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Monetary and Credit Information Review

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Financial Inclusion and Development

Priority Sector Lending – Targets and Classification

The Reserve Bank on March 1, 2018, decided that the sub-target of eight per cent of Adjusted Net Bank Credit (ANBC) or Credit Equivalent Amount of Off-Balance Sheet Exposure (CEOBE), whichever is higher, shall become applicable for the foreign banks with 20 branches and above, for lending to the small and marginal farmers from financial year (FY) 2018-19. Further, the sub-target of 7.50 per cent of ANBC or CEOBE, whichever is higher, for bank lending to the micro enterprises shall also become applicable for the foreign banks with 20 branches and above from FY 2018-19.

Additionally, in the light of feedback received from various stakeholders and in line with the increasing importance of services sector in the economy, the Reserve Bank decided to remove the currently applicable loan limits of ₹ 5 crore and ₹ 10 crore per borrower to micro/ small and medium enterprises (services), respectively, for classification under priority sector. Accordingly, all bank loans to MSMEs, engaged in providing or rendering of services as defined in terms of investment in equipment under Micro, Small and Medium Enterprises Development (MSMED) Act, 2006, shall qualify under the priority sector without any credit cap.

Background

It was stipulated earlier that the sub-targets for lending to small and marginal farmers and micro enterprises shall be made applicable for foreign banks with 20 branches and above, post 2018 after a review in 2017. (https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11223&Mode=0)

Currency Management

Review of Currency Distribution & Exchange Scheme

The Reserve Bank on March 1, 2018 decided to withdraw the incentives which was being given to the banks for installation of Cash Recyclers and Automated Teller Machine (ATMs) dispensing only lower denomination notes.

Background

The Reserve Bank has been providing several incentives to banks, from time to time for installation of various machines by them to encourage technology absorption in their currency operations for improved customer service. It is observed that the objectives of the scheme have largely been achieved. (https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11224&Mode=0)

Foreign Exchange Management

Hedging of Commodity Price Risk and Freight Risk

The Reserve Bank on March 12, 2018 decided that residents hedging their commodity price risk and freight risk under a specific approval from the Reserve Bank given under the approval route based on the previous set of guidelines, would be permitted to continue hedging till June 30, 2018 or the last date specified in the approval, whichever is earlier.

Background

The Reserve Bank had earlier constituted a Working Group to review the guidelines for Hedging of Commodity Price Risk by Residents in overseas markets (Chairman: Shri Chandan Sinha). Based on the report of the working group and comments received on the report, draft directions for hedging of commodity price risk and freight risk were released for comments on January 12, 2018. On the basis of the feedback received, the Hedging of Commodity Price Risk and Freight Risk in Overseas Markets (Reserve Bank) Directions, 2018 has been finalised. (https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11226&Mode=0)

Discontinuance of LoUs and LoCs for Trade Credits

The Reserve Bank on March 13, 2018 decided to discontinue the practice of issuance of Letters of Undertaking (LoUs) and Letters of Comfort (LoCs) for Trade Credits for imports into India by AD Category – I banks with immediate effect. (https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11227&Mode=0)

Separate Limit of IRFs and FPIs

To facilitate further market development and to ensure that access of Foreign Portfolio Investors (FPIs) to Interest Rate Futures (IRFs) remains uninterrupted, the Reserve Bank on March 1, 2018, decided to allocate FPIs a separate limit of ₹ 5,000 crore for long position in IRFs. Accordingly, the directions have been amended as follows:

“Foreign Portfolio Investors, registered with Securities and Exchange Board of India, are permitted to purchase or sell Interest Rate Futures subject to the following conditions:

- the aggregate long position of all FPIs, each of whom has a net long position in any IRF instrument, shall not exceed ₹ 5,000 crore, aggregated across all IRF instruments, and
- the total gross short (sold) position of any Foreign Portfolio

Investor shall not exceed its consolidated long position in Government Securities (G-secs) and Interest Rate Futures, at any point in time".

The limits prescribed for investment by FPIs in G-secs (currently ₹ 3,01,500 crore) will be exclusively available for investment in G-secs. All other terms and conditions of the extant IRF directions will remain unchanged.

Background

Currently, the FPI limit for G-secs is fungible between investments in G-secs and investment in IRF. FPI long positions in IRF are not allowed on G-sec limit utilisation reaching 90 per cent. (https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11225&Mode=0)

Non - Banking Supervision

Returns by the Government-owned NBFCs

The Reserve Bank on March 15, 2018, decided that all Government - owned Non - Banking Financial Companies (NBFCs) would put in place a reporting system for filing periodic returns with the Reserve Bank. The returns should be compiled on the basis of the numbers available in the books of accounts of such NBFCs and filed with the Reserve Bank on-line (using the COSMOS software package) by an authorised official of the NBFC, who shall be specifically authorised in this regard by the Board of Directors of the concerned NBFC. (https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11229&Mode=0)

Government and Bank Accounts

Reporting of Central Government Transactions

The Reserve Bank in consultation with the Government of India on March 19, 2018, decided that the date of closure of residual transactions for the month of March 2018 be fixed as April 10, 2018 for the financial year 2017-18. In view of the ensuing closing of Government accounts for the financial year 2017-18, receiving branches including those not situated locally, should adopt special arrangements, such as, courier service, for passing on challans/scrolls, to the nodal/focal point branches so that all payments and collections made on behalf of the Government towards the end of March, are accounted for in the same financial year.

As regards reporting of March 2018 transactions by nodal/focal point branches in April, the branches may be advised to follow the procedure, as prescribed. To sum up, the nodal/focal point branches will be required to prepare separate sets of scrolls, one pertaining to March residual transactions and another for April transactions during the first 10 days of April 2018. The nodal/focal point branches should also ensure that the accounts for all transactions (revenues/tax collections/payments) are effected at the receiving branches up to March 31, 2018 in the accounts for the current financial year itself and are not mixed up with the transactions of April 2018. Also, while reporting transactions pertaining to March 2018 up to April 10, 2018, the transactions of April 2018 should not be mixed up with the residual transactions relating to March 2018. (https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11230&Mode=0)

Banking Regulation

Sectoral Deployment of Bank Credit

The Reserve Bank on February 28, 2018 placed on its website (www.rbi.org.in) the data on sectoral deployment of bank credit collected from select 41 scheduled commercial banks, accounting for about 90 per cent of the total non-food credit deployed by all scheduled commercial banks, for the month of January 2018.

Mint Street Memo

Working Capital Constraints and Exports: Evidence from the GST Rollout

The Reserve Bank on February 12, 2018 uploaded on the RBI website the tenth release in the series of Mint Street Memo on 'Working Capital Constraints and Exports: Evidence from the GST Rollout' by Shekhar Tomar, Sankalp Mathur and Saurabh Ghosh.

The memo deliberated on the implementation and refund delays under the new tax regime of Goods and Services Tax (GST) that seem to have led to working capital constraints for firms, which in turn might have hurt their exports in October 2017. It provides evidence supporting this hypothesis using sectoral data on exports and finds that the sectors that have high working capital requirements took the maximum hit during this period. However, various initiatives by the Government of India since then appeared to have significantly alleviated exporters' concerns which got reflected in the exports growth pick up in November and December 2017.

The Rebound

Post dismal performance of exports in October, November 2017 exhibited a whopping 30.55 per cent growth. This is one of the highest growth rates observed in the exports in the last two years. There are two possible reasons for this export rebound: (i) fast-tracking of GST refunds and exports sops and (ii) lower base of export growth in November 2016.

Conclusion

This study indicates how a short term liquidity shock could impact firms in the export sector, which are generally believed to be financially sound. The paper concluded that the export contributing sectors with high working capital/ sales ratio were hit the most due to these liquidity constraints. It is also corroborated by the various measures adopted by the government during November to address the concerns of the exporters. Finally, the exports rebound in November 2017 suggests that quick measures partly addressed the temporary credit constraints faced by the exporters during October 2017. (https://www.rbi.org.in/Scripts/MSM_Mintstreetmemos10.aspx)

Speech

Banking Regulatory Powers Should Be Ownership Neutral : RBI Governor

Dr Urjit R. Patel, Governor, Reserve Bank of India, in the Inaugural Lecture at Gujarat National Law University, Gandhinagar on March 14, 2018, deliberated on the topic 'Banking Regulatory Powers Should Be Ownership Neutral'.

Highlighting some fundamental fissures that exist in the regulation of banks, in particular, public sector banks (PSBs) in the context of the recent fraud in the Indian banking sector, the Governor stated that –"Success has many fathers; failures none. Hence, there has been the usual blame game, passing the buck, and a tonne of honking, mostly short-term and knee-jerk reactions. These appear to have prevented the participants in this cacophony from deep reflection and soul searching that can help solve fundamental issues that are the root cause of such frauds and related irregularities in the banking sector, which are infact far too regular."

The Governor, in his speech, cited the observations made by the International Monetary Fund (IMF) and the World Bank (WB) in the publicly released FSSA (Financial System Stability Assessment) Report, on banking supervision, especially the comprehensive and forward-looking Supervisory Programme through SPARC, by the Reserve Bank of India.

However, the Governor also stated that the 2017 Financial Sector Assessment Programme (FSAP) for India lamented at several points the fact that the Reserve Bank's regulatory powers over banks are not neutral to bank ownership. Referring to the Detailed Assessment Report (DAR) on the Basic Core Principles (BCP) on the Effective Banking Supervision, the Governor cited the observations in DAR – "The Reserve Bank's legal powers to supervise and regulate PSBs are also constrained – it cannot remove PSB directors or management, who are appointed by the Government of India (GoI), nor can it force a merger or trigger the liquidation of a PSB; it (Reserve Bank) has also limited legal authority to hold PSB Boards accountable regarding strategic direction, risk profiles, assessment of management, and compensation. Legal reforms are thus highly desirable to empower the RBI to fully exercise the same responsibilities for PSBs as now apply to private banks, and to ensure a level playing field in supervisory enforcement." On Corporate Governance, the Report observed that "Under the law and according to the custom, the RBI cannot hold PSB Boards accountable for assessing and - when necessary - replacing weak and nonperforming senior management and government – appointed Board members".

Banking Regulatory Powers in India are not Ownership Neutral

Elaborating on the Reserve Bank's powers on corporate governance at public sector banks, the Governor said that:

- The Reserve Bank cannot remove directors and management at PSBs as Banking Regulation (BR) Act is not applicable to the PSBs.
- BR Act provisions for supersession of a Bank Board is not applicable in the case of PSBs (and regional rural banks or RRBs) as they are not banking companies registered under the Companies Act.
- BR Act provisions for removal of the Chairman and Managing Director (MD) of a banking company is not applicable in the case of PSBs.
- The Reserve Bank cannot force a merger in the case of PSBs as per Section 45 of the BR Act.
- PSB's banking activity does not require license from the Reserve Bank under BR Act; hence, the Reserve Bank cannot revoke the license under BR Act as it can in the case of private sector banks.
- The Reserve Bank cannot trigger liquidation of PSBs under the BR Act.
- Furthermore, in a remarkable exception of sorts, in some cases there is duality of Managing Director and the Chairman – they are the same – implying the MD is primarily answerable only to himself or herself.

The Governor highlighted that this legislative reality has in effect led to a deep fissure in the landscape of banking regulatory terrain: a system of dual regulation, by the Finance Ministry in addition to the Reserve Bank. This fissure or the fault line is bound to lead to tremors, such as, the most recent fraud.

Temptation to engage in fraud at the level of employee or employees is always present, in banks (or in corporations), be it in public sector or private sector. The question then is whether there is adequate deterrence faced by employees from undertaking frauds and enough incentives for management to put in place preventive measures to pre-empt frauds. To induce discipline against frauds in case of banks, the Governor advocated for three potentially powerful mechanisms, namely, (i) *Investigative/vigilance/legal deterrence* through criminal investigation of frauds and attached penalties; (ii) *Market discipline* by putting in place governance mechanisms to prevent or reduce the incidence of fraud and/or hold larger buffers in the capital structure to bear losses when fraud materialises; and (iii) *Regulatory discipline* through detection and punishment by the regulator.

Highlighting the RBI's standpoint, the Governor stated that *"Legislative changes to the BR Act that make our banking regulatory powers fully ownership neutral-not piecemeal, but fully-is a minimum requirement. It might also be the most readily feasible of these options."*

No Banking Regulator Can Catch or Prevent All Frauds

Emphasising that it is simply infeasible for a banking regulator to be in every nook and corner of banking activity to rule out frauds by "being there", the Governor stated- "What is needed is that various mechanisms to deter frauds and other irregularities are in place and have bite so that fraud incidence is low and magnitudes contained. Indeed, frauds have happened at banks in regimes with varied levels of banking regulatory quality and in both public and private banks." Referring to the recent case of fraud, the Governor said that the Reserve Bank had earlier identified, based on cyber risk considerations, the exact source of operational hazard and accordingly issued precise instructions via three circulars in 2016 to enable banks to eliminate the hazard and the bank had not worked on the instructions.

Need to Refocus on the Bigger Issue of Stressed Assets Resolution

The Governor also took the opportunity to highlight and draw the attention towards the need to refocus on the bigger issue of stressed assets resolution, in his inaugural speech. In this context, the Governor also presented and clarified the rationale behind RBI's revised framework for prompt recognition and resolution of stressed assets and highlighted the salient features of the revised framework. Emphasising the importance of stressed assets resolution, the Governor said the Reserve Bank believes that this is precisely the fundamental reform needed in order to strengthen the credit culture at origination, default, asset quality recognition and resolution stages. By so doing, it should weaken in the first place, opportunities for engaging in frauds relating to loan advances.

Concluding Remarks

The Governor, in his concluding remarks, outlined the steps taken by the Reserve Bank for cleaning up the credit culture of the country – in particular, the comprehensive regulatory overhaul announced by the Reserve Bank on February 12, 2018 for prompt recognition and resolution of NPAs at banks – as the *Mandara* mount or the churning rod in the *Amrit Manthan* or the *Samudra Manthan* of the modern day Indian economy. "Until the churn is complete and the nectar of stability safely secured for the country's future, someone must consume the poison that emanates along the way", the Governor said and further added that "If the Reserve Bank needs to face the brickbats and be the *Neelakantha* consuming this poison, it will do so as our duty; it will persist with its endeavours and get better with each trial and tribulation along the way." He hoped that more promoters and banks, individually – or collectively through their industry bodies, would reconsider being on the side of Devas rather than Asuras in this *Amrit Manthan*.

The Governor concluded his speech with an appeal to the Government, the owner of public sector banks, to consider making important contributions by:

(i) Making banking regulatory powers neutral to bank ownership and leveling the playing field between public sector and private sector banks; and

(ii) Informing itself about what to do with the public sector banking system going forward as part of optimising over the best use of scarce national fiscal resources.

For designing and implementing governance of banking franchise, the Governor opined that restoration of regulatory and market discipline might be more effective than the centralised government control over the banks. These, and other structural reforms in the banking sector, would enable India to grow sustainably at respectable rates, the Governor concluded.(https://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1054)

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Sd/-
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Working Paper

Non-Linear, Asymmetric and Time-Varying Exchange Rate Pass-Through

The Reserve Bank on March 13, 2018 placed on its website a Working Paper titled "Non-Linear, Asymmetric and Time-Varying Exchange Rate Pass-Through: Recent Evidence from India" under the Reserve Bank of India Working Paper Series. The Paper is co-authored by Michael Debabrata Patra, Jeevan Kumar Khundrakpam and Joice John.

Exchange rate pass-through (ERPT) to consumer prices matters for the conduct of monetary policy as it informs the policy maker about the extent to which the domestic inflation is hostage to imported influences. Exploring nonlinearities and time variations over the period from April 2005 to March 2016, the paper finds that ERPT in India was rising until 2014 but it has been declining since then, reflecting the ebbing of inflation and exchange rate volatility under the flexible inflation targeting framework adopted de facto since 2015 and de jure since 2016. Structural changes in the degree of openness and commodity price shifts are other influential factors determining the size of ERPT in India. The policy implications of non-linear and time-varying ERPT are examined in macroeconomic general equilibrium framework and the results indicate that monetary policy transmission is strongest during periods of small depreciations. However, the transmission of these exchange rate changes to domestic inflation would be strong too, sharpening the impossible dilemma. (https://rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=43364)

Edited and published by Jose J. Kattoor for the **Reserve Bank of India**, Department of Communication, Central Office, Shahid Bhagat Singh Marg, Mumbai - 400 001. **MCIR can be accessed at https://mcir.rbi.org.in**