual Policy projection of Rs.4,90,000 crore, while non-food credit growth was below the 24.0-25.0 per cent target for 2007-08. M3 growth, however, was above the indicative trajectory of 17.0-17.5 per cent for 2007-08.

2.16 The Third Quarter Review reaffirmed the stance of monetary policy set out in the Annual Policy Statement of April 2007 and subsequent Reviews reinforcing the emphasis on price stability and well-anchored inflation expectations while ensuring a monetary and interest rate environment conducive to continuation of the growth momentum and orderly conditions in the financial markets. Though credit quality continued to receive priority, credit delivery, particularly to employment-intensive sectors, was emphasised for pursuit of financial inclusion.

Reckoning global factors as becoming increasingly relevant even though domestic factors dominated the policy stance, the Review committed to monitor the evolving heightened global uncertainties and the domestic situation impinging on inflation expectations, financial stability and the growth momentum in order to respond swiftly with both conventional and unconventional measures, as appropriate.

2.17 The period following the Third Quarter Review, was marked by a significant rise in inflation. With a view to absorbing the excess liquidity, tempering the demand pressures and containing the inflationary expectations, the Reserve Bank announced a two-stage hike (25 basis points each) in the CRR to 7.75 per cent and 8.00 per cent, effective from the fortnights beginning April 26, 2008 and May 10, 2008 respectively.

Annual Policy Statement for 2008-09

2.18 Against the backdrop of risks to inflation and inflationary expectations because of upside pressures from international food and energy prices, the Annual Policy Statement for the year 2008-09, issued in April 2008, emphasised that the stance of monetary policy was geared towards maintenance of a monetary and interest rate environment that accorded high priority to price stability, well-anchored inflation expectations and orderly conditions in financial markets while being conducive to continuation of the growth momentum. The Statement pegged the growth rate of the economy for 2008-09 in the range of 8.0 to 8.5 per cent assuming a normal monsoon in the country and no marked deterioration in global financial/commodity markets and the real economy, compared with the initial assessment. It was stated that the policy endeavour would be to bring down inflation from the then high level of above 7.0 per cent to around 5.5 per cent in 2008-09 with a preference for bringing it as close to 5.0 per cent as soon as possible, recognising the evolving complexities in globally transmitted inflation. The resolve, going forward, was to condition policy and perceptions for inflation in the range of 4.0-4.5 per cent so that an inflation rate of around 3.0 per cent became a medium-term objective consistent with India's broader integration into the global economy and with the goal of maintaining self-accelerating growth over the medium-term.

2.19 Movements in banking aggregates during the fourth quarter of 2007-08 enabled a better balance between banks' sources and uses of funds resulting in a decline in the incremental non-food credit deposit ratio to below 75 per cent for the first time since August 2004. Asset prices, particularly equity prices, which had risen to record highs in January 2008, declined significantly during February-March 2008. The Statement observed that despite the dislocations in the securitised credit markets in the US and Europe, the underlying macroeconomic fundamentals of emerging market economies remained resilient though they remained vulnerable to slower export growth and volatility in financial flows. Notwithstanding the significant deterioration in inflationary expectations and other developments, both domestic and international, in relation to the initial assessment in 2007-08, the build-up in supply pressures had the ability to further stoke inflationary pressures.

2.20 On the back of sizeable accretions to the Reserve Bank's foreign exchange assets and a cyclical acceleration in credit and deposit growth, particularly in 2007-08, M3 growth had persisted above indicative projections through 2005-08. In view of the resulting monetary overhang, it was necessary to moderate monetary expansion and plan for M3 growth in the range of 16.5-17.0 per cent in 2008-09, in consonance with the outlook on growth and inflation, so as to ensure macroeconomic and financial stability in the period ahead. Consistent with the monetary projections, the growth in aggregate deposits in 2008-09 was placed at around 17.0 per cent or around Rs.5,50,000 crore and that of non-food credit at around 20.0 per cent. In accordance with the policy stance, it was reiterated that the Reserve Bank would continue with its policy of active demand management of liquidity through appropriate use of the CRR stipulations and OMO, including the MSS and the LAF, using all the policy instruments at its disposal flexibly, as and when warranted by the situation. An increase in the CRR by 25 basis points to 8.25 per cent with effect from the fortnight beginning May 24, 2008 was announced. Besides a number of policy measures for smoother functioning of the money and Government securities markets, furthering access to credit, better risk assessment and strengthening of supervision were also announced.

2.21 On May 30, 2008 special market operations (SMO) were announced to alleviate the binding financing constraints faced by the public oil companies in importing petroleum, oil and lubricants (POL) as also to minimise the potential adverse consequences for financial markets in which these oil companies were important participants. Subsequent to the announcement of the hike in administered POL prices, the repo rate under the LAF was increased by 25 basis points on June 12, 2008 and further by 50 basis points to 8.50 per cent on June 25, 2008. As WPI inflation continued to surge in the months following the policy announcement, the Reserve Bank in accordance with its pre-emptive and calibrated approach to contain inflation expectations, raised CRR in two stages, to 8.50 and 8.75 per cent, from the fortnights beginning July 5, 2008 and July 19, 2008, respectively.

First Quarter Review for 2008-09

2.22 The First Quarter Review for 2008-09 was announced in July 2008 against the backdrop of year-on-year inflation in the country touching a 13-year high. The main drivers for this were the rapid escalation in commodity prices internationally and the rising concern that the spurt in food and energy prices would trigger a more generalised inflation spiral through second-round effects. The elevated level of international food, crude and other commodity prices led to a sizeable expansion in the merchandise trade deficit, putting persistent downward pressure in the foreign exchange market which, in turn, was further aggravated by volatility of capital flows, particularly portfolio outflows and tightening of international bank lending.

2.23 The Review observed that there had been a slight moderation in the industrial and the services sectors, while a favourable outlook for agriculture raised optimism regarding food availability and consequent mitigation of inflationary expectations. The monetary policy stance, it was indicated, would accord the highest priority to bringing down inflation and stabilising inflation expectations. Reinforced policy actions on several fronts were expected to exert a noticeable decline in inflation towards the last quarter of 2008-09. The Reserve Bank, while aiming to bring down inflation to around 3.0 per cent over the medium-term, set a realistic policy endeavour to bring down inflation from the then prevailing level of about 11.0-12.0 per cent to close to 7.0 per cent by March 31, 2009. Setting out the aggregate demand management and supply prospects required, the Review observed that the growth projection for the Indian economy made in the Annual Policy Statement for 2008-09 might prove to be optimistic, and a projection of around 8.0 per cent growth appeared a more realistic central scenario, barring domestic or external shocks.

2.24 The Review emphasised the need for moderating monetary expansion and M3 growth rate in the range of around 17.0 per cent in 2008-09 in consonance with the outlook on growth and inflation so as to ensure macroeconomic and financial stability in the period ahead. Consistent with this, the growth in aggregate deposits in 2008-09 was revised to about 17.5 per cent or around Rs.6,00,000 crore and that of non-food credit was placed at around 20.0 per cent, as indicated in the Annual Policy Statement. In view of the then prevailing macroeconomic and overall monetary conditions, the Reserve Bank increased the fixed repo rate under the LAF by 50 basis points from 8.5 per cent to 9.0 per cent with effect from July 30, 2008 and the CRR for scheduled commercial banks (SCBs) by 25 basis points to 9.0 per cent with effect from the fortnight beginning August 30, 2008 (Table II.1). These measures were expected to impart a stabilising influence on the economy in the period ahead. In view of the criticality of anchoring inflation expectations, a continuous heightened vigil over ensuing monetary and macroeconomic developments

Table II.1: Recent Changes in Policy Rates and Cash Reserve Ratio

(Per cent)

Effective From	Reverse Repo Rate	Repo Rate	Cash Reserve Ratio
1	2	3	4
September 18, 2004	4.50	6.00	4.75 (+0.25)
October 2, 2004	4.50	6.00	5.00 (+0.25)
October 27, 2004	4.75 (+0.25)	6.00	5.00
April 29, 2005	5.00 (+0.25)	6.00	5.00
October 26, 2005	5.25 (+0.25)	6.25 (+0.25)	5.00
January 24, 2006	5.50 (+0.25)	6.50 (+0.25)	5.00
June 9, 2006	5.75 (+0.25)	6.75 (+0.25)	5.00
July 25, 2006	6.00 (+0.25)	7.00 (+0.25)	5.00
October 31, 2006	6.00	7.25 (+0.25)	5.00
December 23, 2006	6.00	7.25	5.25 (+0.25)
January 6, 2007	6.00	7.25	5.50 (+0.25)
January 31, 2007	6.00	7.50 (+0.25)	5.50
February 17, 2007	6.00	7.50	5.75 (+0.25)
March 3, 2007	6.00	7.50	6.00 (+0.25)
March 31, 2007	6.00	7.75 (+0.25)	6.00
April 14, 2007	6.00	7.75	6.25 (+0.25)
April 28, 2007	6.00	7.75	6.50 (+0.25)
August 4, 2007	6.00	7.75	7.00 (+0.50)
November 10, 2007	6.00	7.75	7.50 (+0.50)
April 26, 2008	6.00	7.75	7.75 (+0.25)
May 10, 2008	6.00	7.75	8.00 (+0.25)
May 24, 2008	6.00	7.75	8.25 (+0.25)
June 12, 2008	6.00	8.00 (+0.25)	8.25
June 25, 2008	6.00	8.50 (+0.50)	8.25
July 5, 2008	6.00	8.50	8.50 (+0.25)
July 19, 2008	6.00	8.50	8.75 (+0.25)
July 30, 2008	6.00	9.00 (+0.50)	8.75
August 30, 2008	6.00	9.00	9.00 (+0.25)
October 11, 2008	6.00	9.00	6.50 (-2.50)
October 20, 2008	6.00	8.00 (-1.00)	6.50
October 25, 2008	6.00	8.00	6.00 (-0.50)
November 3, 2008	6.00	7.50 (-0.50)	6.00
November 8, 2008	6.00	7.50	5.50 (-0.50)
December 8, 2008	5.00 (-1.00)	6.50 (-1.00)	5.50

Note : 1. With effect from October 29, 2004, the nomenclature of repo and reverse repo was changed in keeping with international usage. Now, reverse repo indicates absorption of liquidity and repo signifies injection of liquidity. The nomenclature in this Report is based on the new usage of terms even for the period prior to October 29, 2004.

2. Figures in parentheses indicate change in policy rates.

was indicated to be maintained to enable swift responses with appropriate measures as necessary, consistent with the monetary policy stance.

2.25 The extraordinary global developments beginning mid-September 2008, triggered by the bankruptcy/sell-out/restructuring of some of the world's largest financial institutions resulted in severe disruptions of international money markets, sharp declines in stock markets across the globe and extreme investor aversion. Several central banks and financial regulators responded with both unorthodox and unconventional measures to facilitate orderly operation of financial markets and to ensure financial stability. In the wake of the significant deterioration in the global financial environment since mid-September 2008, the Reserve Bank took a number of measures to maintain adequate liquidity in domestic money and foreign exchange markets and to enable banks to continue to lend for productive purpose while maintaining credit quality so as to sustain the growth momentum (Box II.2).

Mid-term Review for 2008-09

2.26 The Mid-term Review of the Annual Policy Statement for the year 2008-09, announced in October 2008, noted that the aggregate supply conditions in the economy had shown resilience in the second quarter of 2008-09 in the face of a deteriorating global macroeconomic and financial environment. There were, however, growing indications that the underlying economic cycle was turning in tune with global economic developments and that domestic economic activity was straddling a point of inflexion. The Mid-term Review thus revised the GDP growth forecast for the year to the range of 7.5 to 8.0 per cent. Keeping in view the supply management measures taken by the Government and the lagged demand response to the monetary policy measures taken by the Reserve Bank which had led to softening of inflation since July 2008, it was decided to maintain the earlier projection of inflation of 7.0 per cent by end-March 2009 for policy purposes. The Mid-term Review reiterated that the Reserve Bank's endeavour would be to bring down inflation to a tolerable level of below 5.0 per cent at the earliest, while aiming for convergence with the global average inflation of around 3.0 per cent over the medium-term.

2.27 The Review indicated that key monetary and banking aggregates – money supply, deposit and non-food credit growth – had been expanding at rates that were significantly elevated relative to indicative trajectories given in the Annual Policy Statement of April 2008. The need to modulate the monetary overhang generated by the sustained expansion of money supply since 2005-06 was emphasised; it was indicated that the Reserve Bank would endeavour to moderate the rate of growth of money supply to 17.0 per cent in 2008-09. The Review mentioned that the liquidity conditions in the domestic markets tightened abruptly in mid-September 2008. As the contagion from the US financial crisis spread further to Europe and Asia, there was continued tightening of domestic liquidity conditions. The Reserve Bank announced a number of measures since mid-September to assuage the domestic liquidity stress. The global financial turmoil reinforced the importance of putting special emphasis on preserving financial stability. At the same time, inflation, which was still in double digits, and the moderation in growth continued to be critical policy concerns. Consequently, the central task for conduct of monetary policy had become more complex than before, with increasing priority being given to financial stability. The Review noted that the challenge was to strike an optimal balance between preserving financial stability, maintaining price stability, anchoring inflation expectations, and sustaining the growth momentum. To manage this challenge, the Reserve Bank would continue to deploy both conventional and unconventional tools (refer Box II.2).

2.28 In response to the evolving macroeconomic and liquidity conditions in the global and domestic financial markets which reinforced the importance of focussing on preserving financial stability, the Reserve Bank announced a number of monetary and other measures in November 2008. Further measures were announced on December 6, 2008 to arrest the growth moderation in the economy (refer Box II.2).

Statutory Pre-emptions

2.29 Prior to the onset of withdrawal of monetary accommodation in September 2004, the Reserve Bank had brought down the CRR to 4.5 per cent, while following a policy of a conscious move away from direct instruments of monetary control to indirect instruments. The CRR for SCBs was increased by a cumulative of 150 basis points during 2007-08 – two hikes of 25 basis points each were effected in April 2007 and two hikes of 50 basis points each were effected in August 2007 and November 2007, respectively. During 2008-09 so far, the CRR was first increased by 150 basis points in six phases of 25 basis points each to 9.0 per cent before a sharp reduction of 250 basis points to 6.5 per cent of NDTL from the fortnight beginning October 11, 2008. The CRR was further reduced in two phases of 50 basis points each to 6.0 per cent and 5.5 per cent of NDTL with effect from the fortnights beginning October 25, 2008 and November 8, 2008, respectively.

2.30 The amendments made to the Reserve Bank of India (RBI) Act, 1934 and the Banking Regulation Act, 1949 during 2006-07 enhanced the Reserve Bank's operational flexibility in monetary management. Provisions of Section 3 of the RBI (Amendment) Act, 2006, came into force on April 1, 2007 following which, the floor and the ceiling on CRR to be prescribed by the Reserve Bank ceased to exist and no interest was payable on the CRR balances of banks with effect from the fortnight beginning March 31, 2007.

2.31 The Banking Regulation (Amendment) Act, 2007, which came into force on January 23, 2007, removed the floor rate of 25 per cent for SLR and empowered the Reserve Bank to determine SLR-eligible assets, among others. The Reserve Bank had maintained the pre-emption under SLR at 25 per cent till the first week of November 2008. Banks, however, have continued to hold more than the prescribed minimum, though the amount exceeding the prescribed minimum has gradually come down in recent years.

2.32 The Reserve Bank began offering to banks additional liquidity support under the LAF from September 17, 2008. Banks obtain liquidity from the Reserve Bank under the LAF against the collateral of eligible securities that are in excess of their prescribed SLR. It was decided that, in addition, purely as a temporary measure, SCBs could avail additional liquidity support under the LAF to the extent of up to 1.0 per cent of their NDTL and seek waiver of penal interest. In November 2008, it was decided to make the reduction permanent and accordingly, the SLR was reduced to 24 per cent of NDTL with effect from the fortnight beginning November 8, 2008. Furthermore, till end-June 2009, banks have been allowed relaxation in maintenance of SLR up to 1.5 per cent of their NDTL to meet the funding requirements of MFs, NBFCs and HFCs.

Interest Rate Structure

2.33 Rationalisation and deregulation of the interest rate structure has been an important

Box II.2: Major Policy Announcements by the Reserve Bank (September-December, 2008)

Important measures initiated by the Reserve Bank since mid-September 2008 are set out below:

Measures Announced in September

- The Reserve Bank indicated that it would continue to sell foreign exchange (US dollar) through agent banks to augment supply in the domestic foreign exchange market or intervene directly to meet any demand-supply gaps.
- The interest rate ceilings on foreign currency non-resident (bank) [FCNR (B)]/non-resident (external) rupee account [NR(E)RA] deposits were increased by 50 basis points each on September 16, 2008.
- As a temporary measure, SCBs (excluding RRBs) and primary dealers were allowed to avail additional liquidity support under the LAF to the extent of up to 1.0 per cent of their net demand and time liabilities (NDTL) and seek waiver of penal interest from September 17, 2008.
- The SLAF began to be conducted on a daily basis with effect from September 17, 2008 (the SLAF was re-introduced on August 1, 2008 to be conducted on reporting Fridays for banks).

Mid-term Review for 2008-09 (October 24, 2008)

- Floating rate bonds to be issued at an appropriate time taking into account the prevailing market conditions.
- The scheme for non-competitive bidding facility of state development loans (SDLs) to be operationalised by end-December 2008.
- Interest rate futures contracts, as recommended by the concerned working group, to be launched in early 2009 along with the supporting changes in the regulatory regime.
- Arrangements for settlement of primary auction bidding under the multi-modal settlements mechanism on the anvil.
- Clearing Corporation of India Limited (CCIL) to operationalise a clearing and settlement arrangement for over-the-counter (OTC) rupee interest rate derivatives on a non-guaranteed basis within a month, and on a guaranteed basis within three months. CCIL to operationalise settlement system of the foreign exchange forward segment within a month.
- A model scheme for financial literacy and credit counselling centres to be notified.
- Feedback to be given to banks to make the process of financial inclusion more effective.
- Guidelines related to liquidity risk management to be significantly revised.
- Guidelines on stress testing to be upgraded.
- An approach paper on appropriate model of risk-based supervision to be finalised by mid-December 2008.
- The working group to facilitate emergence of umbrella organisation/s for the urban co-operative bank (UCB) sector and examine issues concerning creation of a revival fund for the sector to submit its report by end-December 2008.
- The four Advisory Panel reports and the overview report of the Committee on Financial Sector Assessment to be released by December 2008.
- Report of the High Level Committee constituted to review the Lead Bank Scheme and improve its effectiveness to be submitted by December 2008.

Other Measures Announced in October

- The CRR was reduced by 250 basis points to 6.5 per cent of NDTL with effect from the fortnight beginning October 11, 2008.
- The repo rate under the LAF was reduced by 100 basis points to 8.0 per cent on October 20, 2008.
- Systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI) were temporarily permitted to raise short-term foreign currency borrowings under the approval route, subject to compliance with certain norms.
- A term repo facility for an amount of Rs.20,000 crore was instituted under the LAF to enable banks to ease liquidity stress faced by mutual funds (MFs). SCBs were allowed to avail additional liquidity support up to 0.5 per cent of their NDTL for meeting the liquidity requirements of MFs.
- The Reserve Bank announced that it would institute SMO to meet the foreign exchange requirements of public sector oil marketing companies against oil bonds when they become available.
- The interest rate ceilings on FCNR (B)/NR(E)RA deposits were increased by 50 basis points each on October 15, 2008.
- The Reserve Bank provided an advance of Rs.25,000 crore to financial institutions under the Agricultural Debt Waiver and Debt Relief Scheme, 2008.
- External commercial borrowings (ECBs) up to US$ 500 million per borrower per financial year were permitted for rupee/foreign currency expenditure for permissible end-uses under the automatic route.
- The all-in-cost ceiling for ECBs of average maturity period of three to five years and of maturity period over five years was enhanced to 300 basis points above LIBOR and to 500 basis points above LIBOR, respectively. The all-in-cost ceiling for trade credit less than three years was enhanced to 6-month LIBOR plus 200 basis points.
- Authorised Dealer (AD) category - I banks were allowed to borrow funds from their head office, overseas branches and correspondents and overdrafts in nostro accounts up to a limit of 50 per cent of their unimpaired Tier 1 capital as at the close of the previous quarter or US$ 10 million, whichever was higher, as against the existing limit of 25 per cent.

Measures Announced in November

- The repo rate under the LAF was reduced by 50 basis points to 7.5 per cent on November 3, 2008.

- The statutory liquidity ratio (SLR) was reduced by 100 basis points to 24 per cent of NDTL with effect from the fortnight beginning November 8, 2008.
- The CRR was reduced by 100 basis points from 6.5 per cent to 5.5 per cent of NDTL in two stages - by 50 basis points with retrospective effect from the fortnight beginning October 25, 2008 and by a further 50 basis points with effect from the fortnight beginning November 8, 2008.
- A special refinance facility was introduced for SCBs (excluding RRBs) with a limit of 1.0 per cent of each bank's NDTL as on October 24, 2008 at the LAF repo rate up to a maximum period of 90 days. During this period, refinance can be flexibly drawn and repaid. Banks have been encouraged to use the special refinance facility for the purpose of extending finance to micro and small enterprises (MSEs). This facility, available up to June 30, 2009, can be rolled over.
- It was indicated that the special term repo facility, announced in October, would be conducted up to a cumulative amount of Rs.60,000 crore with an associated SLR exemption of 1.5 per cent of NDTL to enable banks to meet the liquidity needs of MFs, NBFCs and and housing finance companies (HFCs). The facility will continue till end-June 2009 and can be availed of either on an incremental or on a rollover basis.
- The Reserve Bank has put in place a mechanism to buy back dated securities issued under the MSS.
- The interest rate ceilings on FCNR (B)/NR(E)RA deposits were increased by 75 basis points each on November 15, 2008.
- As a temporary measure, HFCs registered with the National Housing Bank (NHB) were allowed to raise short-term foreign currency borrowings under the approval route, subject to compliance with prudential norms laid down by the NHB.
- It was indicated that the Reserve Bank would consider, under the approval route, proposals from Indian companies to prematurely buy back their foreign currency convertible bonds (FCCBs). The buy-back should be financed by the company's foreign currency resources held in India or abroad and/or out of fresh ECB raised in conformity with the current norms for ECBs. Extension of FCCBs would also be permitted at the current all-in cost for the relative maturity.
- The period of entitlement of the first slab of pre-shipment rupee export credit and post-shipment rupee export credit was extended by 90 days each with effect from November 15, 2008 and December 1, 2008, respectively.
- The eligible limit of the export credit refinance (ECR) facility for scheduled banks (excluding RRBs) was enhanced to 50 per cent of the outstanding export credit eligible for refinance as at the end of the second preceding fortnight, as against the earlier limit of 15 per cent.
- Amounts were allocated, in advance, from SCBs for contribution to the Small Industries Development Bank of India (SIDBI) and the NHB to the extent of Rs.2,000 crore and Rs.1,000 crore, respectively, against banks' estimated shortfall in priority sector lending in March 2009.
- Provisioning requirement for all types of standard assets was reduced to a uniform level of 0.4 per cent except in the case of direct advances to agriculture and SMEs sectors which would continue to attract provisioning of 0.25 per cent.
- Risk weight on all unrated claims of corporates, long term as well as short term, regardless of the amount of claim, would be 100 per cent. Risk weight on claims secured by commercial real estate was reduced to 100 per cent from 150 per cent. Claims on rated as well as unrated NBFCs-ND-SI are uniformly risk weighted at 100 per cent. Claims on asset financing companies (AFCs) would continue to be governed by the credit rating of the AFCs, except the claims that attracted a risk weight of 150 per cent under the new capital adequacy framework now have a risk weight of 100 per cent.
- Indian banks with foreign branches and subsidiaries have been allowed forex swaps of tenure up to three months, till end-June 2009, to meet the short-term funding requirements at their overseas offices.

Growth Stimulus Announced on December 6, 2008

- The repo rate and the reverse repo rate were reduced by 100 basis points each to 6.5 per cent and 5.0 per cent, respectively, on December 8, 2008.
- To enhance credit flow to the MSE sector, SIDBI would be provided refinance worth Rs.7,000 crore. The facility, available up to end-March 2010, would be available at the prevailing repo rate under the LAF for a 90-day period, during which the amount can be flexibly drawn and repaid and can be rolled over at the end of the 90-day period. The utilisation of funds would be governed by the policy approved by SIDBI's Board.
- A similar refinance facility worth Rs.4,000 crore to be worked out for NHB.
- As a follow-up to the announcement in November 2008, the policy on premature buyback of FCCBs by Indian companies was liberalised and applications for buyback would be considered under both automatic and approval routes and related compliance terms and conditions were issued.
- Up to March 31, 2010, loans granted by banks to HFCs for on-lending to individuals for purchase/construction of dwelling units would be classified under priority sector, provided the housing loans granted by HFCs do not exceed Rs.20 lakh per dwelling unit per family. However, the elegibility under the measure is restricted to 5.0 per cent of the individual bank's total priority sector lending on an ongoing basis.
- Exceptional/concessional treatment of retaining the asset classification of the restructured standard accounts in standard category has been extended to the commercial real estate exposures which are restructured up to June 30, 2009.
- As there are likely to be instances of even viable units facing temporary cash flow problems in the face of the current economic downturn, as a one-time measure, the second restructuring done by banks of exposures (other than exposures to commercial real estate, capital market and personal/consumer loans) up to June 30, 2009, would also be eligible for exceptional regulatory treatment.
- The prescribed interest rate applicable to post-shipment rupee export credit (ceiling of BPLR minus 250 basis points) was extended to overdue bills up to 180 days from the date of advance.

component of the financial sector reforms initiated in the early 1990s. Interest rates have been progressively deregulated barring those on savings bank deposits, non-resident external (NRE) deposits, FCNR (B) deposits, export credit and small loans upto Rs.2 lakh. Interest rate reforms have enhanced competitiveness and efficiency in the resource allocation process in the financial system, while simultaneously improving the monetary transmission mechanism.

Bank Rate and Repo/Reverse Repo Rate

2.34 The Bank Rate has been retained at 6.0 per cent since April 2003. Thus, the Bank Rate now functions as a signalling rate for the medium-term stance of the monetary policy, while the repo and reverse repo rates have become more commonly used signalling devices. With a view to fine-tuning the management of bank reserves on the last day of the maintenance period, the SLAF was re-introduced on August 1, 2008, to be conducted only on reporting Fridays for banks. The salient features of the SLAF are the same as those of the LAF. However, the settlement for the LAF and SLAF is conducted separately and on a gross basis. The SLAF is conducted on a daily basis with effect from September 17, 2008.

2.35 The repo and reverse repo rates were kept unchanged during 2007-08. During 2008-09, up to July 2008, the repo rate was raised by 125 basis points in the light of evolving macroeconomic and monetary conditions. On October 20, 2008, however, the repo rate was cut by 100 basis points to 8.0 per cent. The repo rate was further reduced by 50 basis points to 7.5 per cent on November 3, 2008. On December 8, 2008, both repo and reverse repo rates were reduced by 100 basis points each to 6.5 per cent and 5.0 per cent, respectively (refer Table II.1).

Deposit Rates

2.36 The interest rate on savings bank deposits was last revised on March 1, 2003, when it was reduced to 3.5 per cent per annum from 4.0 per cent. Ceilings on interest rates on NRE deposits and FCNR (B) deposits are linked to the LIBOR/SWAP rates and are reviewed from time to time, depending on monetary and macroeconomic developments. The interest rate ceiling on NRE deposits for one to three year maturity was increased by 50 basis points each on September 16, 2008 and October 15, 2008 to LIBOR/SWAP rates plus 100 basis points (Table II.2). Another 75 basis points hike was effected on November 15, 2008. On September 16, 2008 following a review, the interest rate ceiling on FCNR (B) deposits was raised by 50 basis points to LIBOR/SWAP rates minus 25 basis points. In the light of adverse developments in the domestic money and foreign exchange markets following the deterioration in the international financial environment, the interest rate payable on FCNR (B) deposits was increased by further 50 basis points to LIBOR/SWAP rates plus 25 basis points on October 15, 2008. The ceiling was increased to LIBOR/SWAP rates plus 100 basis points on November 15, 2008.

2.37 In view of the global developments during August-September, 2007 and with a view to giving an opportunity to SMEs to manage the challenges in the global markets, the Reserve Bank, in consultation with the Government of India, permitted all exporters from October 6, 2007 to earn interest on exchange earners' foreign currency (EEFC) accounts to the extent of outstanding balances of US$ 1 million per exporter in the form of term deposits up to one year maturing on or before October 31, 2008. The rate of interest was to be determined by the banks themselves. This, however, was a purely temporary measure subject to further review. Subsequently, the Reserve Bank in

Table II.2: Interest Rate Prescriptions for NRE/ FCNR (B) Deposits and Foreign Currency Export Credit

Type	Effective From	Ceiling Interest Rate
1	2	3
NRE deposit @	November 1, 2004	LIBOR/Swap rates plus 50 basis points.
	November 17, 2005	LIBOR/Swap rates plus 75 basis points.
	April 18, 2006	LIBOR/ Swap rates plus 100 basis points.
	January 31, 2007	LIBOR/Swap rates plus 50 basis points.
	April 24, 2007	LIBOR/Swap rates.
	September 16, 2008	LIBOR/Swap rates plus 50 basis points.
	October 15, 2008	LIBOR/Swap rates plus 100 basis points.
	November 15, 2008	LIBOR/Swap rates plus 175 basis points.
FCNR (B) deposits @	April 29, 2002	LIBOR/Swap rates minus 25 basis points.
	March 28, 2006	LIBOR/Swap rates.
	January 31, 2007	LIBOR/Swap rates minus 25 basis points.
	April 24, 2007	LIBOR/Swap rates minus 75 basis points.
	September 16, 2008	LIBOR/Swap rates minus 25 basis points.
	October 15, 2008	LIBOR/Swap rates plus 25 basis points.
	November 15, 2008	LIBOR/Swap rates plus 100 basis points.
Export Credit in Foreign Currency	April 29, 2002	LIBOR/Swap rates plus 75 basis points.
	April 18, 2006	LIBOR/Swap rates plus 100 basis points.

@ : Interest rates on NRE/FNCR(B) deposits are effective from close of business in India

consultation with the Government of India, announced on August 4, 2008 that it would withdraw this facility from November 1, 2008.

Lending Rates

2.38 In the wake of the currency appreciation in the earlier months of 2007-08, the Government of India, in July 2007, announced a package of measures to provide relief to exporters. This included an interest rate subvention of 200 basis points per annum, for a temporary period, on rupee export credit availed of by exporters in nine categories of exports (textiles including handlooms; readymade garments; leather products; handicrafts; engineering products; processed agricultural products; marine products; sports goods and toys) and to all exporters from the SME sectors defined as micro, small and medium enterprises (MSMEs). Accordingly, it was decided that banks would charge interest rate not exceeding the benchmark prime lending rate (BPLR) minus 4.5 per cent on pre-shipment credit up to 180 days and post-shipment credit up to 90 days on the outstanding amount for the period April 1, 2007 to December 31, 2007 to all SME sectors and the nine sectors as defined above.

2.39 On October 6, 2007, the Government of India partially modified the interest rate subvention to exporters to extend the scheme by three months up to March 31, 2008 and increased the coverage of the scheme to include jute and carpets, processed cashew, coffee, tea, solvent extracted de-oiled cake, plastics and linoleum. On November 30, 2007, the interest rate subvention on rupee export credit was further extended by additional 200 basis points on pre-shipment and post-shipment export credit for the following sectors, *viz.*, leather and leather manufacturers, marine products, all categories of textiles under the existing scheme including readymade garments and carpets but excluding man-made fibre and handicrafts. Banks were to charge interest rates not exceeding BPLR minus 6.5 per cent on pre-shipment rupee export credit up to 180 days and post-shipment rupee export credit up to 90 days on the outstanding amount in respect of the above-mentioned sectors. However, the total subvention was subject to the condition that the interest rate after subvention would not fall below 7.0 per cent, the rate applicable to the agriculture sector under priority sector lending. The Government extended the scheme for one more year *i.e.*, up to March 31, 2009, but in August 2008, it was decided to bring the scheme to a close with effect from September 30, 2008.

2.40 The validity of the reduction in the interest rate ceiling to 250 basis points below BPLR on pre-shipment rupee export credit up to 180 days and post-shipment rupee export credit up to 90 days announced on September 24, 2001 was extended up to April 30, 2009. The period of credit for pre-shipment and post-shipment rupee export credit was extended to 270 days and 180 days, respectively, in November 2008.

2.41 In order to provide credit to the agricultural sector at a reasonable rate, the Union Budget for 2006-07 had announced the availability of short term credit up to Rs.3 lakh to farmers at 7.0 per cent per annum with effect from *Kharif* 2006-07, which was continued for the years 2007-08 and 2008-09. In this regard, the Union Budget made an initial provision of Rs.1,600 crore for interest subvention in 2008-09.

3. Credit Delivery

2.42 The Reserve Bank has promoted a conducive environment for provision of adequate and timely bank finance at reasonable rates to the different sectors of the economy. This is especially important given the structural transformation that is underway and the need to bring the underserved sectors/sections of society within the banking fold. The initiatives taken in the recent past in this regard include improving credit delivery through simplification of the procedures and processes for lending to agriculture and MSMEs, supporting employment generation in rural and unorganised sectors and devising credit relief schemes for sectors in distress due to natural calamities and other factors.

2.43 The major policy initiatives for enhancing credit flow and facilitating credit delivery to the vulnerable sections of the society during 2007-08 included the Agriculture Debt Waiver Scheme, 2008 (farmers whose loans are written off by lending institutions under the scheme, become eligible for fresh finance from the lending institutions); removal of the requirement of 'no dues' certificates from small/marginal farmers, sharecroppers and the like for loans up to Rs.50,000; accepting affidavits submitted by landless labourers, sharecroppers and oral lessees giving occupational status for crop loans up to Rs.50,000; relief measures announced for the bird-flu affected poultry industry and introduction, on a pilot basis, of a cyclical credit product for financing crop production. Several initiatives were taken to increase the flow of credit to the priority sector such as increase in the limit of RRBs' direct finance to housing; permission to sell the priority sector loan assets held by the RRBs in excess of the prescribed level; and allowing commercial/sponsor banks to classify loans made to RRBs for on-lending to agriculture as their indirect lending to agriculture, *etc.* Initiatives were also taken during the year to ease the access to credit and enhance the flow of credit to MSEs such as formulation of the Code of Banks' Commitment to MSE customers.

Priority Sector Lending

2.44 The guidelines on lending to priority sector were revised with effect from April 30, 2007 based on the Report of the Internal Working Group on Priority Sector Lending (Chairman: Shri C.S. Murthy). The priority sector broadly comprises agriculture, MSEs, retail trade, micro credit, education and housing subject to certain limits. The guidelines take into account the revised definition of MSEs as per the Micro, Small and Medium Enterprises Development Act, 2006.

The priority sector lending targets (40 per cent and 32 per cent for domestic and foreign banks, respectively) have been linked to the adjusted net bank credit[2] (ANBC) or the credit equivalent amount of off-balance sheet exposures, whichever is higher, as on March 31 of the previous year, as against the previous practice of linking targets to the ongoing net bank credit.

2.45 The formats used by banks to inform the Reserve Bank about their priority sector advances were revised with effect from September 2007. SCBs should furnish data on priority sector advances on a half-yearly (*ad hoc*) basis as on the last reporting Fridays of March and September of a particular year (within fifteen days from the reference date), as also on a yearly basis (final data) as on the last reporting Friday of March of a particular year (within two months from the reference date).

2.46 RRBs were permitted to extend direct finance up to Rs.10 lakh to the housing sector in rural and semi-urban areas as part of priority sector lending, with the prior approval of their boards. In August 2007, the limit of board-approved direct finance to housing by RRBs was raised to Rs.20 lakh, irrespective of the area.

2.47 The Reserve Bank, in December 2007, allowed all loans granted by commercial banks/sponsor banks to RRBs for on-lending to agriculture and allied activities sector to be classified as indirect finance to agriculture in the books of the lenders. Consequently, the the loans granted by RRBs out of the funds borrowed from commercial banks/sponsor banks may not be classified as their priority sector lending. RRBs should not include such advances as part of their bank credit for the purpose of computing their achievement level under priority sector lending.

2.48 Following the announcement made in the Annual Policy Statement for 2008-09, in May 2008, the Reserve Bank allowed RRBs to sell the loan assets held by them under the priority sector categories in excess of the prescribed priority sector lending target of 60 per cent.

2.49 Domestic SCBs, both in the public and private sector, which fail to achieve the priority sector and/or agriculture lending targets, are required to deposit into the Rural Infrastructure Development Fund (RIDF) such amounts as may be allocated to them by the Reserve Bank. The Fund has completed thirteen years of operation. Domestic SCBs are required to lend 10 per cent of their ANBC or credit equivalent amount of off-balance sheet exposure, whichever is higher, to weaker sections. It was, however, noted that most banks were not meeting this sub-target for lending to weaker sections and hence in May 2008, the Reserve Bank advised that the shortfall in lending to weaker sections would also be taken into account for the purpose of allocating amounts to banks for contribution to the RIDF or funds with other financial institutions with effect from April 2009.

Credit to Agriculture and Allied Activities

2.50 The Union Budget for 2008-09 set a target of Rs.2,80,000 crore for disbursement of agricultural credit during the year by all banks including co-operative banks and RRBs. Several measures were taken during the year to increase the flow of credit to agriculture and allied activities.

2.51 Two proposals of the Working Group for Simplification of Processes and Procedures for Obtaining Agricultural Loans (Chairman: Shri C.P. Swarnkar) were brought into effect in April 2007. One, all SCBs were asked to dispense with the requirement of 'no dues'

[2] Net bank credit plus investments made by banks in non-SLR bonds held in the held-to-maturity (HTM) category.

certificates for loans up to Rs.50,000 to small and marginal farmers, share-croppers and the like and, instead, obtain self-declaration from the borrower. Two, banks were advised to accept certificates regarding the cultivation of crops provided by the local administration/*panchayati raj* institutions for crop loans to landless labourers, share-croppers and oral lessees. In August 2008, banks were advised that where landless labourers, share-croppers and oral lessees faced difficulties in getting the necessary certificates from the local administration/*panchayati raj* institutions regarding the cultivation of crops, they could submit affidavits regarding their occupational status (*i.e.*, details of land tilled/crops grown) for loans up to Rs.50,000. Banks should also encourage the joint liability group/self-help group (SHG) mode of lending for such persons. Banks were, however, cautioned to continue with their procedures of identification as per the 'know your customer' (KYC) norms and other routine checks.

Relief Measure for Agriculture – Interest Rate Subvention

2.52 The Government has in recent years provided interest subvention to the vulnerable sections of the farming and allied sectors which were reeling under natural calamities and afflictions. Pursuant to the announcement in the Union Budget of 2006-07, all SCBs, RRBs and primary agricultural credit societies were advised to grant relief of 2.0 per cent on the borrower's interest liability for loans with principal amount up to Rs.1 lakh. The interest relief on each crop loan granted by banks during *Kharif* and *Rabi* of 2005-06, was to be credited to the borrower's account before March 31, 2006. Furthermore, public sector banks, RRBs and rural co-operative banks were advised that with effect from *Kharif* 2006-07, the Government would provide interest rate subvention of 2.0 per cent in respect of short-term production credit up to Rs.3 lakh provided to farmers. Subsequently, as a one-time extension, the Government decided to provide additional subvention for the period April 1, 2007 to June 30, 2007 in respect of those farmers/borrowers in the *Vidarbha* region of Maharashtra, who could not pay on the due date, *i.e*. March 31, 2007 but repaid/would repay before June 30, 2007. The extended subvention was for repayment of *Kharif* loans. The Government in the Union Budgets for the years 2007-08 and 2008-09 announced continuation of the 2.0 per cent subvention scheme for short-term crop loans. In December 2008, the Government enhanced the subvention for 2008-09 to 3.0 per cent.

Relief Measures for Poultry Industry

2.53 There were instances of outbreak of avian influenza (bird flu) in some areas of the country during 2007-08. Keeping in view the loss of income suffered on account of culling of birds and the steep fall in prices of poultry products, the Reserve Bank, in February 2008, announced the following relief measures to be extended to all accounts of the poultry industry that were classified as standard accounts as on December 31, 2007: (i) banks were advised to convert the principal and the interest due on working capital loans and instalments and interest on term loans (that were due for payment on/after December 31, 2007 but were unpaid) into term loans and recover such loans over a period of three years with an initial moratorium of up to one year; (ii) the remaining portion of the term loan could be rescheduled, with a moratorium period up to one year, depending upon the cash flow generating capacity of the poultry unit; (iii) the re-schedulement/conversion was to be completed on or before April 30, 2008; and (iv) rescheduled/converted loans were to be treated as current dues, following which the borrower would be eligible for fresh need-based finance.

Recommendations of the Radhakrishna Expert Group on Agricultural Indebtedness

2.54 The Government constituted the Expert Group on Agricultural Indebtedness (Chairman: Dr. R. Radhakrishna), which submitted its report in July 2007. The major issues addressed in the report related to the creation of credit absorption capacities, need for risk mitigation practices, introduction of cyclical credit system, setting up of dispute resolution mechanisms and a debt redemption fund. Consequent to the announcement made in the Mid-term Review for 2007-08, an Internal Working Group (Chairman: Shri V.S. Das) was constituted to examine those recommendations that were relevant to the banking system in general and the Reserve Bank in particular (Box II.3). In pursuance of these recommendations, certain measures were initiated by the Reserve Bank. In August 2008, banks were advised to select one rain-fed district for introduction, on a pilot basis, of a new product for financing crop production whereby: (i) 80 per cent of the crop loan requirement of individual borrowers could be released through a short-term production loan in conformity with the extant norms/practices; and (ii) the remaining 20 per cent representing the 'core component' (expenses for land preparation, pre-sowing operations, *etc.*, besides self-labour/consumption) could be sanctioned as a 'clean credit limit' to ensure year-round liquidity. Banks were also advised to allow drawings in the 'clean credit limit' on the pattern of operations in cash credit/over draft accounts as long as the farmers continued to service the interest. It was specified that the asset classification norms as applicable to non-agricultural cash credit/over draft accounts would apply to the 'clean credit limit'. Further, any re-schedulement of the loans in terms of extant guidelines on relief measures to be provided in the event of natural calamities in the area, would warrant clubbing of balances outstanding in the clean credit account with those in the loan account for re-schedulement and a fresh 'clean credit limit' should be made available to the farmer. Under normal circumstances, the extant guidelines of borrower-wise asset classification would prevail for the new product also, unless specifically dispensed

Box. II.3: Internal Working Group to Examine the Recommendations of the Radhakrishna Expert Group on Agricultural Indebtedness

An Internal Working Group (Chairman: Shri V.S. Das) was constituted to examine the recommendations of the Radhakrishna Expert Group on Agricultural Indebtedness. The Internal Group took a close look at the wide-ranging recommendations made by the Expert Group to address the issue of agricultural indebtedness and agreed with most of them. The Internal Group submitted its report in April 2008 which was placed on the Reserve Bank's website for wider consultation. The following were the major recommendations made by the Internal Group.

(i) The Government of India should prescribe transparent but flexible guidelines for choosing debt stressed districts in future.

(ii) A Steering Committee should be formed under the aegis of the State Level Bankers' Committee (SLBC) for monitoring and periodical review of the relief measures in the event of natural calamities.

(iii) Liquidity constraints in rain-fed areas should be mitigated through the cyclical credit system of treating crop loan as a weather cycle long intervention rather than an annual feature.

(iv) Credit counselling centres should be set up to evolve debt restructuring plans in consultation with banks and borrowers and there should be stricter and more transparent regulation of money lenders.

(v) There should be greater thrust towards providing for the various credit needs of small borrower households as part of financial inclusion.

(vi) Agency and mobile banking should be implemented to serve farmers at their door steps.

(vii) State Governments should enact appropriate legislation to facilitate creation of mortgages.

(viii) The procedures for obtaining loans by the disadvantaged farmers be simplified by allowing them to submit an affidavit explaining their identity and status for loans up to a certain amount (say, Rs.50,000).

(ix) Land records be computerised and tenancy be legalised through appropriate legislations.

with as in the case of restructuring in natural calamities. Rate of interest and periodicity of interest application in respect of 'clean credit limit' would be as applicable to other agricultural advances. Banks were asked to try out the new system in select branches.

Agricultural Debt Waiver and Debt Relief Scheme, 2008

2.55 The Union Budget for 2008-09 announced a scheme of agricultural debt waiver and debt relief for farmers with the total value of overdue loans to be waived then estimated at Rs.50,000 crore and a one-time settlement (OTS) relief on the overdue loans estimated at Rs.10,000 crore. The modalities of the debt waiver scheme were finalised by the Government in consultation with the Reserve Bank and the National Bank for Agriculture and Rural Development (NABARD) and were notified on May 23, 2008. The scheme covers direct agricultural loans extended to 'marginal and small farmers' and 'other farmers' by SCBs, RRBs, co-operative credit institutions and local area banks. The Reserve Bank advised all banks to complete implementation of the scheme by June 30, 2008, while NABARD issued similar guidelines to RRBs and co-operatives.

2.56 The eligibility for debt waiver was short-term production loans (the loan amount and the applicable interest) and investment loans (overdue instalments and the applicable interest on such instalments): (a) disbursed up to March 31, 2007 and overdue as on December 31, 2007 and remaining unpaid until February 29, 2008; (b) restructured and rescheduled by banks in 2004 and 2006 through the special packages announced by the Central Government, whether overdue or not; and (c) restructured and rescheduled in the normal course up to March 31, 2007 on account of natural calamities, as per applicable Reserve Bank's guidelines, whether overdue or not.

2.57 The entire 'eligible amount' was to be waived in the case of a small or marginal farmer. In the case of 'other farmers', there was to be a OTS under which the farmer was given a waiver of 25 per cent of the 'eligible amount', subject to the condition that the farmer repays the balance of 75 per cent of the 'eligible amount' in three instalments, *viz.*, September 2008, March 2009 and June 2009. In the case of 237 revenue districts covering Drought Prone Area Programme, Desert Development Programme and the Prime Minister's Special Relief Package districts (listed in Annex-1 of the Scheme), 'other farmers' would be given OTS rebate of 25 per cent of the eligible amount or Rs.20,000, whichever was higher, subject to the condition that the farmer paid the balance of the eligible amount. Further, a farmer classified as 'small or marginal farmer' would be eligible for fresh agricultural loans pursuant to waiver of the eligible amount. In the case of a short-term production loan, the 'other farmer' would be eligible for fresh short-term production loan upon paying one-third of his share. In the case of an investment loan (for direct agricultural activities or allied activities), the 'other farmer' will be eligible for fresh investment loan upon paying his share in full. The Government would reimburse, through the Reserve Bank/NABARD, the lending institutions for the waiving off of the prescribed amounts of the 'small and marginal farmers' and 'other farmers' dues, respectively. The reimbursements would be made in instalments on the basis of duly certified and audited claims submitted through the respective nodal agencies. The Government has also decided to pay interest on the second, third and fourth instalments at the prevailing yield-to-maturity rate on 364 day Government of India Treasury Bills. The interest will be paid from the date of reimbursement of the first instalment till the date of actual reimbursement.

2.58 With a view to ensuring adequate financing of agricultural operations by banks, the Reserve Bank decided to provide temporary liquidity support to RRBs and co-operatives (through NABARD) and scheduled banks to the tune of Rs.17,500 crore (the limit of liquidity support made available to NABARD was revised to Rs.2,500 crore with effect from December 6, 2008) and Rs.7,500 crore, respectively. The limits in this regard are related to the quantum of debt waived by banks under the Agricultural Debt Waiver and Debt Relief Scheme. The liquidity support was provided to scheduled banks and NABARD under Section 17 (3-B) and Section 17 (4-E), respectively, of the RBI Act 1934. The facility would bear interest at the prevailing fixed repo rate under the LAF and would be repayable not later than December 15, 2008.

Credit to Micro, Small and Medium Enterprises (MSMEs) Sector

2.59 MSMEs are crucial to economic development as they further the objectives of employment generation, equitable distribution of national income, regional dispersal of industries, mobilisation of capital and entrepreneurial skills and enhancement of export earnings. MSMEs produce a wide range of products, from simple consumer goods to high precision tools and sophisticated high-end products. To ease the difficulties faced by small manufacturing and services enterprises in accessing credit, the Code of Banks' Commitment to MSEs was formulated (Box II.4).

2.60 The SLBCs were advised in May 2008 to apprise all their members about the Government of India's decision to continue the credit linked capital subsidy scheme (CLCSS) for technology upgradation of MSEs during the Eleventh Five Year Plan (2007-12), subject to the following terms and conditions: (a) ceiling on the loan under the scheme would be Rs.1 crore; (b) the rate of subsidy would be 15 per cent for all MSE units up to the loan ceiling at (a) above; (c) calculation of admissible subsidy to be done with reference to the purchase price of plant and machinery instead of the term loan disbursed to the beneficiary unit; and (d) SIDBI and NABARD to continue as the implementing agencies for the scheme.

Working Group on Rehabilitation of Sick SMEs

2.61 The Standing Advisory Committee on Flow of Institutional Credit to the MSME Sector had observed in January 2007 that there was considerable delay in rehabilitation/ nursing of the potentially viable units, mainly on account of the inability of the promoters to bring in additional contribution. A Working

Box II.4: Formulation of "Banking Code for MSE Customers"

The Banking Codes and Standards Board of India (BCSBI) constituted a Working Group comprising members from select banks, Indian Banks' Association (IBA) and the Reserve Bank to formulate a Banking Code for MSE customers. The Working Group finalised the code on March 11, 2008 pursuant to discussions with industry associations, banks, SIDBI and Government agencies. The Code was released by the Union Finance Minister on May 31, 2008. It is a voluntary code, reflecting banks' positive commitment to their MSE customers to provide easy, speedy and transparent access to banking services in their day-to-day operations and in times of financial difficulty. The following are the main objectives of the voluntary code.

(a) To give a positive thrust to the MSE sector by providing easy access to efficient banking services.

(b) To promote good and fair banking practices by setting minimum standards in dealing with MSE customers.

(c) To increase transparency so that MSEs have a better understanding of what to expect from the banking services offered.

(d) To improve banks' understanding of MSE business through effective communication.

(e) To encourage market forces, through competition, to achieve higher operating standards.

(f) To promote a fair and cordial relationship between MSEs and banks and also to ensure timely and quick response to MSEs' banking needs.

(g) To foster confidence in the banking system.

Group (Chairman: Dr. K.C. Chakrabarty) was, therefore, constituted to look into the issues and suggest remedial measures so that the potentially viable sick units could be rehabilitated at the earliest. The Group submitted its report in April 2008 which was placed on the Reserve Bank's website. Based on the comments received, detailed guidelines on rehabilitation of potentially viable sick SME units would be issued to banks shortly (Box II.5).

Conditions of Work and Promotion of Livelihoods in the Unorganised Sector

2.62 The Government had constituted a National Commission for Enterprises in the Unorganised Sector (NCEUS) (Chairman: Dr. Arjun K. Sengupta) in September 2004. The NCEUS submitted a Report on the "Conditions of Work and Promotion of Livelihoods in the Unorganised Sector" in August 2007, suggesting a package of measures for addressing some of the critical issues relating to farm and non-farm sectors. Consequent to the announcement made in the Mid-term Review for 2007-08, an Internal Working Group was constituted to study the recommendations of the Sengupta Committee Report that were relevant to the financial system and to suggest an appropriate action plan for implementation of the acceptable recommendations. The report of the Group was placed on the Reserve Bank's website for wider dissemination (Box II.6).

Financing of Infrastructure by Banks and Financial Institutions

2.63 In November 2007, the Reserve Bank expanded the scope of the definition of infrastructure lending to include credit facilities sanctioned by banks and select all-India financial institutions (AIFIs) for projects involving laying down and/or maintenance of gas/crude oil/petroleum pipelines, in view of the importance of pipelines in the industrial development of the country. With a view to encouraging the flow of credit to the infrastructure sector, in December 2007, banks were advised that they could invest in unrated bonds of companies engaged in infrastructure activities within the ceiling of 10 per cent for unlisted non-SLR securities.

4. Financial Inclusion

2.64 Financial inclusion is delivery of financial services, at an affordable cost, to the vast sections of disadvantaged/low-income groups who tend to be excluded from the formal financial system. Notwithstanding the widespread expansion of the banking sector during the last three decades, a sizeable proportion of the households, especially in rural areas, remains outside the coverage of the formal banking system. An important step to bring the financially excluded people within the fold of the formal financial sector was the promotion of micro finance in India (detailed in Chapter V). The SHG-bank linkage programme was launched by NABARD in 1992, with policy support from the Reserve Bank to facilitate collective decision making by the poor and provide 'door step' banking. The term 'financial inclusion' was explicitly used for the first time in the Annual Policy Statement for 2005-06. It indicated that the Reserve Bank would: (a) implement policies to encourage banks that provided extensive services, while disincentivising those which were not responsive to the banking needs of the community, including the underprivileged; (b) the nature, scope and cost of services would be monitored to assess whether there was any denial of basic banking services to the common person; and (c) banks were urged to review their existing practices to align them with the objective of financial inclusion. The Reserve Bank's broad approach to financial inclusion is to 'connect' people with the

Box II.5: Working Group on Rehabilitation of Sick SMEs – Major Recommendations

A Working Group (Chairman: Dr. K.C. Chakrabarty) was constituted to suggest measures for improving the credit flow to the SME sector as well as early implementation of rehabilitation/nursing of sick SME units by examining feasibility of bringing in additional capital through alternative routes, such as equity participation and venture financing. The Group held wide ranging discussions with the stakeholders, namely, industry associations, banks and Government agencies. The Group made several suggestions as set out below:

(i) A simplified application *cum* sanction form (printed in the regional language as well) should be introduced for sanction of loans up to Rs.1 crore to all micro enterprises.

(ii) A current ratio of 1.25 should be acceptable in the accounts where bank finance was provided under the Nayak Committee norms.

(iii) The rate of interest on loans should be completely deregulated and should be determined by the lenders based on the competitive market forces.

(iv) The banks may be encouraged to accept inter-changeability of margin and collateral so as to enable the borrowers with poor liquidity to provide additional collateral without inducting funds and the banks could accordingly reduce the margin. The Reserve Bank could consider raising the limit of compulsorily collateral free loans from Rs.5 lakh to Rs.10 lakh incentivised by 80 per cent coverage under the Credit Guarantee Trust for Micro and Small Enterprises (CGTMSE).

(v) Banks that had sanctioned term loan singly or jointly must also sanction working capital limit singly (or jointly, in the ratio of the term loan) to avoid delay in commencement of commercial production of the MSME.

(vi) Banks could focus on opening more specialised MSME branches, while RRBs and co-operative banks could be asked to undertake more MSME financing.

(vii) Banks could consider sanctioning 50 per cent of the working capital as post sales limit. Cash credit (book debt) could be provided at a lower margin of say not more than 30 per cent. Margin could be reduced in the case of bill discounting/factoring also.

(viii) A Rehabilitation Fund, with a corpus of Rs.1,000 crore, should be created as many sick units could not be rehabilitated due to non-availability of promoters' contribution.

(ix) A Marketing Development Fund to provide, *inter alia*, financial assistance to MSMEs in setting up distribution and marketing infrastructure/outlets should be set up.

(x) The State Governments should be directed by the Government of India to provide a one-time financial support for recapitalisation of the viable State Financial Corporations (SFCs) while the unviable SFCs should be wound up with the State Governments settling their creditors/lenders.

(xi) Banks should finance, on an average, at least 10 MSME accounts per semi-urban/urban branch per year.

(xii) Small finance banks could be set up, as suggested by the Raghuram Rajan Committee, to reach out to the poorer sections and MSMEs.

(xiii) Enterprise Development Centres (EDCs) could be set up by the stakeholders for providing comprehensive guidance and training for setting up of new units and provide continuing education on different aspects of successful management of existing business enterprises. The Government may provide grant up to Rs.2.5 crore, which should not be more than 50 per cent of the cost of setting up an EDC, as against the present provision of Rs.1 crore.

(xiv) State Governments should have separate department for MSMEs as also short and long term policies for development/promotion of the MSME sector.

(xv) The incidence of sickness in small enterprises is double of that prevailing in the banking system as a whole. This makes the lenders averse to lending to the sector. Thus, the risk coverage under CGTMSE could be raised to 80 per cent for all micro enterprises without charge of guarantee fees, while the credit guarantee coverage offered could be raised from Rs.50 lakh to Rs.1 crore.

(xvi) Banks should set up credit counselling centres (whether singly or jointly with other banks or with large corporates) exclusively for MSMEs in major industrial towns/clusters.

(xvii) A micro or small enterprise (as defined in the MSMED Act, 2006) could be defined as sick, if any of the borrowal account of the enterprise remained a non-performing asset (NPA) for three months or more, or, accumulated losses led to a 50 per cent erosion of its net worth. Also, the existing stipulation for the unit to have been in commercial production for at least two years should be removed in order to enable banks to rehabilitate units where there was a delay in commencement of commercial production and a resultant need for handholding due to time/cost overruns.

(xviii) The rehabilitation process should start at the point of incipient sickness which is defined as any of the following: (a) delay in commencement of commercial production by more than six months for reasons beyond the control of promoters and entailing cost overrun; (b) incurrence of losses for two years or cash loss for one year, beyond the accepted timeframe on account of change in economic and fiscal policies affecting the working of MSMEs or otherwise; and (c) capacity utilisation at less than 50 per cent of the projected level in terms of quantity or sales at less than 50 per cent of the projected level in terms of value during a year.

Box II.6: Internal Working Group to Study the Recommendations of the Report on Conditions of Work and Promotion of Livelihoods in the Unorganised Sector (Arjun K. Sengupta Committee)

The Internal Working Group (IWG) (Chairman: Shri K.U.B. Rao) was constituted in November 2007 by the Reserve Bank to examine and suggest a way forward for implementation of the recommendations of the NCEUS Report on Conditions of Work and Promotion of Livelihoods in the Unorganised Sector. The IWG submitted its Report in May 2008 which was put on the Reserve Bank's website for wider dissemination and consultation. The main recommendations of the Group are set out below:

(i) The NCEUS had recommended that a sub-target of 12 per cent (out of the total priority sector lending allocation of 40 per cent) should be set for the socio-economically weaker sections. The IWG suggested that the Reserve Bank should evolve a system of disincentives for banks that failed to reach the existent sub-target of 10 per cent for lending to weaker sections.

(ii) The IWG concurred with the NCEUS recommendation that all lending through general credit cards (GCCs) should be treated as indirect finance to agriculture or other priority sectors.

(iii) The NCEUS had recommended an explicit target of 10 per cent for lending to small and micro enterprises and a sub-target of 4 per cent for lending to micro enterprises with capital investment (other than land and building) up to Rs.5 lakh. It also recommended enhancing the sub-target to 8 per cent of the net bank credit over a five year period. The IWG, however, was of the view that setting an explicit target of 10 per cent could further discourage the flow of credit. The extant guidelines that required banks to set a self-target for lending to the SME sector with an increase of 20 per cent each year and to ensure that 60 per cent of loans for SMEs went to micro enterprises, were found to be adequate.

(iv) The IWG supported the NCEUS' recommendation that the subsidy component of *Swarnjayanti Gram Swarozgar Yojana* (SGSY) be pooled into the funds made available under the programme for creating capacity, infrastructure and backward/forward linkages.

(v) The IWG agreed with the NCEUS' recommendation for issue of multi-purpose *Swarozgar* Credit Cards for the self-employed persons in the non-farm unorganised sector.

(vi) The NCEUS had recommended that the Government should set up a Credit Guarantee Fund (CGF) in NABARD, on the lines of the CGF set up by the Ministry of MSME, which provided guarantee cover on loans to small units. The IWG drew attention to the alternative proposal that had been mooted by the Reserve Bank to offer a credit guarantee scheme to distressed farmers through the Deposit Insurance and Credit Guarantee Corporation. It also indicated that the earlier experience with credit guarantee schemes suggested that excessive guarantee coverage could lead to moral hazard. Besides, banks could become lethargic and complacent while undertaking credit assessment.

(vii) The NCEUS recommended rationalisation and reduction in the cost of credit to MSMEs by controlling the rate of interest which needed to be governed by the overall cost and not specifically by the cost of advancing small loans alone. The IWG opined that it would not be appropriate to control interest rates for reducing the cost of funds. The Group, therefore, suggested that credit record bureaus and credit information companies should be quickly established so that data were available to banks to enable them to price credit according to risk. The establishment of credit information bureaus and the improvement in risk assessment was expected to reduce the transaction costs leading to a decrease in interest rates.

banking system and not just to dispense credit. The objective is to provide people with access to payment systems and establish financial inclusion as a viable business model and opportunity. The measures initiated by the Reserve Bank to bring the hitherto financially excluded population into the fold of the formal financial system include introduction of 'no-frills' accounts, promotion of financial literacy and responsible borrowing and encouraging adoption of Information and Communication Technology (ICT) solutions for achieving greater outreach as also reducing transaction costs.

2.65 Pursuant to the announcement in the Union Budget for 2008-09, in April 2008, the Reserve Bank advised all SCBs to adopt the concept of *total financial inclusion* by meeting the entire credit requirements (income generation activities, social needs such as housing, education, marriage, *etc.*, and debt swapping) of SHG members.

'No-Frills' Accounts

2.66 As announced in the Annual Policy Statement for the year 2008-09, and in order to give further impetus to financial inclusion, banks were advised in May 2008 to classify overdrafts up to Rs.25,000 (per account) granted against 'no-frills' accounts in the rural and semi-urban areas as indirect finance to the agriculture sector under the priority sector with immediate effect. 'No-frills' accounts (accounts with low or nil minimum balances as well as charges) were introduced in November 2005 to expand the outreach of banking services to vast sections of the population. To ensure that persons belonging to low income groups, both in urban and rural areas, did not encounter difficulties in opening bank accounts, the KYC norms for opening accounts with balances not exceeding Rs.50,000 and credits thereto not exceeding Rs.1,00,000 in a year, were also simplified. The simplified procedure allowed customers on whom the full KYC drill had been followed, to introduce new customers.

General-purpose Credit Cards

2.67 In December 2005, all SCBs, including RRBs, were advised to introduce a GCC scheme for their constituents in rural and semi-urban areas with a view to providing them with credit card like facilities with limited point-of-sale (POS) and automated teller machine (ATM) facilities. The GCCs could be issued based on the assessment of income and cash flow of the household as is done for normal credit cards. In May 2008, banks were advised to classify 100 per cent of the credit outstanding under the GCCs as indirect finance to agriculture sector under the priority sector as against the earlier limit of 50 per cent of the credit outstanding.

Pilot Project for 100 per cent Financial Inclusion

2.68 The convenor banks of the State Level/ Union Territory Level Bankers' Committees (SLBC/UTLBC) in all States/Union Territories were advised in April 2006 to identify at least one suitable district in their respective jurisdiction for achieving 100 per cent financial inclusion by providing 'no-frills' accounts and issue of GCCs and gradually extending the endeavour to other areas/ districts. The SLBCs/UTLBCs were further advised to allocate villages to various banks operating in the State for taking the responsibility of ensuring 100 per cent financial inclusion and also to monitor financial inclusion in the meetings of the SLBC/UTLBC from September 2006 onwards. 342 districts have been identified for 100 per cent financial inclusion so far and the target reported to be achieved in 155 districts in 19 States and six Union Territories with Haryana, Himachal Pradesh, Karnataka, Kerala, Uttarakhand, Puducherry, Daman and Diu, Dadra and Nagar Haveli, Goa and Lakshdweep reporting achievement of 100 per cent financial inclusion in all districts.

2.69 The Reserve Bank undertook an evaluation, through external agencies, of the progress made in achieving 100 per cent financial inclusion in 26 districts that had reported success. The studies revealed that although several districts had been declared as 100 per cent financially included, the actual financial inclusion had not been to the extent. Further, several accounts that were opened as a part of the financial inclusion drive, remained inoperative due to various reasons. Based on the findings of the studies, feedback would be provided to banks to make the process of financial inclusion more effective.

Use of Intermediaries as Agents

2.70 Pursuant to the announcement in the Union Budget for 2008-09, banks were permitted to engage retired bank employees, ex-servicemen and retired government employees as business correspondents (BCs) with effect from April 24, 2008, in addition to the entities already permitted, subject to appropriate due diligence. The individuals appointed as BCs should be permanent residents of those respective areas. Every BC was to be under the oversight of a specific