*Second Quarter Review of Monetary Policy 2010-11**

Introduction

This Second Quarter Review is set in the context of a mixed backdrop of persistent sluggishness in advanced economies and positive signals from emerging market economies (EMEs). While recovery in advanced economies has slowed in the second half of 2010, EMEs continue to show strong growth. The fragile and uneven nature of the recovery and large unemployment in advanced economies raise concerns about the sustainability of the global recovery, which has prompted the International Monetary Fund (IMF) to project a lower world GDP growth of 4.2 per cent in 2011 as compared with 4.8 per cent in 2010.

2. The rising concerns about the slowing momentum of recovery have prompted the central banks of some advanced economies to initiate (or consider initiating) a second round of quantitative easing to further stimulate private demand. While the ultra loose monetary policy of advanced economies may benefit the global economy in the medium-term, in the short-term it will trigger further capital inflows into EMEs and put upward pressure on global commodity prices.

3. On the domestic front, economic activity is firmly in place. The 8.8 per cent GDP growth for Q1 of 2010-11 suggests that the economy is operating close to the trend growth rate, driven mainly by domestic factors. The South-West monsoon was normal which should boost agricultural output and rural demand. Most industrial and service sector indicators also point towards sustained growth.

* Announced by Dr. Duvvuri Subbarao, Governor, Reserve Bank of India on November 2, 2010 in Mumbai.

4. Notwithstanding some moderation in recent months, headline inflation remains significantly above its medium-term trend. What is of concern is that while non-food manufactured products inflation has stabilised, food inflation has not shown the expected post-monsoon moderation. Persistently rising food prices even in the wake of a normal monsoon raise concerns about the structural nature of food inflation and its consequent impact on inflationary expectations. Further, when the economy is growing close to trend, the risks of structural food inflation spilling over into prices of other commodities are significant and that could potentially offset the recent moderation.

5. This statement is organised in two parts. Part A covers Monetary Policy and is divided into four sections: Section I provides an overview of global and domestic macroeconomic developments; Section II sets out the outlook and projections for growth, inflation and monetary aggregates; Section III explains the stance of monetary policy; and Section IV specifies the monetary measures. Part B covers Developmental and Regulatory Policies and is organised in six sections: *Financial Stability* (Section I), *Interest Rate Policy* (Section II), *Financial Markets* (Section III), *Credit Delivery and Financial Inclusion* (Section IV), *Regulatory and Supervisory Measures for Commercial Banks* (Section V) *and Institutional Developments* (Section VI). Part A of this statement should be read and understood together with the detailed review in *Macroeconomic and Monetary Developments* released yesterday by the Reserve Bank.

Part A. Monetary Policy

I. The State of the Economy

Global Economy

6. In its World Economic Outlook released in October 2010, the IMF revised upwards its forecast for global growth for 2010 from 4.6 per cent to 4.8 per cent. However, the estimate for the second half of the year is significantly lower than for the first. Moreover, the growth process remains uneven being driven largely by emerging and developing countries. In advanced economies, the recovery continues to be fragile as private demand has not picked up sufficiently to offset the waning fiscal stimulus.

7. In the US, growth remained sluggish in the third quarter of 2010. Household spending is constrained by high unemployment, modest income growth, lower housing wealth and tight credit. The economic recovery in Japan has also moderated recently as reflected in slowdown in industrial production and growth in exports. On the other hand, economic activity in the Euro area is showing signs of resilience in the aftermath of the sovereign debt problems in May-June 2010, though at an uneven pace across the region. Growth in the EMEs continues to be strong, led mainly by domestic demand but supported by exports.

8. Inflation rates in advanced economies remain subdued due to high level of slack in resource utilisation and high unemployment. In the US and Japan, inflation rates are significantly below desired levels providing a rationale for central banks to provide further stimulus

through quantitative easing. In sharp contrast, EMEs are witnessing rising domestic demand which is beginning to generate inflationary pressures. These could be aggravated by significant increases in commodity prices driven by investment flows into these markets. Inflation is a growing concern in several EMEs.

Domestic Economy

9. India's growth of 8.8 per cent in Q1 of 2010-11 suggests that the recovery set in the second half of 2009-10 is consolidating. The normal South-West monsoon and its delayed withdrawal have boosted the prospects of both *kharif* and *rabi* agricultural production.

10. Industrial growth has been robust, although apparently with a significant increase in volatility. The year-on-year increase in the index of industrial production (IIP) varied in a range of 5.6 to 15.2 per cent during April–August 2010, with an average of 10.6 per cent. Industrial growth was high in the capital goods, consumer durables and intermediate goods sectors. While the volatility raises concerns about a deceleration, other indicators of economic activity suggest continuing momentum. Exports have grown steadily during the first half of 2010-11, showing an increase of 27.6 per cent over the corresponding period of last year. Based on an analysis of a sample of 2,546 non-financial companies, private corporate sector sales rose by 24 per cent year-on-year in Q1 of 2010-11. Early results of corporate performance indicate sustained sales growth and improved profitability in Q2 of 2010-11. Direct tax collections, as reflected in advance taxes paid in September 2010, rose by 16.5 per cent over last year. Similarly, indirect tax collections during the April-September period were 43.1 per cent higher than in the corresponding period of 2009.

11. The buoyancy in various service sectors witnessed in the second half of 2009-10, has continued this year as well. The latest quarterly industrial outlook survey conducted by the Reserve Bank indicates improvement in the overall business conditions. Other business conditions surveys also indicate a similar trend. While the Reserve Bank's survey on capacity utilisation indicates that there is a small decline in utilisation at the aggregate level, several sectors appear to be facing capacity constraints, resulting in increased imports.

12. On the inflation front, the new series of wholesale price index (WPI) released on September 14, 2010 is a better representative of commodity price levels with an updated base (2004-05=100) and wider coverage of commodities. While inflation at the aggregate level does not show much variation over the medium-term between the old and new series, there are significant differences in inflation at the disaggregated level. As per the new WPI series, the year-on-year inflation moderated to 8.5 per cent in August 2010 and 8.6 per cent in September 2010 after remaining in double digits during March-July 2010. At a disaggregated level, inflation in primary articles, especially food articles, in the new series has been significantly higher than in the old series, whereas for manufactured products, it has been somewhat lower.

13. During 2010-11, although the year-on-year primary food inflation moderated from

21.4 per cent in May 2010 to 15.7 per cent in September 2010, the moderation was not commensurate with patterns following a normal monsoon on previous occasions. This is partly a reflection of the growing importance of protein-rich items in the consumption basket for which price increases have been large. The year-on-year inflation rate in protein-based food items such as pulses, milk, eggs, fish and meat (with a combined weight of 6.4 per cent in WPI basket), peaked at 34 per cent in May 2010 and remained very high at 23.9 per cent in September 2010. Inflation in the other primary food articles (weight: 8.0 per cent) moderated from 14.0 per cent in June 2010 to 9.4 per cent in September 2010, more visibly reflecting the impact of normal monsoon on prices of major cereals, fruits and vegetables. In sum, despite some moderation, overall food price inflation remains at an elevated level. The year-on-year inflation as of September 2010 was also high for certain primary non-food articles such as raw rubber (57.4 per cent), sugarcane (53.3 per cent) and cotton (27.5 per cent). The rise in cotton prices reflected global trends.

14. Focusing on the manufacturing sector, the year-on-year WPI non-food manufactured products (weight: 55.0 per cent) inflation increased from (-) 2.0 per cent in September 2009 to a peak of 5.9 per cent in April 2010, before moderating to 5.0 per cent in September 2010. Non-food items inflation (WPI excluding food products and food articles), which was (-) 2.9 per cent in September 2009, rose sharply to 9.2 per cent in April 2010 before moderating to 7.8 per cent by September 2010. Non-food items (weight: 75.7 per cent) contributed 65.5 per cent to WPI inflation in September 2010, up from 40.5 per cent in January 2010.

15. Inflation based on CPI for industrial workers has moderated to single digit since August 2010 after remaining in double digits for 13 months. However, the various CPI baskets still reflect the consumption pattern of the mid-1980s and 2001 which have a relatively higher weight for cereals, whereas more updated (2004-05) WPI basket suggests that food consumption has shifted towards protein-rich items where price increase has been high. To that extent, CPI baskets understate the underlying food inflation.

16. Money supply (M_3) growth moderated from 16.8 per cent on a year-on-year basis at end-March 2010 to 14.5 per cent at end-May 2010 before increasing to 15.2 per cent by October 8, 2010. At this level, it was below the indicative projection of 17.0 per cent for 2010-11. The lower M_3 growth essentially reflected the moderation in growth in bank deposits, particularly long-term deposits. Furthermore, currency growth has been higher than deposits growth which reduced the money multiplier, thereby lowering M_3 growth. A contributory factor to this trend has been negative real interest rates on deposits, which have induced depositors to both hold currency and invest in non-financial assets, including gold and real estate, whose prices have shown significant increases over the course of the current year.

17. Non-food credit growth accelerated from 17.1 per cent on a year-on-year basis at end-March 2010 to 22.3 per cent by July 2, 2010, reflecting in part the higher credit demand emanating from telecom spectrum auctions. Although it moderated to 20.1 per

cent as of October 8, 2010, it was in line with the indicative trajectory of 20 per cent for 2010-11 set out in the Monetary Policy Statement of April 2010. Even after adjusting for spectrum auction related advances, growth in bank credit during the current financial year so far has been in line with the long-term trend. Disaggregated data suggest that year-on-year credit growth to large industries, including infrastructure (especially power and telecom), and housing sectors improved significantly. The increase in bank credit to the commercial sector was also supplemented by the higher flow of funds from other sources. Rough estimates showed that the total flow of financial resources from banks, non-banks and external sources to the commercial sector during the first half of 2010-11 was higher at ₹4,85,000 crore, up from ₹3,29,000 crore during the same period of previous year.

18. On the lending side, the Base Rate system replaced the Benchmark Prime Lending Rate (BPLR) system with effect from July 1, 2010. Base Rates of scheduled commercial banks (SCBs) were fixed in the range of 5.50-9.00 per cent. Subsequently, several banks reviewed and increased their Base Rates in the range of 10–50 basis points by October 2010. Base Rates of major banks, accounting for over 94 per cent in total bank credit, are in the range of 7.50-8.50 per cent. Banks have also raised their BPLRs in the range of 25-75 basis points for their old loans.

19. Liquidity conditions, which remained tight between end-May 2010 and July 2010 due to huge outflow of liquidity from the system, eased in August 2010. After alternating between surplus and deficit for a brief period, the Liquidity Adjustment Facility (LAF) window of the Reserve Bank has remained in an injection mode since September 9, 2010 with an average daily net injection of around ₹24,000 crore in September and ₹61,700 crore in October 2010 and a peak injection of ₹1,28,685 crore on October 30, 2010. While the injection mode in the LAF window has been consistent with the stated policy stance, the sharp changes have largely been due to significant increases in government cash balances, which stood at ₹77,736 crore as on October 30, 2010.

20. With a view to alleviating frictional liqudity pressure, the Reserve Bank on October 29, 2010 decided to conduct second LAF (SLAF) and also allowed scheduled commercial banks to avail of additional liquidity support under the LAF to the extent of up to 1.0 per cent of their NDTL as on October 8, 2010. In view of the likely persistence of the frictional liqudity pressure and in order to provide liquidity comfort, these measures have been extended up to November 4, 2010.

21. Both the increases in lending rates by the banking system and liquidity conditions are consistent with the monetary policy stance of reining in inflation. Tight liquidity conditions are helping to strengthen the transmission from policy rates to commercial lending rates, and the process is becoming much more transparent through the operation of the Base Rate system. As desirable as these conditions may be from the viewpoint of inflation management, there are legitimate concerns that the deficit, as reflected by borrowings under the LAF in recent weeks, is significantly in excess of the Reserve Bank's comfort zone of (+/-)

one per cent of net demand and time liabilities (NDTL) of banks. The high level of government balances indicates that the tight liquidity situation is likely to ease to some extent as the Government draws down its balances in the coming weeks.

22. On the basis of large spectrum auction realisations, buoyant tax revenues and in anticipation of significant inflows from disinvestment during the current year, the Government announced that it would pare its market borrowing by ₹10,000 crore in the second half of the financial year. Further, on October 21, 2010, as a part of its cash management operations, the Government, in consultation with the Reserve Bank, announced the repurchase of government securities amounting to ₹28,553 crore maturing during 2010-11. The repurchase operations would be funded through the surplus cash balances of the Government. In the first tranche, repurchase of securities for an aggregate amount of ₹12,000 crore was notified and ₹2,148 crore was accepted in the auction held on October 26, 2010.

23. The increase in the overall revenue realisation of the Government during the current year is a welcome development. It virtually eliminates the possibility of the fiscal deficit overshooting the budget estimate. Fiscal consolidation is important for a number of reasons, including the fact that monetary policy works most efficiently, particularly when it is dealing with an inflationary situation, when the fiscal situation is under control. Several things are important to make the fiscal consolidation effort credible and effective. The focus must be as much on expenditure restructuring as on revenue augmentation, recurring expenditure commitments should not be made against one off revenues such as from disinvestment and the quality of adjustment should not be lost sight of.

24. The combination of liquidity conditions and revised government borrowing estimates have had contrasting impacts on the yield curve. At the short end, as the LAF window operated in deficit mode, the overnight interest rates were generally close to the ceiling of the LAF rate corridor during September-October 2010, even exceeding it on occasions in response to sudden surges in demand. However, at the long end, the announced reduction in net borrowing of the Central Government had a downward impact on government bond yields, as the 10-year benchmark government security yield fell to about 7.92 per cent in early October 2010 from a high of 8.07 per cent in August. Yields have risen again recently, reaching a high of 8.14 per cent on October 20, 2010, reflecting the tightening of liquidity conditions.

25. Domestic equity prices firmed up significantly in recent weeks due to large inflows from foreign institutional investors (FIIs), driven by better domestic growth prospects and a surfeit of global liquidity. The foreign exchange market, which witnessed a significant increase in net inflows beginning September 2010, has remained orderly with the rupee showing two-way movements in the range of ₹44.03 – ₹44.74 per US dollar during October 2010.

26. During 2010-11 so far (October 22, 2010), the rupee appreciated by 0.4 per cent on the basis of trade based 36-currency real effective exchange rate (REER). The extent of appreciation was, of course, higher on the basis of 6-currency trade based

REER (3.1 per cent) reflecting both the nominal appreciation of the rupee against the US dollar during this period and the higher inflation differential with major advanced countries. Since the 36-currency REER includes the currencies of many countries which are India's direct competitors in the global market, it is a better reflection of the impact of global exchange rate movements on competitiveness. The relatively small appreciation in this index reflects the fact that many competing countries have also seen their currencies appreciate during this period. From this perspective, the impact of the recent nominal appreciation of the rupee may not have a significant implication for competitiveness.

27. The continuing sluggishness of the global economy led to some moderation in exports growth and invisible receipts, while import growth accelerated due to the strong domestic recovery. Consequently, both the trade deficit and the current account deficit (CAD) widened in Q1 of 2010-11. If the current trend persists, CAD as a percentage of GDP will be significantly higher than in the previous year. It is generally perceived that a CAD above 3 per cent of GDP is difficult to sustain over the medium-term. The challenge, therefore, is to rein in the deficit over the medium-term and finance it in the short-term. The medium-term task has to receive policy focus from both the Government and the Reserve Bank. The short-term task is to see that the current account is fully financed while ensuring that capital flows are not far out of line with the economy's absorptive capacity and that the component of long-term and stable flows in the overall capital flows is high.

II. Outlook and Projections

Global Outlook

Growth

28. In its latest World Economic Outlook, the IMF has projected global growth to slow down from 4.8 per cent in 2010 to 4.2 per cent in 2011. Various indicators of economic activity in advanced economies point to deceleration of growth in the second half of 2010 which could persist through the first half of 2011. The room to provide additional fiscal stimulus to support the growth process remains constrained due to debt sustainability issues in some major advanced economies. Reflecting global linkages, the slowdown in the global recovery will have an adverse impact on growth in EMEs, including India, especially through the trade channel.

Inflation

29. Inflation in advanced economies in the short-term is expected to remain subdued due to the prevailing low levels of capacity utilisation and high unemployment rates. However, the recent upward movements in international commodity prices, despite prospects of slow global recovery, raise some concerns. Several EMEs are already facing inflationary pressures. Food, energy and metal prices, in particular, have seen significant increases. The upward risk to inflation, therefore, has increased for EMEs, both from rising domestic capacity utilisation and from global commodity price increases.

Domestic Outlook

Growth

30. Taking into account the good performance of the agriculture sector,

and a range of indicators of industrial production and service sector activity amidst the prevailing global macroeconomic scenario, the baseline projection of real GDP growth for 2010-11, for policy purposes, is retained at 8.5 per cent, as set out in the July 2010 review (Chart 1).

31. The Reserve Bank's growth projection for 2010-11 is consistent with the median growth forecast from its professional forecasters' survey and other agencies.

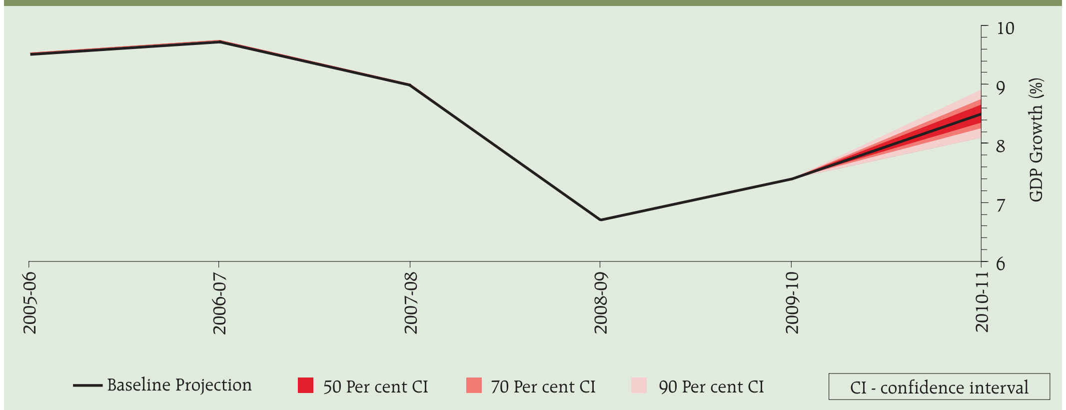
Inflation

32. Although the headline inflation has moderated in recent months, the current rate of inflation is still well above the comfort zone of the Reserve Bank. The Reserve Bank's quarterly inflation expectation survey conducted during the first fortnight of September 2010 indicates that short-term household inflationary expectations have increased marginally. Further, notwithstanding some moderation, food price inflation has remained persistently elevated for over a year now, reflecting in part the structural demand-supply mismatches in several commodities - besides protein sources, oilseeds and vegetables also show this pattern. Given the changing consumption patterns and as yet inadequate supply response, food price inflation is becoming increasingly structural in nature. Further, even as non-food manufacturing inflation has indeed moderated, it still remains above its medium-term trend.

33. Going forward, the inflation outlook will be shaped by the following factors. First, it will depend as to how food price inflation evolves. Second, rising global commodity prices have become a cause for concern. Third, demand pressures arising from sustained growth amidst tightening capacity constraints will have an impact. On balance, inflation is expected to moderate from the present elevated level, reflecting in parts, some easing of supply constraints and concerted policy action.

34. In its July Review, the Reserve Bank made a baseline projection of WPI inflation

Chart 1: Projection of GDP Growth for 2010-11



for March 2011 of 6.0 per cent. This projection was based on the old series of WPI. As has been indicated, there is not much difference at the aggregate level in the medium-term inflation trend between the old and new series, but there are significant differences at the group levels. On the basis of currently available information and the fact that expected moderation in food price inflation has also not fully materialised, the baseline projection of WPI inflation for March 2011 has been placed at 5.5 per cent, which is equivalent to 6.0 per cent under the old series. Effectively, this means that the projection remains unchanged from that made in the July 2010 Review (Chart 2).

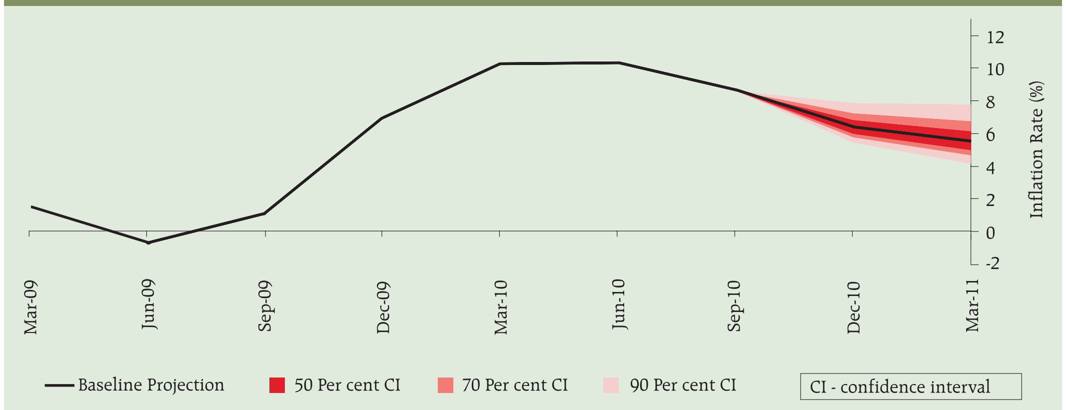
35. The Reserve Bank will endeavour to achieve price stability and anchor inflation expectations. In pursuit of these objectives, the Reserve Bank will continue to evaluate an array of aggregate and disaggregated measures of inflation in the context of the evolving macroeconomic situation.

36. Notwithstanding the current inflation scenario, it is important to recognise that in the 2000s, the average headline inflation rate remained in the range of 5.0-5.5 per cent, down from its historical trend rate of about 7.5 per cent. A combination of factors played a role in this transformation. One of these was the commitment on the part of the monetary policy to keep inflation low and stable. This record is an important foundation for the credibility of monetary policy and, more generally, the broader inflation management framework. Against this backdrop, the conduct of monetary policy will continue to condition and contain perception of inflation in the range of 4.0-4.5 per cent. This will be in line with the medium-term objective of 3.0 per cent inflation consistent with India's broader integration into the global economy.

Monetary Aggregates

37. While the year-on-year money supply (M_3) growth at 15.2 per cent in early October 2010 was below the indicative projection of 17.0 per cent, non-food credit growth at 20.1 per cent was close to the indicative projection of 20.0 per cent. There are already some signs of pick-up in deposit and credit growth. It is

Chart 2: Projected Path of Y-o-Y Inflation



expected that monetary aggregates will evolve along the projected trajectory indicated in the April policy statement. Accordingly, the M_3 and non-food credit growth projections for 2010-11 have been retained at 17 per cent and 20 per cent, respectively. As always, these numbers are indicative projections and not targets.

Risk Factors

38. The above macroeconomic and monetary projections are subject to a number of upside and downside risks. First, the main downside risk to growth emanates from the prospects of a prolonged slow and halting recovery process in advanced economies as evidenced by the recent indicators of global economic activity. Concerns are being expressed that the ongoing fiscal consolidation in the absence of revival of private demand might weigh on the recovery process. Should the global recovery falter, the growth performance of EMEs, including India which has remained robust so far, is likely to be adversely affected. While India's exports as a percentage of GDP are relatively low compared to other major EMEs, a widespread slowdown in global trade cannot but have an impact on the manufacturing and service sectors.

39. Second, although overall inflation and non-food manufactured products inflation have moderated in the recent period, inflationary pressures remain which may accentuate for several reasons. Despite the fragile global recovery, international commodity prices have risen in recent months due to strong demand from EMEs and some financialisation of commodities due to large surplus global liquidity. Should there be further quantitative easing by advanced economies, it will pose a further risk to global commodity prices. Persistently high domestic food inflation points to the presence of some structural component, which will continue to weigh on the overall inflation. With the domestic capacity utilisation slowly approaching the pre-crisis peak in many industries, demand side pressures may accentuate. Going forward, therefore, the risks to inflation are largely on the upside.

40. Third, given the weak recovery in advanced economies, Japan has already resorted to further monetary easing through unsterilised intervention in the forex market. Some other advanced economies are in the process of resorting to another round of quantitative easing. Given that growth prospects in EMEs, including India, are much better, the surplus liquidity generated by central banks in advanced economies could flow into the EMEs. In fact, the expectation of further quantitative easing in advanced economies has already resulted in large capital inflows to EMEs. As a result, exchange rates have been appreciating and asset prices have been rising in EMEs. Excess global liquidity combined with the significant growth differential, interest rate differential and higher financial market returns in India *vis-à-vis* the advanced economies might lead to intensification of capital flows to India. Although India needs capital flows to finance its widening current account deficit, large capital flows beyond the absorptive capacity of the economy could pose a major challenge for exchange rate and monetary management.

41. Fourth, India's current account deficit has widened in the recent period due to slowing down of exports and invisibles on the one hand and rising imports on the back of strong rebound of the domestic economy on the other. Although the current account deficit has been easily financed by the rising capital flows so far, the widening of the current account deficit raises concerns given the uncertainty associated with international capital flows.

42. Fifth, asset prices in India, as in many other EMEs, have risen sharply. The equity market is close to its previous all-time peak level. Residential property prices in metropolitan cities have gone beyond the pre-crisis peak level. Gold prices are ruling at an all-time high level. Although the income levels of households and earnings of corporates in India have continued to rise, a sharp rise in asset prices in such a short time causes concern.

III. The Policy Stance

43. Since October 2009, the Reserve Bank has cumulatively raised the cash reserve ratio (CRR) by 100 basis points, and the repo and reverse repo rates under the LAF by 125 basis points and 175 basis points, respectively. The monetary policy response has been calibrated on the basis of India's specific growth-inflation dynamics in the broader context of persistent global uncertainty.

44. Thus, our policy stance for 2010-11 for the remaining period has been conditioned by three major considerations:

45. First, the domestic economy is on a strong footing. The 8.8 per cent GDP growth for Q1 of 2010-11 suggests that the economy is steadily regaining the pre-crisis growth trajectory. Although uncertainty persists with regard to global recovery, India's domestic growth drivers are robust which should help absorb to a large extent the negative impact of slowdown in global recovery.

46. Second, inflation remains high. Both demand side and supply side factors are at play. Inflationary expectations also remain at an elevated level. Given the spread and persistence of inflation, demand side inflationary pressures need to be contained and inflationary expectations anchored.

47. Third, even though a liquidity deficit is consistent with an anti-inflation stance, excessive deficiency can be disruptive both to financial markets and to credit growth in the banking system. To ensure that economic activity is not disrupted by liquidity constraints, the liquidity deficit needs to be contained within a reasonable limit.

48. Against the above stated backdrop, the stance of monetary policy is intended to:

- Contain inflation and anchor inflationary expectations, while being prepared to respond to any further build-up of inflationary pressures.
- Maintain an interest rate regime consistent with price, output and financial stability.
- Actively manage liquidity to ensure that it remains broadly in balance, with neither a surplus diluting monetary transmission nor a deficit choking off fund flows.

IV. Monetary Measures

49. On the basis of the current assessment and in line with the policy stance as outlined in Section III, the following policy measures are announced.

Bank Rate

50. The Bank Rate has been retained at 6.0 per cent.

Repo Rate

51. It has been decided to:

- increase the repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 6.0 per cent to 6.25 per cent with immediate effect.

Reverse Repo Rate

52. It has been decided to:

- increase the reverse repo rate under the LAF by 25 basis points from 5.0 per cent to 5.25 per cent with immediate effect.

Cash Reserve Ratio

53. The cash reserve ratio (CRR) of scheduled banks has been retained at 6.0 per cent of their net demand and time liabilities (NDTL).

Expected Outcomes

54. These actions are expected to:

i. Sustain the anti-inflationary thrust of recent monetary actions and outcomes in the face of persistent inflation risks.

ii. Rein in rising inflationary expectations, which may be aggravated by the structural nature of food price increases.

iii. Be moderate enough not to disrupt growth.

55. The Reserve Bank will continue to closely monitor both global and domestic macroeconomic conditions. We will take action as warranted with a view to mitigating any potentially disruptive effects of lumpy and volatile capital flows and sharp movements in domestic liquidity conditions, consistent with the broad objectives of price and output stability.

56. Based purely on current growth and inflation trends, the Reserve Bank believes that the likelihood of further rate actions in the immediate future is relatively low. However, in an uncertain world, we need to be prepared to respond appropriately to shocks that may emanate from either the global or domestic environment.

Mid-Quarter Review of Monetary Policy 2010-11

57. The next mid-quarter review of Monetary Policy for 2010-11 will be announced through a press release on December 16, 2010.

Third Quarter Review of Monetary Policy 2010-11

58. The third quarter review of Monetary Policy for 2010-11 is scheduled on January 25, 2011.

Part B. Developmental and Regulatory Policies

59. The recent global financial crisis has underlined the need for fundamental changes in the way banks and financial institutions are regulated. Important steps in this regard at the international level have been taken under the auspices of G-20, Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS). The broad elements of emerging framework that have been agreed upon are ring-fencing of banking institutions with more and better quality capital under Basel III, an appropriate framework for systemically important financial institutions (SIFIs), aligning the compensation practices to prudent risk-taking and long term value creation, and improving the accounting standards, that promote financial stability. India being a member of G-20, FSB and BCBS, the Reserve Bank has been actively associated with the evolution of the reform package.

60. The thrust of the regulation by the Reserve Bank in recent years has not only been on strengthening the financial system, but also on developing financial markets, promoting financial inclusion, improving credit delivery, especially to the small and medium enterprises (SMEs) sector, improving customer service and strengthening the payment and settlement systems. The Reserve Bank, therefore, will continue to pursue reforms in these areas so as to enhance the efficiency and stability of the financial system.

61. A synopsis of the action taken on the past policy announcements together with a list of fresh policy measures is set out below.

I. Financial Stability

Financial Stability Report

62. The Reserve Bank conducts macro-prudential surveillance of the financial system on an ongoing basis. Assessment of financial stability and the findings thereof are shared with financial institutions, market players and general public in the form of Financial Stability Reports (FSRs). The first FSR was published in March 2010. The second FSR will be published in December 2010. Going forward, FSRs will be published in June and December every year.

Assessment of Financial Stability

63. Steps are being taken to strengthen macro-prudential surveillance. Towards this end, more frequent internal assessments, including systemic risk monitor reports twice a year, have started. As per the latest internal assessment, the financial system at the current juncture is largely stable. The banking sector is sound and the financial sector is considered resilient to shocks emanating from adverse domestic and international developments. However, evolving risks to financial stability, both globally and within the country, need to be monitored carefully on an ongoing basis.

II. Interest Rate Policy

Base Rate

64. As indicated in the Monetary Policy Statement of April 2010, the system of Base Rate came into effect on July 1, 2010. The transition from the benchmark prime lending rate (BPLR) system to the base rate system has been smooth.

Deregulation of Interest Rate on Savings Bank Deposits

65. As a part of financial sector reforms, the Reserve Bank has deregulated interest rates on deposits, other than savings bank deposits. The interest rate on savings bank deposits has remained unchanged at 3.5 per cent per annum since March 1, 2003. Keeping in view progressive deregulation of interest rates, it is proposed:

- to prepare a discussion paper, which will delineate the pros and cons of deregulating the savings bank deposits interest rate.

66. The discussion paper will be placed on the Reserve Bank's website by end-December 2010 for feedback from the general public.

III. Financial Markets

Financial Market Products

Interest Rate Futures

67. The Monetary Policy Statement of April 2010 had indicated that exchange traded interest rate futures (IRFs) on 5-year and 2-year notional coupon bearing Government of India securities and 91-day Treasury Bills would be introduced. It was also indicated that the RBI-SEBI Standing Technical Committee would finalise the product design and operational modalities. The issue relating to product design was deliberated by the RBI-SEBI Standing Technical Committee. The Reserve Bank will introduce such IRFs after taking into account the experiences of cash-settled IRF regimes in other countries.

Regulation of Non-Convertible Debentures of Maturity Less than One Year

68. It was proposed in the Monetary Policy Statement of April 2010 to issue the final guidelines on the issuance of non-convertible debentures (NCDs) of maturity less than one year by end-June 2010. Accordingly, keeping in view the feedback received, the guidelines on NCDs were issued in June 2010, which came into force with effect from August 2, 2010. The guidelines, among others, covered eligibility criteria to issue NCDs, rating requirement, maturity, denomination, limits and amount of issue of NCDs and responsibilities of corporates, debenture trustees and credit rating agencies.

Introduction of Credit Default Swaps

69. It was indicated in the Monetary Policy Statement of April 2010 that the draft report of the internal Working Group on introduction of credit default swap (CDS) for corporate bonds would be placed on the Reserve Bank's website by end-July 2010. Accordingly, the draft report was placed on the Reserve Bank's website on August 4, 2010 for public comments till October 4, 2010. The comments/suggestions received are being examined by holding wider consultations with all the stakeholders, including corporates.

Repo in Corporate Bonds

70. For development of the corporate bond market, the Reserve Bank had issued guidelines in January 2010, permitting repo in corporate bonds, subject to certain terms and conditions. To further facilitate repo transactions in corporate bonds, a review of the guidelines governing repo in corporate

bonds has been undertaken by the Reserve Bank in consultation with the market participants. Accordingly, it has been decided:

- to permit settlement of repo in corporate bonds on a T+0 basis in addition to the existing T+1 and T+2 basis and revise the repo haircut requirements suitably.

71. Detailed guidelines, which will be effective December 1, 2010, are being issued separately.

Guidelines on Over-the-Counter Forex Derivatives

72. The draft guidelines on over-the-counter (OTC) foreign exchange derivatives were placed on the Reserve Bank's website in November 2009 for public comments. The feedback received from stakeholders was discussed in the meeting of the Technical Advisory Committee on the Money, Foreign Exchange and Government Securities Markets. On the basis of the discussions, the revised draft guidelines on the subject were again placed on the Reserve Bank's website in July 2010 for final comments by August 13, 2010. Comments received from stakeholders were examined and deliberated in the meeting of the Technical Advisory Committee on the Money, Foreign Exchange and Government Securities Markets. Final guidelines in the light of the feedback received will be issued by end-November 2010.

Introduction of Exchange Traded Currency Option Contracts

73. It was indicated in the Monetary Policy Statement of April 2010 that the Reserve Bank would permit the recognised stock exchanges to introduce plain vanilla currency options on spot US dollar/rupee exchange rate for residents. In July 2010, the Reserve Bank permitted trading of currency options on spot USD-INR rate in the currency derivatives segment of the recognised stock exchanges. The currency options market will function subject to the guidelines issued by the Reserve Bank and the Securities and Exchange Board of India (SEBI) from time to time.

Money Market

Working Group to Review the Operating Procedure of Monetary Policy

74. As announced in the First Quarter Review of Monetary Policy of July 2010, the Reserve Bank, on October 4, 2010, constituted a Working Group to review the current operating procedure of monetary policy, including the liquidity adjustment facility (Chairman: Shri Deepak Mohanty), with representations from the concerned departments of the Reserve Bank, Indian Banks' Association (IBA) and Fixed Income Money Market and Derivatives Association of India (FIMMDA). The Group also includes external experts. The Group will submit its report in three months from the date of its first meeting.

Financial Market Infrastructure

Reporting Platform for Certificates of Deposit and Commercial Papers

75. The reporting platform for secondary market transactions in Certificates of Deposit (CDs) and Commercial Papers (CPs) developed by the FIMMDA has been

operationalised with effect from July 1, 2010. As mandated, entities regulated by the Reserve Bank, the SEBI and the Insurance Regulatory and Development Authority (IRDA) are now reporting the OTC trades in CDs and CPs on the FIMMDA platform. FIMMDA is also making available online information on trades in CDs and CPs, including prices, transaction amount and yields.

IV. Credit Delivery and Financial Inclusion

Credit Flow to the Micro, Small and Medium Enterprises Sector

High Level Task Force on MSMEs

76. A High Level Task Force constituted by the Government (Chairman: Shri T.K.A. Nair) to consider various issues raised by micro, small and medium enterprises (MSMEs) associations and draw up an agenda for action submitted its report in January 2010. In terms of the recommendations of the Task Force, the Reserve Bank issued guidelines in June 2010, advising scheduled commercial banks that the allocation of 60 per cent of the micro and small enterprises (MSEs) advances to the micro enterprises was to be achieved in stages, *viz.*, 50 per cent in the year 2010-11, 55 per cent in the year 2011-12 and 60 per cent in the year 2012-13. Further, banks were mandated to achieve a 10 per cent annual growth in the number of micro enterprise accounts and a 20 per cent year-on-year growth in credit to the MSE sector. The Reserve Bank is closely monitoring the achievement of targets by banks in this regard.

Rural Credit Institutions

Licensing of Co-operatives

77. The Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) had recommended that rural co-operative banks, which failed to obtain a licence by 2012, should not be allowed to operate. Accordingly, it was proposed in the Annual Policy Statement of April 2009 to work out a roadmap for licensing of unlicensed state and central co-operative banks in a non-disruptive manner. For this purpose, revised guidelines, in consultation with National Bank for Agriculture and Rural Development (NABARD), were issued on licensing of these banks. Subsequent to the issuance of revised guidelines on licensing of state co-operative banks (StCBs)/district central co-operative banks (DCCBs), 10 StCBs and 133 DCCBs have been licensed, bringing down the number of unlicensed StCBs from 17 to 7 and DCCBs from 296 to 163 as on September 30, 2010.

Revival of the Rural Co-operative Credit Structure

78. The Government of India, based on the recommendations of the Task Force on Revival of Rural Co-operative Credit Institutions (Chairman: Prof. A. Vaidyanathan) and in consultation with the state governments, had approved a package for revival of the short-term rural co-operative credit structure. As envisaged in the package, 25 states have so far entered into Memorandum of Understanding (MoU) with the Government of India and NABARD. Sixteen states have made necessary amendments to their respective Co-operative

Societies Acts. As on August 31, 2010, an aggregate amount of about ₹7,990 crore has been released by NABARD to primary agricultural credit societies (PACS) in 14 states as the Government of India's share under the package.

Financial Inclusion through Grass-root Co-operatives

79. It was proposed in the Monetary Policy Statement of April 2010 to constitute a Committee comprising representatives from the Reserve Bank, NABARD and a few state governments to study the functioning of well-run PACS, large *adivasi* multi-purpose co-operative societies (LAMPS), farmers service societies (FSS) and thrift and credit co-operative societies set up under the parallel Self-Reliant Co-operative Societies Acts to gather information on their working and assess their potential to contribute to financial inclusion. Accordingly, the Reserve Bank, in association with NABARD and the concerned state governments, is studying the working of select (about 220) well-functioning rural co-operatives across the country to assess their potential to contribute to financial inclusion. The study is expected to be completed by end-January 2011.

Liberalisation in Branch Licensing of Regional Rural Banks

80. As part of further liberalisation of the extant branch licensing policy in respect of regional rural banks (RRBs), it is proposed:

- to allow RRBs to open branches in Tier 3 to Tier 6 centres as identified in the Census 2001 (with population up to 49,999) without prior authorisation of the Reserve Bank, subject to their fulfilling certain conditions.

81. Detailed guidelines in this regard will be issued separately.

Priority Sector Lending

82. As announced in the Second Quarter Review of October 2009, a Working Group was constituted (Chairman: Shri V. K. Sharma) to examine the pros and cons of priority sector lending certificates (PSLCs) as recommended by the Committee on Financial Sector Reforms (Chairman: Dr. Raghuram G. Rajan). As indicated in the Monetary Policy Statement of April 2010, the terms of reference of the Working Group were expanded to review the pros and cons of inclusion of bank lending to micro-finance institutions (MFIs) under priority sector lending. The Working Group submitted its report in August 2010. However, considering the more recent developments in the MFI space, a Sub-Committee of the Central Board of the Reserve Bank (Chairman: Shri Y. H. Malegam) has been constituted to examine the various issues relating to micro-finance extended by non-banking financial companies (NBFCs) while also taking into account the recommendation of the Sharma Working Group. The Sub-Committee will make recommendations, among others, relating to regulation of micro-finance activities of NBFCs, especially with regard to issues impinging on borrowers' interests. The Sub-Committee is expected to submit its report by end-January 2011. A holistic view will be taken on issues relating to PSLCs and bank lending to MFIs under priority sector lending after the Malegam Sub-Committee submits its report.

Financial Inclusion Plan for Banks

83. Considering the objective of increasing banking outreach for financial inclusion, domestic scheduled commercial banks, both in the public and private sectors, were advised, among others, to put in place a board approved three-year financial inclusion plan (FIP) and submit the same to the Reserve Bank by March 2010. Domestic scheduled commercial banks have since prepared and submitted their FIPs to the Reserve Bank. These plans have been discussed with major banks and revised plans based on the discussions have been submitted by banks. To closely monitor the progress made in implementation of these plans, a quarterly reporting format has been communicated to banks and the implementation of these plans is being closely monitored by the Reserve Bank.

Roadmap for Provision of Banking Services in Villages with Population of over 2000

84. In pursuance of the announcement made in the Monetary Policy Statement of April 2010, the roadmap to provide banking services in every village with a population of over 2000 has been finalised by state level bankers' committees (SLBCs) and 73,113 unbanked identified villages as per 2001 Census have been allotted to various banks for provision of banking services by March 2012. The time line for provision of banking services has been extended to March 2012 from March 2011 in line with the Finance Minister's announcement in the Union Budget 2010-11. March 2011 is retained as an intermediate target. The progress in the implementation of the roadmap is being discussed and closely monitored by respective SLBCs.

Opening of Sub-Offices of the Reserve Bank in North-Eastern States

85. At present, the Reserve Bank has only one office at Guwahati to cater to the needs of all the North-Eastern states. Over a period of time, while the population of these states and banking needs have increased significantly, bank branches have not kept pace with the requirements in these areas. Considering the relative economic and infrastructural backwardness of these states and the need for financial inclusion and general economic development in these states, it has been decided:

- to open sub-offices of the Reserve Bank in the remaining six states of the north-east, *viz.*, Arunachal Pradesh, Nagaland, Manipur, Mizoram, Tripura and Meghalaya, in a phased manner.

Business Correspondents - Relaxations

86. In pursuance of the announcement made in the Monetary Policy Statement of April 2010, the Reserve Bank issued guidelines in April 2010 permitting banks to engage any individual, including those operating common service centres (CSCs) as banking correspondents (BCs), subject to banks' comfort level and their carrying out suitable due diligence as also instituting additional safeguards as may be considered appropriate to minimise the agency risks. A discussion paper on "Engagement of 'for profit' Companies as Business Correspondent"

was placed on the Reserve Bank's website in August 2010 inviting comments from the public by August 20, 2010. Taking into consideration the pros and cons and based on the feedback received from various quarters, banks were permitted to engage companies registered under the Indian Companies Act, 1956, excluding NBFCs, as BCs in addition to the individuals/ entities permitted earlier, subject to compliance with the guidelines issued in September 2010.

Urban Co-operative Banks

Licenses for Setting up new Urban Co-operative Banks

87. As indicated in the Monetary Policy Statement of April 2010, an Expert Committee (Chairman: Shri Y. H. Malegam) was constituted in October 2010 with representations from all stakeholders for studying the advisability of granting licenses for setting up new urban co-operative banks (UCBs) under Section 22 of the Banking Regulation Act, 1949 [as applicable to co-operative socieities (AACS)]. The Committee is expected to submit its report in six months. The Committee will also look into the feasibility of an umbrella organisation for the UCB sector.

Extension of Area of Operation of UCBs

88. In order to further facilitate the growth of well managed and financially sound UCBs, it is proposed:

- to withdraw the existing restrictions on granting multi-state status and extension of area of operation beyond the state of registration for such UCBs having a minimum net worth of ₹50 crore;
- to allow such UCBs which have acquired weak banks in other state(s) to extend the area of operation to the entire state of registration of the target bank provided they have minimum net worth of ₹50 crore; and
- to allow Tier II UCBs registered or deemed to be registered under the Multi-State Co-operative Societies Act, 2002 to extend area of operation to the entire state of original registration.

89. Detailed guidelines in this regard will be issued separately.

Liberalisation of Branch Licensing Policy for UCBs

90. In order to further liberalise the branch licensing policy for urban co-operative banks (UCBs), it is proposed:

- to allow well managed and financially sound UCBs to open branches and extension counters within their existing/approved area of operation, beyond the current ceiling of 10 per cent as long as they have sufficient headroom capital for each branch.

91. Detailed guidelines in this regard will be issued separately.

Business Correspondents/Business Facilitator Model for UCBs

92. With a view to expanding the outreach of the UCBs, thereby furthering the

objective of financial inclusion, it is proposed:

- to allow well managed and financially sound UCBs to engage business correspondents (BCs)/business facilitators (BFs) using information and communication technology (ICT) solutions.

Enhancement of Limits on Unsecured Loans and Advances Granted by UCBs

93. Keeping in view the growth in business of the UCBs over the years, it is proposed:

- to enhance the existing limits on individual unsecured loans and advances extended by the UCBs, which are complying with the regulatory capital to risk-weighted assets ratio (CRAR) of 9 per cent, subject to the overall ceiling of 10 per cent of total assets.

94. Detailed guidelines in this regard will be issued separately.

Exposure of UCBs to Housing Loans

95. At present, UCBs can provide housing, real estate and commercial real estate loans up to 15 per cent of their deposit resources as on March 31 of the previous year. It has now been decided to link housing, real estate and commercial real estate loans of UCBs to their total assets instead of deposits. Accordingly, it is proposed:

- to replace the existing limit of 15 per cent of deposits for housing, real estate and commercial real estate loans by a limit of 10 per cent of total assets; and
- an additional limit of 5 per cent of total assets will be available for housing loans granted to individuals by the UCBs for purchase/construction of dwelling units up to ₹10 lakh.

Exemption from Share Linking to Borrowing Norm

96. It is mandatory for borrowers of UCBs to subscribe to the shares of the bank to the extent of 2.5-5.0 per cent of their borrowings. In order to provide flexibility to UCBs, which are already well capitalised to extend loans without adding to capital, it is proposed:

- to exempt UCBs which maintain a minimum CRAR of 12 per cent on a continuous basis from the mandatory share linking norms.

Access to INFINET Membership, Current/SGL Accounts with the Reserve Bank and RTGS Membership for UCBs

97. In order to enable UCBs to serve their customers better, it is proposed:

- to allow all licensed UCBs (other than those under all inclusive directions) the facility of Indian financial network (INFINET) membership, current and subsidiary general ledger (SGL) accounts with the Reserve Bank; and
- to allow real time gross settlement (RTGS) membership to only well managed and financially sound UCBs having a minimum net worth of ₹25 crore.

Customer Service

98. Pursuant to the announcement made in the Monetary Policy Statement of April 2010, a Committee on Customer Service (Chairman: Shri M. Damodaran) was constituted to look into banking services rendered to retail and small customers, including pensioners. The Committee will also look into the system of grievance redressal mechanism prevalent in banks – its structure and efficacy – and suggest measures for expeditious resolution of complaints. The Committee will also examine the international experiences in this regard. A need for conducting on-site inspection and rating banks on customer service will be examined based on the outcome of the report of the Committee. The Committee is expected to submit its report by end-January 2011.

99. As indicated in the Monetary Policy Statement of April 2010, banks were advised in May 2010 to devote exclusive time in a Board meeting once in every six months to review and deliberate on customer service.

V. Regulatory and Supervisory Measures for Commercial Banks

Strengthening the Resilience of the Banking Sector

100. The Basel Committee on Banking Supervision (BCBS), in response to the financial crisis, submitted a report to the G-20 in October 2010. The report contained the measures taken by the BCBS and its governing body - the Group of Central Bank Governors and Heads of Supervision (GHOS) - to strengthen the resilience of banks and the global banking system. The new global standards to address both bank-specific and broader systemic risks have been referred to as Basel III. Measures suggested under Basel III, among others, include revisions to the definition of regulatory capital, capital conservation buffer, counter-cyclical buffer, the treatment of counterparty credit risk, the leverage ratio, and the global liquidity standards.

101. It may be recalled that the BCBS had issued in December 2009 two consultative documents for public comments. It also undertook a comprehensive quantitative impact study (QIS) and top-down calibration of minimum capital requirement. At its July and September 2010 meetings, the GHOS broadly agreed on the overall design of the capital and liquidity reform package, based on the comments received, the QIS and top-down calibration. The fully calibrated Basel III rules will be published by the BCBS by end-December 2010.

102. The Reserve Bank has been adopting the international best regulatory practices as appropriate to banks in India. Banks are, therefore, advised:

- to study the new developments and be in preparedness to meet the requirements; and
- to continue with the parallel run beyond March 31, 2010, as advised to them in April 2010, to ensure that their Basel II minimum capital requirement continues to be higher than the prudential floor of 80 per cent of the minimum capital requirement as per Basel I framework for credit and market risks. The parallel run should continue

for a period of three years, *i.e.*, till March 31, 2013, subject to review.

Implementation of Advanced Approaches under Basel II Framework

103. The Reserve Bank had announced timeline for implementation of advanced approaches for computation of regulatory capital under the Basel II framework in India in July 2009. The guidelines for the standardised approach (TSA)/alternate standardised approach (ASA) for operational risk were issued in March 2010 and those for internal models approach (IMA) for market risk were issued in April 2010. Guidelines for advanced measurement approach (AMA) for operational risk will be finalised by December 2010. Guidelines for internal rating based approach for credit risk are under preparation.

Housing Loans by Commercial Banks

Loan to Value Ratio in Housing Loans

104. At present, there is no regulatory ceiling on the loan to value (LTV) ratio in respect of banks' housing loan exposures. In order to prevent excessive leveraging, it is proposed:

- that the LTV ratio in respect of housing loans hereafter should not exceed 80 per cent.

Risk Weights on Residential Housing Loans

105. At present, the risk weights on residential housing loans with LTV ratio up to 75 per cent are 50 per cent for loans up to ₹30 lakh and 75 per cent for loans above that amount. In case the LTV ratio is more than 75 per cent, the risk weight of all housing loans, irrespective of the amount of loan, is 100 per cent. Accordingly, it is proposed:

- to increase the risk weight for residential housing loans of ₹75 lakh and above, irrespective of the LTV ratio, to 125 per cent.

Teaser Rates for Housing Loans

106. It has been observed that some banks are following the practice of sanctioning housing loans at 'teaser rates', wherein the loans are offered at a comparatively lower rate of interest in the first few years, after which rates are reset at higher rates. This practice raises concern as some borrowers may find it difficult to service the loans once the normal interest rate, which is higher than the rate applicable in the initial years, becomes effective. It has been observed that many banks at the time of initial loan appraisal do not take into account the repaying capacity of the borrower at normal lending rates. In view of the higher risk associated with such loans, it is proposed:

- to increase the standard asset provisioning by commercial banks for all such loans to 2 per cent.

Banks' Investments in Non-Financial Companies

107. Under the extant prudential framework, banks are not required to obtain prior approval of the Reserve Bank for investment in companies other than financial services companies. Banks may be able to exercise control on such entities

through their direct or indirect holdings or have significant influence over them. Thus, banks may indirectly undertake activities not permitted to them under Sub-section (1) of Section 6 of the Banking Regulation Act, 1949 or activities which are not conducive to the spread of banking in India or otherwise useful or necessary in the public interest. Therefore, it is proposed:

- to stipulate prudential limits to regulate the investments of banks in companies engaged in forms of business other than financial services. Banks will be required to review their investments in such companies and be compliant with the guidelines as per the roadmap to be laid down.

108. Detailed guidelines in this regard will be issued separately.

Prudential Norms on Financial Conglomerates

109. The Reserve Bank had constituted an Internal Group on the Supervision of Financial Conglomerates (FCs) in India. The Internal Group had made various recommendations for strengthening the supervision of the FCs, including changes in certain regulatory norms. The Annual Policy Statement of April 2009 indicated that the Reserve Bank was examining the recommendations of the Group from the regulatory and supervisory perspectives. To start with, it has been decided:

- to implement the recommendations of the Group on (i) capital adequacy for FCs; and (ii) intra-group transactions and exposures in FCs.

Capital Adequacy for FCs

110. As per Basel II framework, investments in the equity of subsidiaries or significant minority investments in banking, securities and other financial entities, where control does not exist, together with other regulatory capital investment in these entities are required to be excluded from the banking group's capital if these entities are not consolidated. The Group recommended that the threshold of significant influence/investment may be fixed at 20 per cent instead of the present 30 per cent. Accordingly, it is proposed:

- that the entire investments in the paid up equity of the entities (including insurance entities), where such investment exceeds 20 per cent of the paid up equity of such entities shall be deducted at 50 per cent from Tier I and 50 per cent from Tier II capital when these are not consolidated for capital purposes with the bank. In addition, entire investments in other instruments eligible for regulatory capital status in these entities shall also be deducted at 50 per cent from Tier I and 50 per cent from Tier II capital; and
- the deductions indicated above will also be applicable while computing capital adequacy ratio of the bank on a solo basis.

111. The capital adequacy requirement will be further calibrated after finalisation of the Basel III rules, as indicated earlier.

Intra-Group Transactions and Exposures in FCs

112. In order to limit the inter-connectedness between the bank and other

group entities, it is proposed:

- to put in place an appropriate limit for such transactions and exposures, both for a single entity and on an aggregate basis for all other group entities.

113. Detailed guidelines in this regard will be issued separately.

Principles for Enhancing Corporate Governance in Banking Organisations

114. The BCBS in October 2010 issued '*Principles for Enhancing Corporate Governance*' for banking organisations. The Principles address fundamental deficiencies in bank corporate governance that became apparent during the financial crisis. Taking into account different categories of banking organisations in India, the Reserve Bank has been taking appropriate steps to improve corporate governance standards in banks. Implementations of 'fit and proper' criteria for directors on the boards of banks and splitting of post of the Chairman and Managing Director in private sectors banks as per the recommendations of the Ganguly Committee (2002) are some of the notable steps taken by the Reserve Bank in this direction in the recent past, which have improved standard of corporate governance. However, a review of the corporate governance standard in the banks is necessitated in the light of the principles issued by the BCBS. Accordingly, it is proposed:

- to take appropriate steps to fully align the corporate governance practices in banks in India with the principles enunciated by the BCBS.

115. Detailed guidelines in this regard will be issued separately.

Working Group on Valuation Adjustment and Treatment of Illiquid Positions

116. It was indicated in the Monetary Policy Statement of April 2010 to constitute a Working Group to recommend an appropriate framework for valuation adjustment for various risks/costs and treatment of illiquid positions. Accordingly, a Working Group (Co-ordinator: Shri P. R. Ravi Mohan) was set up in June 2010 with members drawn from the Reserve Bank, IBA, FIMMDA, Foreign Exchange Dealers Association of India (FEDAI) and select banks. The Working Group submitted its report in September 2010. The Group has given recommendations on a wide range of issues, including identification of illiquid positions, adjustment for illiquidity and valuation adjustment for unearned credit spread and closeout costs for the derivative portfolio of banks. The recommendations of the Group are under examination.

Convergence of Indian Accounting Standards with International Financial Reporting Standards

117. As indicated in the Monetary Policy Statement of April 2010, a Working Group (Chairman: Shri P. R. Ravi Mohan) was constituted to address the implementation issues and facilitate formulation of operational guidelines in the context of convergence of Indian Accounting Standards with the International Financial Reporting Standards (IFRSs) and prepare banking and NBFCs and UCBs to adhere to the roadmap

of implementation. As per the roadmap, all scheduled commercial banks will convert their opening balance sheet as on April 1, 2013 in compliance with the accounting standards converged with the IFRS. As regards NBFCs and UCBs, a gradualist approach has been adopted.

Introduction of Bank Holding Company/Financial Holding Company in India

118. In pursuance of the announcement made in the Monetary Policy Statement of April 2010, a Working group (Chairperson: Smt. Shyamala Gopinath) has been constituted to examine the introduction of a holding company structure together with the required legislative amendment/ framework. The work is in progress.

Compensation Practices

119. In line with the steps taken by the global community and the initiatives taken by G-20 nations, draft guidelines for private sector banks and foreign banks with regard to sound compensation policy were framed and placed on the Reserve Bank's website in July 2010 for public comments. These guidelines are largely based on the FSB's principles on sound compensation practices. The guidelines cover effective governance of compensation, alignment of compensation with prudent risk-taking and disclosures for whole time directors/chief executive officers, risk takers of banks as well as staff in the audit, compliance and risk management functions. Comments received from various banks/organisations/ individuals are being examined. Accordingly, it is proposed:

- to issue final guidelines on compensation practices by end-December 2010.

Licensing of New banks

120. The Hon'ble Finance Minister in the Union Budget 2010-11 had mentioned that the Reserve Bank would consider giving some additional bank licences to private sector players. Consequently, the Monetary Policy Statement of April 2010 indicated that a discussion paper would be prepared marshalling the international practices, the Indian experience as also the extant ownership and governance (O&G) guidelines for placing it on the Reserve Bank's website by end-July 2010 for wider comments and feedback, after which the guidelines will be finalised. Accordingly, the discussion paper was put in public domain in August 2010. Based on the comments and suggestions received from various parties and discussions held with major stakeholders in October 2010, it is proposed:

- to put the draft guidelines in public domain by end-January 2011 for public comments.

Presence of Foreign Banks in India

121. It was indicated in the Monetary Policy Statement of April 2010 that drawing lessons from the crisis, a discussion paper on the mode of presence of foreign banks through branch or wholly-owned subsidiary (WOS) would be prepared by September 2010. Accordingly, a discussion paper in consultation with the Government on the form of presence of foreign banks in India is in final stages of preparation.

Capacity Building in Banks

122. Banks should gear themselves up to meet various challenges in the coming years. In particular, the implementation of Basel III by all banks, the need for large and internationally active banks to move to the advanced approaches under Basel II and convergence with IFRS as on April 1, 2013 would require banks to upgrade their technology and risk management capabilities. Banks should undertake a review of the skills required and take up capacity building in right earnest and in a time bound manner. The Reserve Bank will also intensify its efforts in this regard by undertaking more capacity building programmes for the banking sector in the coming years.

Information Technology and Related Issues: Enhancement to the Guidelines

123. It was proposed in the Monetary Policy Statement of April 2010 to set up a Working Group on information security, electronic banking, technology risk management, and tackling cyber frauds. Accordingly, a Working Group on Electronic Banking, Controls, Governance and Technology Risk Management Standards (Chairman: Shri G. Gopalakrishna) was constituted. The recommendations of the sub-groups on technology, governance, operational issues, legal and educational aspects set up by the Group were discussed by the Working Group and are now being formalised. The Working Group is likely to finalise its report by end-November 2010.

VI. Institutional Developments

Payment and Settlement Systems

Membership to the Committee on Payment and Settlement Systems

124. India became a member of the Committee on Payment and Settlement Systems (CPSS) constituted under the aegis of the Bank for International Settlements (BIS). The Reserve Bank is represented on four Working Groups of CPSS, *viz.*, (i) General Review of Standards; (ii) Repo Market Infrastructure; (iii) Post Trade Services; and (iv) Retail Payment Systems.

Standardisation of Security Features on Cheque Forms

125. As indicated in the Monetary Policy Statement of April 2010, a cheque truncation system (CTS)-2010 standard with benchmark specifications for security features on cheques and field placements on cheque forms has been prescribed. The CTS-2010 standard, *inter alia*, included a prescription prohibiting alterations/ corrections on cheque forms. It has since been clarified that the prescription is applicable only to cheques cleared under the image-based cheque truncation system and will be effective December 1, 2010. The prescription will not be applicable to cheques cleared under magnetic ink character recognition (MICR) clearing, non-MICR clearing, OTC collection (for cash payment) or direct collection of cheques outside the clearing house arrangement.

126. The IBA and National Payments Corporation of India (NPCI) have been

jointly vested with the responsibility for implementation of the new cheque standards.

Operationalisation of National Payments Corporation of India

127. As indicated in the Monetary Policy Statement of April 2010, the NPCI has the envisioned role to look at future innovations in the retail payment space in the country. The NPCI has implemented a pilot project for settlement of inter-bank mobile payments. Further, the roll-out of the grid-based cheque truncation system (CTS) project at Chennai is likely to be operationalised by the end of March 2011.

Performance of National Electronic Funds Transfer System

128. As at end-July 2010, around 70,000 branches of 98 banks had participated in the national electronic funds transfer (NEFT) system and the volume of transactions processed increased to 9.5 million in July 2010.

Automated Data Flow from Banks

129. As indicated in the Monetary Policy Statement of April 2010, a Core Group consisting of experts from banks, the Reserve Bank, the Institute for Development and Research in Banking Technology (IDRBT) and the IBA has been constituted for preparing an approach paper on automated data flow (a straight through process) from the core banking solution (CBS) or other IT systems of commercial banks to the Reserve Bank. The Core Group has prepared an approach paper, which deals with automated data flow from banks to the Reserve Bank. The paper, *inter alia*, discusses the methodology to be adopted by banks to classify themselves into a cluster based on its technology and process dimensions. Based on this, estimated timelines for achieving complete automation of submission of returns have also been furnished. The approach paper is being examined and it is expected to be circulated to the banks for necessary action at their end.

130. The approach suggested for banks will be implemented in two phases. In the first phase, banks would be required to ensure seamless flow of data from their transaction server to their management information system (MIS) server and generate all returns from the MIS server automatically, without any manual intervention. In the second phase, the Reserve Bank would introduce a pull mechanism for the flow of data from the MIS server of banks in a straight through process. The timeline of the entire project will be determined in consultation with banks.

Real Time Gross Settlement System

131. The Indian RTGS has displayed tremendous growth in both transactions volume and the values that it has been processing since its inception in March 2004. With the increased number of electronic payment transactions, it has become expedient to position the Indian RTGS system primarily for processing and settling large value payment orders. Further, the Reserve Bank has set up a robust retail electronic funds transfer system in the form of NEFT, with near real-time settlement finality with 11 settlement cycles in a day.

Accordingly, it has been decided, in consultation with system participants:

- to increase the threshold limit for RTGS transactions from the present limit of ₹1 lakh to ₹2 lakh.

132. As a further incentive to customers to move their transactions to NEFT, a new value band in the ₹1 lakh to ₹2 lakh will be created, with customers having to pay lower charges *vis-à-vis* RTGS transactions.

133. The detailed guidelines in this regard will be issued separately.

134. As indicated in the Monetary Policy Statement of April 2010, a Working Group comprising representatives from the Reserve Bank and select commercial banks, *viz.*, SBI, PNB, ICICI Bank and HDFC Bank was constituted for preparing an approach for implementation of next generation RTGS. The Group submitted its report in August 2010, which has since been accepted. The implementation of the next generation RTGS system is in progress, which may take about two years for completion.

Cheque Truncation System

135. The CTS was successfully implemented in the National Capital Region of New Delhi in February 2008. Following complete migration to CTS, the separate MICR clearing was discontinued from July 2009. The CTS, on an average, processes over 0.5 million instruments per day. The next roll out of CTS is planned for March 2011 at Chennai, with the project being implemented by the NPCI. The process of roll out will be a grid-based approach to cover the clearing houses in the other cities of Tamil Nadu and the adjoining states of Kerala and Karnataka. Simultaneously, efforts are underway to establish common disaster recovery (DR) arrangements for both New Delhi and Chennai CTS operations.

Currency Management

136. Banks were mandated to use Note Sorting Machines in all their branches having average daily cash receipts of ₹1 crore and above by March 2010. As of now, 1,108 branches (other than currency chest branches) have been identified having average daily cash receipt of ₹1 crore and above. Banks have reported that Note Sorting Machines have been installed and made operational in 669 branches. For the remaining branches, banks have made arrangements with the nearest currency chest branch/currency administration branch. It was also indicated in the Second Quarter Review of October 2009 that banks should use such machines in all their branches having average daily cash receipts between ₹50 lakh and ₹1 crore by March 2011. Banks are expected to enhance their efforts to reach this position by March 31, 2011.

137. As indicated in the Second Quarter Review of October 2009, banks were advised to have the responsibility of currency management entrusted to a nodal official of the rank not less than that of a General Manager and will be accountable for the obligations cast upon currency chests by the Reserve Bank. All commercial banks have since appointed nodal officers.

Mumbai

November 2, 2010