

Mid-Term Review of Monetary and Credit Policy for the Year 2000-2001

I. Mid-Term Review of Macro-economic and Monetary Developments in 2000-01

Domestic Developments

On the basis of the meteorological reports available upto September 2000, it has been observed that the south-west monsoon was active and the quantum and distribution of rainfall were fairly satisfactory at the aggregate level. Of the 35 meteorological sub-divisions, 28 sub-divisions received excess or normal rainfall, which was the same as that of the last year. As some sub-divisions were affected by deficient rainfall or floods, the agricultural out-turn in 2000-01 remains somewhat uncertain. As of now, the output of foodgrains during the year is expected to remain close to that of last year. The total buffer stock of foodgrains stood at 40.8 million tonnes at the end of August 2000, which is higher by 38.3 per cent over the stock level of 29.9 million tonnes at the end of August 1999. The stocks of rice at 13.56 million tonnes are higher by 57.5 per cent, and those of wheat by 27.9 per cent. Overall, therefore, the outlook for agricultural supplies is comfortable during the year.

2. The industrial outlook presents a mixed picture. The increase in industrial production during the first four months of the current financial year was lower at 5.4 per cent than 5.9 per cent recorded during the corresponding period of the previous year. Manufacturing sector recorded a growth rate of 5.7 per cent upto July 2000 as compared with 6.7 per cent in the same period of last year. According to the use-based classification, basic goods production registered an accelerated growth rate of 4.7 per cent in comparison with 3.8 per cent during the same period of the previous year. Production in consumer goods sector also showed a better performance at 8.3 per cent compared with 2.5 per cent during the previous year. The intermediate goods sector recorded a lower growth of 5.2 per cent against 9.6 per cent during the previous year. The capital goods sector showed a negative growth of 0.3 per cent so far. The general deceleration observed in the Index of Industrial Production is partly attributable to the Central Statistical Organisation (CSO) incorporating the revised Wholesale Price Index (1993-94=100) as the deflator.

3. The CSO, in their recent release, has placed the real GDP growth in the first quarter (April-June) of 2000-01 at 5.8 per cent as against 6.9 per cent observed in the first quarter of 1999-2000. Taking the first quarter estimates into account, as per present indications, the real GDP growth during 2000-01 can be placed in the range of 6.0 - 6.5 per cent as against the projection of 6.5 - 7.0 per cent indicated in the April policy statement.

4. The rate of inflation on a point-to-point basis as on September 23, 2000 was 6.06 per cent as against 3.20 per cent a year ago. On an average basis, the annual inflation rate was at 4.96 per cent as against 4.37 per cent in the last year. Inflation as measured by rise in Consumer Price Index (CPI) for the month of August 2000 was 3.99 per cent as compared with 3.15 per cent in August 1999. On an average basis, the annual CPI inflation was, however, substantially lower at 3.25 per cent as against 10.16 per cent in the same period of last year.

5. The contribution to inflation has primarily arisen from the 'fuel, power, light and lubricants' group, the index of which recorded an increase of 25.9 per cent as on September 23, 2000 over the previous year. The increase in particular was in 'mineral oils'. This is a consequential impact of the substantial rise in international oil prices since September 1999. The increase in prices of other items among both the primary articles and the manufactured products, excepting fertilizers, were subdued. The inflation rate, excluding the effect of price increase in the fuel and petroleum group, works out to only 2.44 per cent on a point-to-point basis. While a close watch has to be kept on the inflation front, and the international oil prices continue to be a matter of particular concern, the overall demand/supply conditions in respect of sensitive commodities and manufactured goods remain comfortable. On the whole, as of now, the rate of inflation for the year as a whole is likely to be close

to the average of last two years.

6. Growth of money supply during the current financial year upto September 22, 2000 was 6.6 per cent as against 6.8 per cent observed in the same period last year. On an annual basis (September 22, 2000 over September 24, 1999), growth was lower at 13.6 per cent ^{1999, M₃} than 16.3 per cent observed in the comparable period of the preceding year. Aggregate deposits of scheduled commercial banks in the current financial year so far increased by Rs.59,603 crore (7.3 per cent) as compared with Rs.51,680 crore (7.2 per cent) in the same period last year. Assuming that the strong deposit accretion will continue, the increase in aggregate deposits during the current year will be of the order of Rs.1,25,000 crore as envisaged in the April policy statement. The monetary expansion during 2000-01 so far, is in the expected trajectory as indicated in the April policy statement, and the projected growth for 2000-01 is likely to remain around ^{M₃} 15.0 per cent.

7. Reserve money in the current financial year upto September 29, 2000 increased by Rs.688 crore (0.2 per cent) as against an expansion of Rs.3,617 crore (1.4 per cent) in the comparable period of last year. Currency in circulation increased by 1.9 per cent as against 3.8 per cent in the corresponding period of the last year. On an annual basis, currency expansion was 9.9 per cent as against 14.8 per cent in the previous year. There has been a shift in the sources contributing to the reserve money expansion during this year. During 1999-2000, the reserve money expansion was mainly due to increase in net foreign exchange assets and RBI credit to commercial sector whereas during this year so far, it has been mainly due to increase in net RBI credit to the central government. There is a sharp decline in the RBI credit to commercial sector in the current year. Net foreign exchange assets of the RBI in the current financial year have also declined by Rs.2,799 crore as against an increase of Rs.5,219 crore during the same period last year. Net RBI credit to the Government, however, increased substantially by Rs.10,588 crore as against Rs.308 crore in the corresponding period of last year. On the components side, bankers' deposits with the RBI declined substantially by Rs.4,124 crore (primarily due to reduction in CRR). On the whole, the reserve money expansion is expected to remain moderate and significantly lower than last year.

8. There has been a significant pick up in the bank credit and other flows to the commercial sector from the banking system during the current year. Scheduled commercial banks' credit expanded by Rs.30,867 crore (7.1 per cent) upto September 22, 2000 as against an increase of Rs.11,821 crore (3.2 per cent) in the previous year. Food credit increased by Rs.6,398 crore as against Rs.3,716 crore in the previous year. Non-food bank credit increased by Rs.24,469 crore (6.0 per cent) as against an increase of Rs.8,105 crore (2.3 per cent) in the previous year. Together with the provisional data on investments in commercial paper, investments in bonds / shares / debentures of PSUs and private corporate sector, the flow of resources from scheduled commercial banks to the commercial sector increased by Rs.26,471 crore (5.6 per cent) as against Rs.13,647 crore (3.4 per cent) in the previous year. Banks' investments in instruments issued by financial institutions and mutual funds this year increased by Rs.171 crore as against Rs.1,773 crore last year. Total resource flow to the commercial sector including capital issues, GDRs and borrowings from financial institutions increased by Rs.58,838 crore as compared with Rs.34,235 crore in the previous year.

9. The significant expansion in resource flow from banks to the commercial sector has occurred despite some evidence of deceleration in the growth rate of industrial output in the past few months of the current year. The feedback received from select bankers indicates that there have been positive increases in stocks of fertilizers, sugar, petroleum and automobiles. There has been some pick up in infrastructure sector and working capital growth in financing bills receivables. Export growth has also been higher resulting in higher export credit. Data collected internally by the RBI on additional limits of Rs.150 crore and above show a high year-on-year growth in limits for manufacture of silk and synthetic fibres, drugs and pharmaceuticals, fertilizers, light engineering, leasing and hire purchase, etc.

10. The Union Budget for 2000-01 placed the net market borrowings of the Central Government

at Rs.76,383 crore and gross borrowings at Rs.1,17,704 crore. Upto October 6, 2000, the Central Government, keeping the normal pace, completed net borrowings of Rs.47,026 crore, and gross borrowings of Rs.77,183 crore. RBI continued to combine auction issues with acceptance by private placement of dated securities of the Government consistent with market conditions. In the current financial year so far, devolvement and private placements with the RBI amounted to Rs.31,977 crore. However, the reserve money impact of this remained moderate due to decreases in the RBI credit to commercial sector and net foreign currency assets. The commercial banks' investment in government securities this year showed an increase of Rs.23,934 crore against an increase of Rs.35,766 crore in the corresponding period of the previous year. However, in the aggregate, banks continued to hold government securities in excess of SLR prescription by a sizeable margin.

11. Government of India's fiscal deficit upto August 2000 this year is reported to be significantly lower at Rs.36,447 crore representing an improvement by 24.3 per cent compared to last year. This has been contributed by a substantial increase in revenue receipts of Rs.64,523 crore, an increase of 27.5 per cent over last year, and a marginal increase of 2.7 per cent in expenditure. This is encouraging. However, two major uncertainties which may finally affect the budgetary outlook are: the pace of progress in realising the projected receipts from disinvestments, and the budgetary outgo to meet the shortfall in the oil pool account. Notwithstanding these uncertainties, it is absolutely essential to contain the borrowing programme within the budgeted levels. In fact, a reduction in the borrowing programme would be desirable as it would make a positive contribution to keeping the interest rate outlook positive and stable.

12. Several initiatives have been taken recently in regard to the internal debt management policy. Consequently, there has been a lengthening of the maturity structure in the last two years. Reissues and price based auctions were also introduced in order to enable consolidation of securities. Combining private placement with strategic open market operations whenever appropriate, has enabled the conduct of the government borrowing programme without being unduly disrupted by unanticipated external and domestic developments. An internal debt management policy, however deft, cannot continuously handle a widening deficit without serious adverse consequences in the debt market. It is, therefore, necessary that a strong framework is put in place to build up positive expectations on the fiscal front and it is hoped that the proposed Fiscal Responsibility Legislation will address this issue.

External Developments

13. There have been marked changes in the external environment since April 2000 when the annual monetary and credit policy statement was presented. During the year 1999-2000, despite a sharp increase in oil prices, the foreign currency assets of India had increased by US \$ 5.54 billion, and forex markets were generally stable. In the month of March 2000 alone, the increase in foreign exchange reserves was US \$ 2.1 billion, and both exports and capital flows had registered substantial growth. The subsequent period, from about mid-May to early August 2000, however, proved to be difficult for management of the external sector. Forex markets were affected by considerable uncertainty with the rupee depreciating against the US dollar by 3.2 per cent between May 31 and September 29, 2000, and overall foreign exchange reserves declining by US \$ 1.8 billion. Since the middle of August 2000, the situation has shown some improvement, and forex markets and reserve levels have been relatively stable.

14. As is well-known, in the very short-run, "expectations" about the likely behaviour of a currency next day or over a week or fortnight can play a major role in determining its movement against foreign currencies, particularly the US dollar. Given the "bandwagon" effect of any adverse movements, and the herd behaviour of market participants, expectations can often become self-fulfilling. This is particularly true of thin developing country market, where **net** volumes are relatively small. The day to day movement in currency markets is further complicated by volatility in

private capital flows, which are highly sensitive to short-term domestic and international developments as well as future expectations. In view of these and other imponderables, it is not possible to come to a definitive conclusion about the relative role of different factors in explaining the behaviour of forex markets in India during May - August 2000. Some of the factors which had a bearing on developments during this period were:

- The increase in US interest rates by 50 basis points in May 2000, which was followed by hikes in the European interest rate by 50 basis points in June and 25 basis points in August 2000. The increase in US interest rate in May coming on top of several earlier increases, significantly reduced the interest differential in respect of holdings in US dollars *vis-a-vis* Indian rupees.
- In April 2000, there was considerable uncertainty about the prospects of the US economy. This was reflected, among other things, in the sharp drop in equity prices. In April, the NASDAQ index fell by nearly 25 per cent, which in turn affected equity prices, in all major stock exchanges, including the Sensex in India. The US outlook, however, changed dramatically in June/July with an increasing consensus that the US economy was “soft landing” and US growth rates were likely to be sustained at a relatively high level.
- In view of the continuing uncertainty about recovery in Japan and the outlook for European economies, the US dollar appreciated sharply against most major currencies. US dollar appreciated by 5.7 per cent, 2.2 per cent and 0.8 per cent against Euro, Pound-Sterling and Japanese Yen, respectively, during the period end-May to end of September 2000. US dollar also appreciated by 7.8 per cent against Thai Baht, 1.7 per cent against Indonesian Rupiah, 8.5 per cent against Philippines Peso, and 0.4 per cent against Singapore dollar during the same period. (It may be noted that, as depreciation of the rupee against the US dollar was less than that of several other currencies, the rupee also appreciated against the Euro and Pound Sterling from end-May to mid-September by 4.4 per cent and 3.4 per cent, respectively. However, rupee depreciated by 1.8 per cent against the Japanese Yen during the same period).
- The price of crude oil imported by India increased further during the year, on top of the sharp increase recorded in the previous year. Average prices of Brent crude in September 2000 were US \$ 32.97 per barrel as compared with US \$ 25.55 in December 1999 and US \$ 22.51 in September 1999. As a result, there was a substantial increase in the volume of demand for foreign currency by Indian Oil Corporation (IOC) and other bulk importers of crude oil.
- For various reasons, including some uncertainty about the prospects of the equity market in India, there was a sharp reversal in capital flows on account of Foreign Institutional Investors (FIIs). In the months May to August, 2000, there was a net outflow of US \$ 505 million as against a net inflow of US \$ 948 million during the first quarter of the calendar year.

15. In order to cope with the adverse effects of the above factors, which persisted for several weeks, the Reserve Bank had to adopt a combination of measures. These included: (a) use of foreign exchange reserves to partially meet the excess demand in currency markets, particularly on account of oil imports and government debt servicing; (b) increasing the cost of bank financing for imports and overdue export bills; (c) allowing the exchange rate to move in response to the prevailing demand/ supply situation; (d) increasing the Bank Rate to pre-April level in order to partially reverse the narrowing of interest differential between dollar/rupee holdings in order to improve inflows. In order to mop up some excess liquidity in the system, CRR was also increased by 0.5 percentage point. The very short-term Repo and reverse Repo rates were also increased in order to make it less attractive to hold daily long positions in US dollars; and (e) repatriation of 50 per cent of balances held in EEFC accounts, along with reduction in entitlement in respect of further accretions to these accounts.

16. It may be argued that a recourse to one or two measures more intensively would have been more appropriate, or alternatively the rupee exchange rate could have been allowed to depreciate much more sharply and “find its own level”. Under certain circumstances, depending on availability of firm information on what exactly was causing the turbulence in forex markets, either of these positions could be valid. However, while at times the underlying causes of exchange market volatility are easy to diagnose (*e.g.*, effects of contagion, sanctions or hostilities at the border), often the precise cause and the degree of volatility as well as its duration are difficult to estimate or forecast. Multiplicity of factors, which can also change from time to time, and which are often self-fulfilling can influence forex market outcomes (*e.g.*, uncertainty of economic outlook, changes in oil prices, behaviour of equity markets abroad or movements in the exchange rate of US dollar *vis-a-vis* Euro, or rumours about central bank actions, etc.). In the situation prevailing in our exchange markets during May-August 2000, based on a continuous analysis of the evolving situations, recourse to a combination of measures was preferred so that the adverse impact on the rest of the economy could be minimised. A reliance on one or two measures (*e.g.*, sharp monetary tightening or unchecked depreciation of the exchange rate, and/or unlimited use of reserves) could have had unacceptable longer term consequences for the economy and the financial system, including a much greater risk of non-reversible destabilisation.

17. A related issue that has figured in the recent debate on the management of the external sector is that it would be appropriate if, during periods of excess capital flows or capital surge (as experienced during some months in 1999- 2000, and also earlier), the rupee was allowed to appreciate substantially (rather than the RBI absorbing part or whole of the excess supply). From a theoretical point of view, this argument has some merit. If there were sharp two-way movements in the exchange rate, market operators would be subject to two-way risks rather than being able to take “one-way” bet during periods of excess demand for foreign currency. In reality, however, the situation is somewhat more complicated. It is not clear whether greater volatility in exchange rates, and continuing sharp depreciation within a very short period during periods of excess demand, would stabilise expectations or destabilise currency markets beyond the levels of tolerance. The world-wide experience of emerging markets is that there is always a greater rush to “get out” (when exchange rate is falling sharply) than to “get in” (when exchange rate is rising). In countries with a current account deficit, like India, a build-up of reserves is also essential to take into account various types of “liquidity risks” associated with different types of flows and other requirements. As pointed out in the April policy statement, the recent international experience particularly during the period of East Asian crisis, has highlighted the fact that emerging market economies have to largely rely on their own resources during external exigencies as there is no “lender of the last resort” to provide additional liquidity at short notice. While two-way movements in currency are certainly desirable and no attempt should be made to provide a “floor” when there are excess capital inflows, it is necessary to keep the above considerations in view in order to guard against unexpected contingencies.

18. A lesson of experience, not only in India but also in other countries, is that, given the nature of foreign exchange markets and uncertainty in the direction of capital flows in a floating rate environment, the situation and outlook can change dramatically within short periods and extreme caution and care need to be exercised in the management of the exchange rate and foreign exchange reserves.

19. Looking ahead to the second-half of the current year, there is need for continued caution and vigilance on the external front in view of several uncertainties. Despite the action by OPEC in early September to increase supplies and the action by the United States to release some oil from strategic reserve, international prices of crude oil continue to be very high and cast a substantial burden on oil. Internationally, while growth/inflation outlook in industrialised countries as a whole remains favourable, the exchange markets continue to be characterised by sharp volatility and unpredictable movements (as revealed, for example, by the sudden depreciation of Euro and Pound Sterling *vis-a-*

vis US dollar in early September). The behaviour of equity markets world wide, which in turn influences inflows of foreign capital for portfolio investment, is also far from stable, and an unexpected turnaround in such investments cannot be ruled out.

20. In coping with these uncertainties, the favourable factors for India are: continued good performance of exports, particularly software exports; a comfortable level of foreign exchange reserves; a favourable outlook for foreign direct investment in certain important sectors (such as, Information Technology and Telecommunications); a relatively low level of external commercial debt, particularly short-term debt; and a positive outlook for sustained economic growth. No effort should be spared to take maximum advantage of these positive factors, and to further accelerate the process of growth with particular emphasis on exports.

21. Exports have done well during the current year and capital inflows have also increased in the very recent period. India's exports during the first four months of the current financial year at about US \$ 13.9 billion recorded an increase of over 25.0 per cent over the exports during the corresponding period of the preceding year. During the same period, imports at US \$ 17.6 billion, also increased by about 25.0 per cent compared to 1.1 per cent in the preceding year. Of the total imports, oil imports increased by US \$ 5.5 billion (or nearly 100 per cent) impacted by higher prices. Trade deficit in the first four months of the current financial year was US \$ 3.7 billion as against US \$ 3 billion in the same period last year. However, despite the substantial increase in the oil import bill, increase in exports and invisible receipts is expected to keep the current account deficit for the year 2000-01 at less than 2.0 per cent of GDP, which is considered reasonably satisfactory.

22. In the last two years, as pointed out in the April policy statement, several measures have been introduced to ensure timely delivery of credit to exporters and remove procedural hassles. These measures included provision of 'On Line Credit' to exporters, extension of 'Line of Credit' for longer duration for exporters with good track record, peak/non-peak credit facilities to exporters, permission for interchangeability of pre-shipment and post-shipment credit and meeting the term loan requirements of exporters for expansion of capacity and modernisation of machinery and upgradation of technology. Improvements were also made in the procedure for handling of export documents and fast track clearance of export credit at specialised branches of banks. Similarly, new simplified guidelines were issued for sanction of credit facilities for software services, project services and software products and packages.

23. In order to ensure that the above procedural and other improvements in the credit delivery system were actually reaching the exporters, the Reserve Bank had also set up a Bankers' Group at the operational level (comprising senior officials from commercial banks and the Reserve Bank). The Group held a number of interactive sessions with exporters as also base-level officials of the commercial banks at 21 major export centres in the country in addition to discussions with industry associations. In order to further improve the credit delivery system, the Reserve Bank had invited exporters, particularly those who were located in non-metropolitan centres, to send their reactions on whether the new system was working satisfactorily. They were also requested to send their suggestions for improvement in procedures, particularly those which were designed to reduce paper work without diluting accountability.

24. In response to this request, a number of suggestions, mainly of a procedural nature, were received from export organisations and exporters. These have recently been examined by the Bankers' Group. Banks are being advised separately to implement the recommendations of the Group to further simplify the procedures for export credit.

25. The action taken by the Reserve Bank to reduce accumulated balances and further accretions to EEFC account in August 2000 has no doubt caused some disappointment among exporters. It may be recalled that this account was essentially meant for use by exporters for certain specified purposes to facilitate mostly current account and other permissible payments. While most exporters were using the scheme for the intended purposes, in the recent period, it was noticed that balances in these

accounts were being increased, which added to the magnitude of “leads” and “lags” in external receipts. The Reserve Bank has reviewed the scheme in the light of previous experience and feedback received from premier export organisations. It is desirable to persevere with the positive feature of the scheme, *viz.*, the reduction in the “transaction” and banking costs for exporters for making current account and other permissible payments, while at the same time ensuring that the scheme is not used for unintended purposes. The details of the revised EEFC scheme are given in Part III.

26. In the last two years, a number of changes have also been introduced in various schemes for remittances, investment and maintenance of bank accounts by Non-Resident Indians (NRIs) in order to make these special facilities procedurally simple. In April, the Reserve Bank had also invited responses from NRIs on the actual working of these simplified procedures, and suggestions for further improvement. It is gratifying to note that most of the responses have been highly positive, and no special problems in the operation of these schemes have been reported.

27. In recent months, the Government has taken several initiatives to encourage the flow of Foreign Direct Investment (FDI) on mutually beneficial basis. Thus, new foreign investment proposal in the IT sector will now be entitled to automatic approval irrespective of whether the investor has an existing joint venture or technical collaboration in the country. IT companies with an existing joint venture or a technical collaboration need not henceforth seek “no objection certificate” from existing joint venture partners/associates to float new business. Government has also permitted foreign equity investment in micro credit/rural credit activities. FDI upto 100 per cent has been allowed for business-to-business e-commerce subject to certain conditions. The upper limit of Rs.1,500 crore for FDI in projects of electricity generation, transmission and distribution (other than atomic reactor power plants) has been removed. The level of FDI in oil refining sector under automatic route has also been raised from the existing 49 per cent to 100 per cent. It may be mentioned that “in principle” or prior approval of the Reserve Bank is no longer required for any FDI proposal as long as it is in conformity with Government guidelines.

28. Recently, the Government has delegated powers to the Reserve Bank to approve External Commercial Borrowings (ECB) upto US \$ 50 million under the automatic route, and upto US \$100 million on a case-by-case basis. In order to avoid recourse to short-term or high-cost ECBs, Government has also laid down certain conditions regarding minimum maturity period and acceptable spreads for such borrowings. In respect of ECB proposals under the automatic route, which conform to Government guidelines, prior approval of the RBI will not be required. The procedure for proposals requiring specific approval of the RBI is also being simplified.

II. Stance of Monetary Policy for the Second Half of 2000-2001

29. On April 1, 2000, the Reserve Bank had announced a number of measures to enhance liquidity and reduce the cost of funds to banks. These measures included a reduction in the Bank Rate, CRR and the Repo rate by 1 percentage point each. On April 27, 2000, the annual monetary and credit policy statement expressed RBI’s intention “to continue the current stance of monetary policy and ensure that all legitimate requirements of bank credit are met while guarding against any emergence of inflationary pressures due to excess demand. Towards this objective, the Reserve Bank will continue its policy of active management of liquidity through OMO, including two-way sale/ purchase of treasury bills, and reduction in Cash Reserve Ratio as and when required”. On July 21, 2000, however, the RBI increased the Bank Rate by 1 percentage point and CRR by 0.5 percentage point. Short-term repo rates were also substantially raised in several stages, soon after the introduction of Liquidity Adjustment Facility (LAF) on June 5, 2000 (these rates have recently been reduced). The change in course within four months of the April 1 reductions in Bank Rate/CRR has elicited a fair amount of comment and debate among experts, market participants and bankers.

30. It is useful to recall that, while confirming the intention to continue the then prevailing stance

of monetary policy, the April policy statement had also cautioned that, “it cannot be over-emphasised that the above outlook can change dramatically within a relatively short period of time in the event of unanticipated domestic or international events. Several unfavourable events that affected the outlook for the economy during the years 1997 through 1999 point to the need to respond quickly and to change course, if and when required”. Further, it was stated that, “the Reserve Bank will continue to monitor domestic monetary and external developments, and **tighten** monetary policy through the use of instruments at its disposal, when necessary and unavoidable”. Moreover, banks and financial institutions were specifically urged to, “make adequate allowances for unforeseen contingencies in their business operational plans, and take into account the implications of changes in the monetary and external environment on their operations”. Thus, the possibility of “a change in course” and “tightening of monetary policy” in the event of a change in the domestic or international situation was specifically recognised in the April policy statement. And as it happened, such a change of course did indeed become necessary a few months later.

31. It may also be mentioned that, in the conduct of monetary policy, a change of course in response to the emerging situation is often unavoidable. This has also been the experience of most central banks in developing economies as well as industrialised countries with well developed financial systems. For instance, the US Federal Reserve **reduced** interest rates in successive steps from September to November 1998 from 5.5 per cent to 4.75 per cent, but, revised the stance in June 1999 and hiked the rate in successive steps to 6.5 per cent beyond the level at which easing commenced. Similarly, the European Central Bank, which strongly opposed the easing stance till March 1999, actually **reduced** the interest rate by 50 basis points in April 1999, but subsequently changed course when new information became available and hiked the rates in November 1999. The Bank of England which eased the rates in June 1999, reversed its stance and hiked the rates in September 1999.

32. As financial systems become more open and more deregulated, it becomes difficult to anticipate or accurately predict the market behaviour. Financial market conditions, and market actions, in turn can have important impact on macro-economic outcomes in terms of investment, growth, inflation or external stability. For example, when markets were highly controlled, bank interest rates were fixed by the Reserve Bank, and credit allocation was centralised, it was possible for monetary policy prescriptions to remain fixed for a long period. As we move towards a more efficient, more competitive and a more vibrant financial system, it is necessary to accept the fact that monetary instruments will be used more flexibly. It is also essential for market participants to take greater recourse to appropriate asset-liability and risk management techniques in order to take account of the unanticipated changes in monetary conditions and the interest rate outlook.

33. Apart from the impact of sharp increase in the international prices of crude oil, the domestic inflationary outlook is somewhat uncertain. As on September 23, 2000, the point-to-point inflation in “manufactured products” which account for a weight of 63.75 per cent was 2.91 per cent and in “primary articles” accounting for a weight of 22.03 per cent was 1.25 per cent. In fact, the prices of foodgrains declined by 5.44 per cent. On the supply side, stocks of foodgrains at the end August 2000 were at a comfortable level of 40.8 million tonnes. The low rate of inflation in “primary articles” and “manufactured products” combined with comfortable stocks of foodgrains are sources of comfort in the management of the overall inflationary environment. The M3 growth as on September 22, 2000 was 13.6 per cent which was also in line with the projected growth of 15.0 per cent envisaged in the April policy statement and thus, as of now, no undue pressure from the demand side is anticipated. However, as mentioned earlier, the external outlook principally in respect of crude oil prices, remains highly uncertain and is a cause of concern.

34. Taking the above factors as well as Government’s borrowing requirements into account, as per present indications, liquidity conditions are likely to remain adequate during the rest of the year. The banking system is not expected to face any difficulty in meeting fully the demand for

commercial credit from industrial and other sectors. The Reserve Bank also stands ready to provide appropriate liquidity through its LAF as necessary in order to manage the overall liquidity situation in the economy.

35. During the rest of the current year, the interest rate outlook would crucially depend on external market conditions, domestic developments in respect of the overall rate of inflation, demand for credit from the commercial sector and Government's borrowing requirements. To the extent possible, It will continue to be the endeavour of the RBI to maintain a stable interest rate environment. However, as mentioned in the April policy statement, it will be prudent for banks and financial institutions to make sufficient allowance for unforeseen contingencies, including possible changes in monetary measures, in their business operational plans though, as of now, Reserve Bank's policy will continue to be to maintain stable monetary conditions.

36. In the last four months, the LAF introduced since June 5, 2000 has been effectively used to influence short-term interest rates by modulating day-to-day liquidity conditions and to contain volatility in foreign exchange market. For a few weeks, the repo rates were increased sharply and remained high. In the more recent period, they have been brought down to a more reasonable level. The LAF would continue to be operated in a flexible manner, both in terms of the applicable rates and tenors, in keeping with the developments in financial markets. It may, however, be mentioned that the full effectiveness of the LAF is at present constrained by the automatic additional liquidity available through refinance and liquidity support facilities to banks and primary dealers.

III. Financial Sector Reforms and Monetary Policy Measures

37. The recent annual Monetary and Credit Policy Statements as well as Mid-Term Reviews have focussed on structural measures to strengthen the financial system and to improve the functioning of the various segments of financial markets. As pointed out in the April policy statement, the main objectives of these measures have been five-fold: (a) to increase operational effectiveness of monetary policy by broadening and deepening various segments of the market; (b) to redefine the regulatory role of the Reserve Bank in order to make it more efficient and purposive; (c) to strengthen the prudential and supervisory norms; (d) to improve the credit delivery system; and (e) to develop the technological and institutional infrastructure of the financial sector.

38. To meet the above objectives, a number of measures have been initiated in various areas. In the following paragraphs, an attempt is made to review briefly the progress made so far in respect of these initiatives and to modify some of them, where necessary. As far as possible, changes proposed, have been decided after extensive consultations with experts and market participants. Suggestions made by commentators in media as well as specialised journals have also been taken into account, wherever appropriate.

39. It is not proposed to make any change in some of the important monetary measures, such as the Bank Rate, the CRR or the LAF. As emphasised in earlier Policy statements, changes in respect of Bank Rate, CRR and the Repo Rates (under LAF) will be made as and when necessary, and will not necessarily be linked to half-yearly policy statements.

Development of Money Market

40. As part of April 2000 policy statement, certain measures were announced to facilitate the development of the Forward Rate Agreements/ Interest Rate Swaps (FRAs/IRS) and Certificates of Deposit (CDs). Similarly, the policy stance relating to call/notice money market and Commercial Paper (CP) had also been indicated. After a review of the developments, the following measures are being introduced :

(a) Permission to Non-Banks to Lend in the Call Money Market

Following the recommendations of Narasimham Committee II, the Reserve Bank has taken several steps to widen the participation in repo market such as, (i) permission to non-bank participants

maintaining current and SGL accounts with the RBI, Mumbai to undertake both repo and reverse repo; (ii) reduction in minimum maturity for repo transactions to 1 day; (iii) state government securities being made eligible for undertaking repos; and (iv) opening of its purchase window to impart liquidity to government securities whenever situation warrants. In the context of improving the efficacy of the LAF and to make the money market more efficient and enable the development of a short-term rupee yield curve, as recommended by the Committee, it is necessary to move towards the objective of pure inter-bank call money market as early as possible. However, considering the fact that the repo market is yet to be broad-based in terms of instruments and participants and acquire enough depth, it has been decided to extend the permission granted to select corporates, which have been given specific permission to route call money transactions through Primary Dealers (PDs) which is available now upto December 2000 for a further period of six months, *i.e.*, upto June 2001. In addition to select corporates which have been permitted to route call money transactions through PDs, there are several non-bank institutions such as Financial Institutions and Mutual Funds which are currently permitted to lend directly in the call/ notice money market. In order to make necessary transitional provisions, in respect of these institutions also, before the call money market is confined only to banks/PDs, it has been decided to constitute a Group to suggest a smooth phasing out by a planned reduction in their access to call/notice money market. This Group will also include representatives of non-bank institutions.

(b) Guidelines for Issue of Commercial Paper (CP)

It was indicated in the April policy statement that the current guidelines for issue of CP would be modified in the light of recommendations made by an Internal Group. Accordingly, a draft of the revised guidelines as also the Report of the Internal Group were circulated in July 2000. Taking into account the suggestions received from the participants, the guidelines have now been finalised. A summary of the guidelines is in Annexure I. Full Text is being issued separately. The new guidelines are expected to provide considerable flexibility to participants and add depth and vibrancy to the CP market while at the same time ensuring prudential safeguards and transparency. In particular, the guidelines will enable companies in the services sector to more easily meet their short-term working capital needs. At the same time banks and FIs will have the flexibility to fix working capital limits duly taking into account the resource pattern of companies' finances including CPs.

(c) Transfer of Certificates of Deposit (CDs)

- At present, while the minimum maturity period for CDs is fixed at 15 days, there is also a restriction that CDs issued by banks and financial institutions cannot be transferred or transacted in the secondary market before 15/30 days from the date of issue. With a view to providing flexibility and depth to the secondary market, it is proposed to withdraw the restriction on transferability period for CDs issued by both banks and financial institutions.

(d) Rating Requirement for Term Deposits Raised by Financial Institutions

At present, mobilisation of term deposits by select all-India financial institutions, which are governed by the Reserve Bank of India guidelines, do not require any rating. In order to improve the functional efficiency of the market, it is proposed to make rating mandatory for the term deposits accepted by all-India financial institutions with effect from November 1, 2000.

Development of Government Securities Market

41. Important developments in respect of the measures announced in the April policy statement are :

- It was proposed to introduce a scheme for automatic invocation by the SGL Account holder of undrawn refinance/ liquidity support from the RBI for facilitating smooth securities settlement. Detailed guidelines for implementation of the facility has since been issued.
- With a view to facilitating sale of securities allotted in primary issues on the same day, it was

proposed to allow the entities which get allotments in primary issues to sell the allotted securities on the same day. Relevant instructions have been issued.

- The day of payment in respect of 14 and 91 day Treasury Bills was changed from Saturday to the next working day pending a review after six months. Since the system has been working smoothly, it has been decided to continue with the change of day of payment from Saturday to the next working day.
- A detailed review of liquidity support to PDs has been undertaken and modifications introduced in the scheme in consultation with them. Further, the commission payment to PDs for auction Treasury Bills has since been withdrawn. A note containing the proposed capital adequacy standards for PDs was circulated and suggestions received from them have been examined and incorporated in the guidelines. Revised guidelines are being separately issued to the PDs.
- State Bank of India as the chief promoter has constituted a Core Group, which is working on a Report for setting up a Clearing Corporation for money, debt and foreign exchange markets. The Core Group is presently engaged in having presentations from different entities with expertise for setting up the proposed Clearing Corporation and it would come out with its recommendations shortly.

42. It is now proposed to introduce some further measures for development of government securities market :

(a) Guidelines for Constituents' SGL Accounts

Currently, SGL Account holders are provided the facility to maintain a second SGL Account called Constituents' SGL Account in the books of the Reserve Bank of India to enable them to hold government securities on behalf of their constituents. With a view to encouraging investors to hold securities in scrip-less form and to ensure that entities holding securities in custody employ practices and procedures so that the constituents' securities are appropriately accounted and kept safe, it has been decided to frame a set of guidelines governing the maintenance of the Constituents' SGL Accounts. The guidelines are being issued separately.

(b) Order-driven Screen-based Trading in Government Securities

Reserve Bank of India has decided, in principle, to move over in due course to order-driven screen-based trading in government securities on the stock exchange. Reserve Bank of India would specify the date for switchover to order-driven screen-based system in consultation with SEBI. As and when the date is specified, it will be applicable to all Stock Exchanges on which banks and FIs can operate.

Prudential Measures

43. With a view to strengthening the financial position of banks prudential norms on income recognition, asset classification and provisioning have been implemented in a phased manner commencing from the accounting year 1992-93. The basic principles of these norms were income recognition based on record of recovery, classification of assets on the basis of uniform and objective criteria and provisioning based on chances of recovery and period for which the assets remain as Non-Performing Assets (NPA). Further, over these years emphasis has also been made to move towards adopting the international best practices in these areas. Keeping in view the wide-ranging and rapid changes taking place in the financial sector, following further measures are being introduced :

(a) General Provisions on Standard Assets as Tier 2 Capital

The Narasimham Committee on Banking Sector Reforms had observed that our standards with regard to asset classification in banks were liberal and needed to be revised to fall in line with the international best practices. In this connection, the Committee had recommended for a general provision of 1 per cent on standard assets, which the RBI should consider introducing in a phased manner. Accordingly, as a part of tightening the prudential norms, banks were advised in October 1998 to make a general provision on standard assets of a minimum of 25 basis points from the year

ended March 31, 2000. The guidelines were partially modified on April 24, 2000 stipulating that the provision should be made on a global portfolio basis and not on domestic advances, the general provision on standard assets will not be eligible for inclusion in Tier 2 Capital, etc. In view of the international best practices followed in this regard, it is proposed to include the general provision on standard assets in Tier 2 Capital. Necessary instructions will be issued separately.

(b) Categorisation and Valuation of Banks' Investment Portfolio

As mentioned in the Mid-Term Review of Monetary and Credit Policy for 1999-2000, the Report of the Informal Group on Valuation of Banks' Investment Portfolio was circulated among banks and discussed with the Institute of Chartered Accountants of India and the Indian Banks Association. The guidelines have now been finalised keeping in view the comments and suggestions received from them. The revised guidelines are in consonance with the best international practices on categorisation and valuation of investments and are effective from the half-year ended September 30, 2000. A summary of the revised guidelines on categorisation and valuation of banks' investments is in Annexure II. Detailed operational instructions are being issued separately.

(c) Annexing Balance Sheets of Subsidiaries to Parent Bank's Balance Sheet

Banks are required to voluntarily build-in risk weighted components of their subsidiaries into their own balance sheet on notional basis and earmark additional capital in their books, in stages, beginning from the year ending March 2001. However, at present, public sector banks are not required to annex the balance sheets of their subsidiaries to their balance sheet. In order to bring more transparency to the balance sheets of public sector banks and as a further step towards consolidated supervision and to provide additional disclosures, it has been decided that public sector banks should also annex the balance sheets of their subsidiaries to their balance sheet beginning from the year ending March 31, 2001.

(d) Non-Performing Asset - "Past Due" Concept

Taking into account the existing legal framework, production and payment cycles, business practices, geographical spread and agrarian nature of the economy and problems involved in payment and settlement systems, the concept of "past due" was incorporated into the two quarter delinquency norm on income recognition, asset classification and provisioning introduced in April 1992. However, the "past due" concept (grace period of 30 days) is not applicable in case of cash credit / overdraft accounts and bills purchased and discounted, which are classified as non-performing when such accounts remain out of order or overdue for a period of more than 180 days. Advances granted for agricultural purposes are, however, treated as NPA only if interest and/or instalment of principal remains unpaid, after it has become past due, for two harvest seasons but for a period not exceeding two half years. Due to the improvements in the payment and settlement systems, recovery climate, upgradation of technology in the banking sector, etc., the concept of "past due" is not considered relevant any more. The "past due" concept is therefore, being dispensed with. This will be made effective from March 31, 2001.

(e) Move towards Risk Based Supervision

As part of the April policy statement, it was announced that the Reserve Bank would be engaging the services of reputed international consultants to develop an overall plan for moving towards Risk Based Supervision (RBS) incorporating international supervisory best practices. Accordingly, the Department for International Development of the UK consented to fund RBS project and appointed an international consultant. They commenced their activity in July 2000. The consultants completed Phase 1 of the project by conducting a review and evaluation of current supervisory and regulatory framework, policies, guidelines, instructions, tools, techniques, systems, available IT infrastructure and various internal and external linkages. They have submitted the Draft Report consisting of their recommendations and findings. The thrust of the Phase 1 recommendations is on enhancements to the regulation and supervision framework leading to increased effectiveness of overall supervision through greater focus on risk as well as a realignment of the inspection process to fall in line with a

more risk-based approach. Their recommendations cover vital areas such as data management, supervisory process, inspections, feedback to banks, external audit, etc. During Phase 2 of the project, the Consultants are expected to work out the practical and operational aspects of the above recommendations and suggest a new risk based supervisory framework including the sequencing of the different stages and a time frame for implementation.

(f) Discussion Paper on Prompt Corrective Action

To guard against regulatory forbearance and to ensure that regulatory intervention is consistent across institutions and in keeping with the extent of problem, a framework for Prompt Corrective Action (PCA) has been prepared with various trigger points for prompt responses by the supervisors. The framework provides certain mandatory and discretionary action points for the supervisors. The schedule of corrective actions has been worked out based on three parameters, *i.e.*, Capital to Risk-Weighted Assets Ratio (CRAR), Net NPAs and Return on Assets (ROA) which represent the three important parameters of capital adequacy, asset quality and profitability. When a bank's performance activates these trigger points, a certain set of mandatory/ discretionary actions will follow. These action points are proposed to pre-empt any deterioration in the soundness of banks. The PCA has been put on the web site (www.rbi.org.in) for wide discussion, debate, and comments. The scheme will be finalised in the light of comments and suggestions received from experts and market participants.

(g) Macro-Prudential Indicators (MPIs)

The health and stability of financial systems have traditionally been measured by MacroEconomic Indicators (MEIs). Financial sector supervisors have been using their own set of Micro-prudential Indicators based on CAMELS framework. Following the East Asian Crisis, the interest in micro-prudential indicators has increased and it has been postulated that Aggregated Micro-prudential Indicators (AMPIs) coupled with MEIs would be better macro-level indicators of health and stability of financial systems. The Macro-prudential Indicators (MPIs), comprise of AMPIs and MEIs. A half-yearly Financial Stability review using MPI data would be initially prepared for internal circulation.

(h) Credit Exposures to Individual/Group Borrowers

It was announced in the Mid-Term Review of Monetary and Credit Policy of October 1999 to reduce the exposure ceiling in respect of individual borrower from 25 per cent to 20 per cent of capital funds effective April 1, 2000 and where the (then) existing level of exposure was more than 20 per cent, banks should reduce the level to 20 per cent over a two year period ending October, 2001.

A review of current practices regarding credit exposure limits *vis-à-vis* international best practices shows that there are certain issues which require further consideration. The first relates to the concept of 'capital funds'; second relates to the scope of the measurement of credit exposure, in particular, the coverage of non-fund and other off-balance sheet exposures; and the third relates to the level of exposure limit itself. Taking into account the complexities involved, it has been decided to prepare a detailed Discussion Paper on the subject which would *inter alia* address issues relating to current practices in India *vis-à-vis* international best practices and the possible alternative approaches with pros and cons and other relevant aspects. The Discussion Paper which is expected to be finalised by December 2000, will be circulated among banks. Based on the comments and suggestions on the issues, and followed by an interaction with banks, the RBI will take a final view on the approach that should be adopted with a view to making it effective from March end 2002.

Bank Financing of Equities and Investments in Shares

44. The Standing Technical Committee, comprising officials of the RBI and SEBI, which was requested to develop operating guidelines for a transparent and stable system of bank financing of equities and investments in shares, submitted its report in August 2000. This report was released for public comments by the RBI. On the basis of the comments received from experts and other market

participants on the proposals made by the Committee as well as the views expressed by banks in the meeting taken by the RBI with the Chief Executives of major banks in September 2000, draft guidelines were prepared by the RBI and circulated once again, among select banks, and also placed on the RBI website for comments from banks, financial institutions and other market participants. Based on the feedback received from banks and other market participants, the guidelines on bank financing of equities and investment in shares have now been finalised. These are given in Annexure III.

45. These guidelines are expected to enable the Boards of banks to frame suitable operational guidelines for each bank, taking into account their individual risk profiles, and provide for investments by banks in the equity market on a more stable and long-term basis subject to appropriate prudential considerations. The RBI-SEBI Technical Committee will review the actual working of these new guidelines after six months in consultation with select banks. If any changes in operational procedures and/or overall framework are required, the Committee's recommendations will be widely circulated and discussed with all concerned.

Review of Exchange Earners Foreign Currency A/cs (EEFC) Facility

46. Since August 14, 2000, banks are permitted to credit 35 per cent of the inward remittances in the EEFC accounts of Export oriented units, units in Export Processing Zone, Software Technology Park or Electronic Hardware Technology Park and 25 per cent of inward remittances in respect of others. Prior to this, the respective entitlements were 70 per cent and 50 per cent. On a review, in order to facilitate quick export-related payments and reduce transaction costs, it has been decided to restore fully the earlier entitlements to 70 per cent and 50 per cent, respectively. Payments which can be made from these accounts will also remain the same as before.

47. As balances in the accounts are meant to be used by the account holders for their current account trade transactions and other permitted payments, the EEFC accounts (including existing accounts) will henceforth be held in the form of current accounts. The cheque-issuing facility against these accounts will continue to be available for convenience of exporters. No credit facilities, either fund based or non-fund based, will be provided by banks against the EEFC balances.

Credit Delivery Mechanisms

48. Credit delivery mechanisms have been strengthened by improving and simplifying procedures and reducing documentation and enhancing decentralised decision making such that the targeted sector *viz.*, agriculture, exports, macro-credit institutions and small scale industries are able to access credit without undue hassles. As a further step in this direction the following measures are being taken :

(a) Charging of Penal Interest: Deregulation

In terms of the current instructions, banks have been advised about the overall penal/additional interest to be charged by banks which should not exceed 2 per cent over and above the rate of interest applicable/ normally charged to the respective borrowers. It may be mentioned that since issue of the above instructions, interest rates on loans and deposits have been substantially deregulated and banks' Boards have been empowered to formulate policy on lending rates taking into account their cost of fund, the underlying credit risk, etc. Since the Boards have been empowered to decide the Prime Lending Rate (PLR) as also the spread over PLR, it is felt that the decision on penal interest that should be levied for reasons such as default in repayment, non-submission of financial statements, etc., should also be left to the Boards of each bank. This would also give further operational autonomy to the banks. It has, therefore, been decided that banks may formulate transparent policy for charging penal interest rates, with the approval of their Boards. The policy should be governed by well accepted principles of transparency, fairness, incentive to service the debt and due regard to genuine difficulties of customers.

(b) Margins on Credit for Free Sale Sugar: Deregulation

Prescription of margins under selective credit control are at present in vogue only in respect of sugar. Effective October 22, 1997, for unreleased stocks of sugar with sugar mills, which contain both the levy and free sale components, separate margins have been stipulated. The minimum margin for levy stock is prescribed as 10 per cent, while free sale sugar is subject to a margin of 15 per cent. There is no margin on the buffer stock. On a review of market conditions and with a view to providing the flexibility to banks in prescribing margins, it has been decided to withdraw the existing prescriptions under selective credit control on free sale sugar. Margins in respect of free sale sugar will be decided by the banks based on their commercial judgment. The prescribed margins of 10 per cent in respect of levy stock and zero margin in respect of buffer stocks will continue without change.

(c) Review of Consortium Arrangement for Food Credit

At present, food credit is disbursed under a single window consortium led by SBI. However, the consortium arrangement is regulated by the Reserve Bank in respect of fixing sanctions of limits for the procurement of foodgrains by the state governments and the FCI, the percentage share among the members of the consortium and the interest rate chargeable on food credit. In the context of the present policy of providing more flexibility and operational freedom to banks as well as government and other enterprises, it has been decided to undertake a review of these arrangements. A Committee representing banks, RBI, Government and FCI will be constituted for the purpose.

(d) Export Credit

As mentioned in Part I, in response to the request to exporters to send their suggestions, the RBI has received a number of suggestions from export organisations and exporters mainly of a procedural nature for further improvement in the credit delivery system. These suggestions have been examined by the Bankers' Group and the RBI, and banks are being requested to implement the recommendations of the Group.

(e) Review of Recommendations of the Bills Discounting Group

A Working Group on Bills Discounting by Banks was constituted under the Chairmanship of Shri K.R. Ramamoorthy, to examine *inter alia* the possibility of extending bills discounting facility to services sector especially industries such as information technology, software services, travel and tourism, etc. In view of the services sector transforming the economic profile of the country and is poised to register tremendous growth and contribute significantly to the overall economy, the Group undertook a detailed scrutiny of the key issues involved in bill financing and examined the possibility of strengthening the existing bill discounting mechanism and extending its scope to services sector. The Group has made several recommendations duly taking into account the Indian context in respect of bill financing, Banker's Acceptance, Bill financing - services sector and challenges of e-commerce that may be thrown up in the financial sector of the country. The Working Group has submitted its report to the Reserve Bank of India recently. The full text of the Report has already been placed on the RBI website (www.rbi.org.in), for wider debate and discussion. Based on the feedback and in consultation with market participants, the RBI will evolve suitable guidelines for implementation.

(f) Kisan Credit Cards

Pursuant to the budget announcement a model scheme for issue of Kisan Credit Card to farmer borrowers was formulated in 1998 and all banks were advised to implement it. The scheme was primarily formulated for catering to the short-term credit requirements of the farmers. All public sector banks have been advised to set monthly targets within the yearly target fixed for the bank and draw action plan for achieving the overall target.

(g) Implementation of Swarnjayanti Gram Swarozgar Yojana (SGSY)

The year 1999-2000 was the first year of implementation of SGSY. The scheme was launched with effect from April 1, 1999 and detailed guidelines were issued to banks by the Reserve Bank for speedy implementation of the scheme. Public sector banks were also advised to organise special workshops to discuss the scheme and its implementation. Banks are advised to monitor the progress

of the scheme periodically and put in earnest efforts for its success.

(h) Self Help Groups (SHGs)

The Finance Minister made an announcement in the Budget Speech about the special emphasis laid on the promotion of micro enterprises in rural areas set up by vulnerable sectors including women, scheduled castes, scheduled tribes and other backward classes. In 1999-2000, the credit-linkage as also loan disbursements by banks to SHGs were more than twice the cumulative performance upto the end of the previous year under the NABARD programme. A coverage of additional one lakh SHGs by NABARD and SIDBI during the year 2000-01 has been announced. Banks are advised to provide maximum support to SHGs as per the RBI circular dated March 3, 2000.

(i) Small Scale Industries (SSI)

The Finance Minister in his Budget Speech on February 29, 2000 announced that the public sector banks should accelerate their programme of opening SSI branches to ensure that every district and SSI clusters within districts are served by at least one such branch. The Lead Banks of the districts have been advised to take steps for operationalising these branches in their respective districts either by opening new branches or by converting the existing branches. The convenor bank of SLBC in each state has been asked to monitor the progress in the respective states. The public sector banks have also been advised to complete the process of opening/operationalising SSI branches by December 31, 2000.

Non-Banking Financial Companies (NBFCs)

49. Of 37,212 NBFCs which applied for registration, the Bank has so far approved registration to 702 deposit taking companies permitting them to accept public deposits and also granted registration to 9,857 NBFCs in the category of non-public deposit taking companies. Since the expiry of time period for attaining the minimum stipulated level of Net Owned Fund (NOF) of Rs.25 lakhs on January 10, 2000, Bank has received applications from as many as 8,027 NBFCs reporting attainment of NOF of Rs.25 lakhs and 2,207 NBFCs for extension of time. The Bank is at present engaged in processing applications of such NBFCs as had the NOF below Rs.25 lakhs as on January 10, 2000. It has already been announced that the extension of time would be considered on merits of each NBFC. The Bank has also taken a number of steps like prohibition from acceptance of public deposits, launching of prosecution proceedings, filing of winding up petitions against delinquent companies besides rejection of 15,727 applications which did not fulfil the necessary criteria for registration.

(a) Regulatory Norms for NBFCs

The Reserve Bank is working out the modalities in consultation with the associations of NBFCs, for formation of a Self Regulatory Organisation of NBFCs. Draft guidelines for asset liability management and formats of separate balance sheet for NBFCs have been circulated among the members of Informal Advisory Group on NBFCs for the views of industry. Further steps would be taken to put in place the disclosure norms and guidelines for risk management for NBFCs.

(b) Working Group on Asset Securitisation

With a view to laying down the road map for development of asset securitisation in the Indian financial system, the Working Group on asset securitisation appointed by the Reserve Bank submitted its Report in December 1999. Various recommendations of the Working Group have been grouped into short-term, medium-term and long-term with definite time frame in each category. The major recommendations pertain to changes in the legal framework relating to various statutes, tax-neutrality for securitisation transactions, rationalisation of stamp duty and reduction in registration charges, appropriate accounting policies and prudential norms, standardisation of documents, development of specialised financial intermediaries, etc. The Reserve Bank has set up an Implementation Committee for suggesting the framework for giving effect to the above recommendations.

Technology Upgradation

50. The Reserve Bank has been playing an important role in the setting up of an effective and efficient payment and settlement system in the country. Much progress has been made in consolidating the existing payment system, developing technologically advanced modes of payment and moving towards the ultimate objective of linking various payment and settlement systems into an efficient and integrated system that will function in an online real time environment. Towards this end, the following measures are introduced :

(a) Preparation of a "Payment System Vision Document"

This document will detail the payment system agenda proposed to be followed for the next 2/3 years. The Vision Document will focus on the implementation of the systemically important payment system applications having an impact on large value inter-bank funds transfers. It would detail the extensive use of INFINET for information flow and funds movements. It would also detail the need for integration of the IT plans of the banks with INFINET.

(b) Working Group on Internet Banking

The Bank has established an internal Group on Internet Banking. The tasks set out for the Group are to : identify the risks to the organization and the banking system; suggest an appropriate supervisory and legal framework; suggest measures for adoption of the international best practices; recommend adequate security systems in conformity with international standards; and suggest a clearing and settlement arrangement for electronic banking and electronic money transfers. Commercial banks are invited to send their suggestions for consideration by the Working Group.

(c) Use of Imaging Technology for Reducing Clearing Reconciliation Differences

In the four metros where MICR operations are being handled by the Bank, the Reserve Bank is all set to introduce Greyscale Imaging Technology which will be a value added service to the members of the Clearing House. The advantages of imaging are manifold. Primarily, it will aid in the creation of a record of the cheques that have been passed through the reader sorters. This will aid in the reconciliation process. Importantly, imaging parameters can be set to find out suspect instruments.

(d) Imaging to Serve as Pre-cursor for Cheque Truncation

Cheque truncation will enable retention of the paper payment instruments at the Presenting Bank level itself, with only the image of the instrument travelling over the network. This will to a large extent reduce the time lags in the collection of instruments especially inner-city cheques. However, for cheque truncation to take place, amendments to the Negotiable Instruments Act have to be carried out to obviate the need for physically presenting instruments to the paying banker. The Task Force on Legal Issues set up by the National Payments Council is looking into the need for amendments to various Acts as also the need for framing new legislation for the regulation of multiple electronic payments.

Legal Reforms

51. With the rapid advancements in information and communication technologies, the financial system is undergoing a continuous process of change. For central banks to keep pace with these developments, it is important that they have sufficient flexibility in appropriately reorienting the operative, regulatory and supervisory frameworks. In his budget speech in February 2000, the Union Finance Minister has also underscored the need for according greater flexibility in the conduct of monetary policy. The Reserve Bank of India is working on proposals for amendments to the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 in this regard.

International Financial Standards and Codes

52. As mentioned in the April policy statement, a Standing Committee on International Financial Standards and Codes was set up to identify and monitor the developments in global standards and

codes being evolved in the context of the international developments and consider the applicability of these standards and codes to the Indian financial system and chalk out a road map for aligning India's standards and practices with international best practices. Advisory Groups in ten major subject areas were set up in the beginning of this year to assist the Standing Committee. Of these ten Advisory Groups, the Advisory Group on "Transparency in Monetary and Financial Policies" submitted its Report in September 2000. The Group has examined issues related to the clarity of roles and responsibilities including transparency in monetary policy formulation and implementation in detail. The Advisory Groups on "Payment and Settlement System", "Banking Supervision" and "Insurance Regulation" have also submitted the first part of their Report. The Report on "Payment and Settlement System" deals with issues pertaining to the inter-bank payment and settlement system covering Core Principle and Central Bank responsibilities. The Report on "Banking Supervision" has taken an exhaustive account and given recommendations pertaining to 4 major areas in banking regulation, viz., corporate governance in banks, transparency practices in Indian banking, supervision of cross-border banking and internal rating practices adopted by banks. The Report on "Insurance Regulation" mainly deals with the various provisions relating to licensing of insurance companies in the light of standards set by the International Association of Insurance Supervisors (IAIS) and the Twenty Insurance Guidelines issued by OECD. The Reports of the Advisory Groups are available on Bank's Website (www.rbi.org.in).

53. Report of the Advisory Group on "Accounting and Auditing" has discussed issues regarding transparency practices in accounting and auditing, the status of compliance with international accounting standards in India and also various issues pertaining to adoption of US-GAAP. The Group is likely to submit its Report by November 2000.

54. The remaining five Advisory Groups namely Advisory Group on "Corporate Governance", "Data Dissemination", "Bankruptcy Laws", "Fiscal Transparency" and "Securities Market Regulation" have made considerable progress and it is expected that the Advisory Groups would be finalising their Reports by end November 2000.

Regulations Review Authority

55. The Reserve Bank would like to take this opportunity to express its appreciation to bankers, experts, market participants and members of the public who have sent their suggestions to the Regulations Review Authority (RRA) set up by the Bank in April 1999. The RRA has completed one and half year of its operation and has reviewed several of Reserve Bank's rules, regulations and reporting systems on the basis of suggestions received by it. During this period, RRA received 235 applications which contained more than 400 suggestions, pertaining to various functional areas of the Bank. A few important developments during the current year (April-September, 2000) as a result of implementation of the suggestions were (a) putting in place in the Bank, a comprehensive and effective information transmittal system in electronic form for the benefit of seekers of information from the Bank, (b) revision in Bank's instructions relating to nomination facility, etc., for the benefit of investors in Relief Bonds, (c) increase in the limit of same day credit of local/outstation instruments sent for collection by banks from Rs.5,000 to Rs.7,500, (d) streamlining the procedure for prompt payment of interest to scheduled commercial banks on their CRR balances and (e) relaxation in the prescribed eligibility criteria for opening and maintaining Non-Resident External Rupee Accounts by the District Central Co operative Banks. 56. Out of several Master Circulars being prepared on important areas of compliance by banks and institutions, under the aegis of RRA, one circular on Exposure Norms has already been issued to banks and others are in various stages of finalisation.

57. The RRA will formally cease to operate on March 31, 2001. However, various departments of the Reserve Bank will continue with their efforts to further simplify procedures, reduce paper work and improve service. Suggestions from bankers and others will be welcome.

Annexure I

Summary of Guidelines for Issue of Commercial Paper (CP)

Eligibility: Corporates, Primary Dealers (PDs), Satellite Dealers (SDs), and all-India Financial Institutions (FIs) ; for a corporate to be eligible, (a) the tangible net worth of Rs.4 crore; (b) having a sanctioned working capital limit from a bank/FI; and (c) the borrowal account is a Standard Asset.

Rating Requirement: The minimum credit rating shall be P-2 of CRISIL or such equivalent rating by other approved agencies.

Maturity: A minimum of 15 days and a maximum upto one year.

Denomination: Minimum of Rs.5 lakh and multiples thereof.

Limits and Amount : CP can be issued as a “stand alone” product. Banks and FIs will have the flexibility to fix working capital limits duly taking into account the resource pattern of companies’ financing including CPs.

Issuing and Paying Agent (IPA): Only a scheduled bank can act as an IPA.

Investment in CP: CP may be held by individuals, banks, corporates, unincorporated bodies, NRIs and FIIs.

Mode of Issuance: CP can be issued as a promissory note or in a dematerialised form. Underwriting, not permitted.

Preference for Demat: Issuers and subscribers are encouraged to prefer exclusive reliance on demat form. Banks, FIs, PDs and SDs are advised to invest only in demat form as soon as arrangements are put in place.

Stand-by Facility: It is not obligatory for banks/FIs to provide stand-by facility. They have the flexibility to provide credit enhancement facility within the prudential norms.

Role and Responsibilities: The Guidelines prescribe role and responsibilities for issuer, IPA and Credit Rating Agency. FIMMDA as an SRO may prescribe standardised procedure and documentation in consonance with the international best practices. Till then, the procedures/documentations prescribed by the IBA should be followed.

Annexure II

A Summary of Guidelines on Categorisation And Valuation of Banks’ Investments

The categorisation of the banks’ investment portfolio both in the SLR and non-SLR segments will be as per details given below. The proposed guidelines will be made effective from the half-year ended September 30, 2000.

A. Categorisation :

1) The entire investment portfolio of the banks (including SLR securities and non-SLR securities) will be classified under three categories, viz., ‘Held to Maturity’, ‘Available for Sale’ and ‘Held for Trading’. Under each category the six-fold classification, if applicable, will continue as hitherto. Consequently, in the balance sheet, the investments will continue to be disclosed as per the existing six classifications (a) Government Securities, (b) Other approved securities, (c) Shares, (d) Debentures and Bonds, (e) Subsidiaries and Joint Ventures and (f) Others.

[Definitions : The securities acquired by the banks with the intention to hold them up to maturity will be classified under **Held to Maturity**. The securities acquired by the banks with the intention to trade by taking advantage of the short-term price/interest rate movements will be classified under **Held for Trading**. The securities which do not fall within the above two

categories will be classified under *Available for Sale*]

2) Banks should decide the category of the investment at the time of acquisition and the decision should be recorded on the investment proposals.

Held to Maturity

3) The investments classified under “Held to Maturity” will include the following :

i) Re-capitalisation bonds.

ii) Investment in subsidiaries and joint ventures.

iii) Investments in debentures, which are deemed to be in the nature of an advance.

iv) Any other investment that the bank may decide to include in this category. Such investments will **not** exceed 25 per cent of the total investments, which will exclude the investments specified at (i), (ii) and (iii) above.

4) The banks, which had already marked to market more than 75 per cent of their SLR portfolio, will be given the option to re-classify their investments under this category up to the permissible level.

5) Profit on sale of investments in this category should be first taken to the Profit and Loss Account and thereafter be appropriated to the ‘Capital Reserve Account’. Loss on sale will be recognised in the Profit & Loss Account.

Available for Sale and Held for Trading

6) The banks will have the freedom to decide on the extent of holdings under Available for Sale and Held for Trading categories. This will be decided by them after considering various aspects such as basis of intent, trading strategies, risk management capabilities, tax planning, manpower skills and capital position.

7) The investments classified under Held for Trading category are to be sold within 90 days. If the bank is not able to sell the security within 90 days due to exceptional circumstances such as tight liquidity conditions, or extreme volatility, or market becoming unidirectional, the security should be shifted to the Available for Sale category.

8) Profit or loss on sale of investments in both the categories will be taken to the Profit and Loss Account.

B. Shifting among categories :

9) Banks may shift investments **to/from Held to Maturity** category with the approval of the Board of Directors once a year. Such shifting will normally be allowed at the beginning of the accounting year. No further shifting to/from this category will be allowed during the remaining part of that accounting year.

10) Banks may shift investments **from Available for Sale** category to Held for Trading category with the approval of their Board of Directors/ALCO/Investment Committee.

11) Shifting of investments **from Held for Trading** category to Available for Sale category is generally not allowed. However, it will be permitted only under exceptional circumstances as mentioned at item 7 above with the approval of the Board of Directors/ALCO/Investment Committee.

12) Transfer of scrips from one category to another, under all circumstances, should be done at the acquisition cost/book value/market value on the date of transfer, whichever is the least, and the depreciation, if any, on such transfer should be fully provided for.

C. Valuation :

13) Investments classified under **Held to Maturity** category need not be marked to market and will be carried at acquisition cost unless it is more than the face value, in which case the premium should be amortised over the period remaining to maturity.

14) Banks should recognise any diminution, other than temporary, in the value of their investments in subsidiaries/joint ventures which are included under **Held to Maturity** category and provide therefor. Such diminution should be determined and provided for each investment individually.

15) The individual scrips in the **Available for Sale** category will be marked to market at the year-end or at more frequent intervals.

16) The individual scrips in the **Held for Trading** category will be revalued at monthly or at more frequent intervals.

Market value

17) The 'market value' for the purpose of periodical valuation of investments included in the Available for Sale and the Held for Trading categories would be the market price of the scrip as available from the trades/quotes on the stock exchanges, price of SGL transactions, price list of the RBI.

18) Reserve Bank of India will not announce the Yield to Maturity (YTM) rates for unquoted Government securities, as hitherto, for the purpose of valuation of investments by banks. The banks should value the unquoted SLR securities on the basis of the YTM rates to be put out by the Primary Dealers Association of India (PDAI) jointly with the Fixed Income Money Market and Derivatives Association (FIMMDA) at quarterly intervals. The valuation of the other unquoted non-SLR securities, wherever linked to the YTM rates, will be with reference to the YTM rates as put out by the PDAI/FIMMDA.

Annexure III

Guidelines on Bank Financing of Equities and Investments in Shares

The Standing Technical Committee on Bank Financing of Equities, comprising officials of the RBI and SEBI, set up to develop operating guidelines for a transparent and stable system of bank financing of equities and investments in shares submitted its report on August 30, 2000. The report was released for public comments. On the basis of the comments received from the media and other market participants on the proposals made by the Committee as well as the views expressed by banks in the meeting taken by the RBI with the Chief Executives of major banks on September 19, 2000, the RBI prepared new draft guidelines. These draft guidelines were again circulated among select banks and also placed on the RBI website for comments from banks, financial institutions and other market participants.

Based on the feed back received from banks and others, the guidelines on bank financing of equities and investments in shares have now been finalised. These are given below.

1. Bank Financing of Equities

(i) Financing of Initial Public Offerings (IPOs)

(a) The financing of Initial Public Offerings (IPOs) should be treated as advances against shares to individuals. Accordingly, banks may grant advances for subscribing to IPOs only to individuals. Further, the terms and conditions for financing of IPOs should be the same as those applicable to advances against shares to individuals, set out in our Master circular DBOD.No. Dir. BC. 90/ 13.07.05/1998 dated August 28, 1998. The maximum amount of finance that can be extended to an individual against IPOs should be Rs.10 lakh, as applicable to advances against

physical shares. The corporates should not be extended credit by banks for investment in other companies' IPOs. Similarly, banks should not provide finance to NBFCs for further lending to individuals for IPOs.

(b) Finance extended by a bank for IPOs should be reckoned as an exposure to capital market.

(ii) Issue of Guarantees on Behalf of Brokers

A minimum margin of 25 per cent inclusive of cash margin, should be obtained by banks for issue of guarantees on behalf of share brokers. Banks may, at their discretion, obtain margin higher than 25 per cent as per the policy approved by their Board of Directors.

(iii) Total exposure

The Board of Directors of banks may lay down a prudential ceiling on the bank's aggregate exposure to capital market, keeping in view its overall risk profile. Boards of each bank should also take a view on the exposure on a particular corporate either through primary or secondary market or through book building route, keeping in view its overall risk management policy. The bank's exposure should, however, meet the statutory requirements regarding holding of shares of a company contained in sections 19(2) and (3) and 20(1)(a) of the Banking Regulation Act, 1949, as also the single borrower and borrower-group exposure norms stipulated by the RBI. The following may be excluded for reckoning the bank's aggregate exposure to capital market:

(a) Advances against collateral security of shares.

(b) Advances to individuals for personal purposes like education, housing, consumption, etc., against the security of shares.

(c) Credit substitutes like Commercial Paper, non-convertible debenture, etc., may not be reckoned as part of credit portfolio for arriving at the bank's exposure to capital market.

2. Banks' Investments in Shares and Debentures

(i) In terms of circular DBOD No.Dir.BC..61/13.07.05/94 dated May 18, 1994, banks are free to acquire shares, convertible debentures of corporates and units of equity oriented mutual funds, subject to a ceiling of 5 per cent of the incremental deposits of the previous year. The RBI-SEBI Technical Committee has recommended that the ceiling prescribed for banks' investments in shares, convertible debentures, etc., should be related to outstanding advances and not to incremental deposits of the previous year. It has, therefore, been decided that within the overall exposure to sensitive sectors, a bank's total exposure to capital market by way of investments in shares, convertible debentures and units of mutual funds (other than debt funds) should not exceed 5 per cent of the banks' total outstanding credit as on March 31 of the previous year. It is further clarified that the ceilings for investments in shares, etc., are maximum permissible ceiling and a bank's Board of Directors is free to adopt a lower ceiling for an individual bank, keeping in view the bank's overall risk profile and volatility in equity prices. In respect of those banks where the present outstanding investments in equities are relatively small and well below the 5 per cent overall ceiling, as a prudential measure, the Board should also lay down an annual ceiling for fresh investments in equities so that any increase in fresh investments in equities take place in a phased, gradual and cautious manner, within the absolute ceiling fixed by the Board for each year.

(ii) Banks may make investment in shares directly or through UTI and SEBI approved other diversified mutual funds with good track records. Investment in UTI/mutual funds will be as per the investment policy approved by the Board of Directors, taking into account the in-house expertise available within the bank. It is advised that the decisions in regard to investments in shares, etc., should be taken by the Investment Committee set up by the bank.

(iii) Underwriting commitments taken up by the banks in respect of primary issues through book

building route would also be within the above norms.

(iv) Loans sanctioned to corporates for meeting promoters' contributions and bridge loans sanctioned to companies for a period not exceeding one year against expected equity flows/issues, expected proceeds of non-convertible debentures, external commercial borrowings, GDRs and/or funds in the nature of foreign direct investments (which are now within the ceiling of 5 per cent of the incremental deposits of the previous year), would also continue to be within the above overall ceiling.

(v) The decision on investments in shares, debentures, etc., maybe made by the Board/ALCO of each bank keeping in view the permitted tolerance levels of mismatch. The quantum and tenure of such investments may be decided by Boards of each bank.

(vi) Banks whose investments in shares, etc., are now in excess of 5 per cent of outstanding credit as on March 31, 2000 may bring down their investments gradually to conform to this prudential norm, by March 31, 2001.

3. Valuation and Disclosure

Banks should mark to market their investment portfolio in equities like other investments on a quarterly basis. Further, banks should disclose the total investments made in shares, convertible shares and units of equity oriented mutual funds as also aggregate advances against shares, etc., in the 'Notes on Accounts' to their balance sheets, beginning from the year ending March 2001.

4. Review of Guidelines

The Standing Technical Committee of the RBI and SEBI will review the guidelines after six months in consultation with banks, keeping in view the operational mechanism and the experience gained. In case any changes are required in the light of actual experience, the Committee will make appropriate recommendations to the RBI.