Mid-Term Review of Monetary and Credit Policy for the Year 2001-2002

The Statement on Mid-term Review of Monetary and Credit Policy consists of three parts: I. Mid-term Review of Macroeconomic and Monetary Developments in 2001-02; II. Stance of Monetary Policy for the Second Half of 2001-02; and III. Financial Sector Reforms and Monetary Policy Measures.

I. Mid-term Review of Macroeconomic and Monetary Developments in 2001-02

Domestic Developments

2. The annual Statement on monetary and credit policy, released on April 19, 2001 projected a GDP growth of 6.0 to 6.5 per cent for the year 2001-02. This projection was based on the assumptions of a reasonable monsoon, good performance of exports and a revival of the industrial sector beginning second quarter of the year. As per the latest information available from the India Meteorological Department, the behaviour of the South-West monsoon this year has been better than last two years, with 30 out of 35 sub-divisions showing normal or excess rainfall. According to the current estimates of the Ministry of Agriculture, *kharif* output this year is expected to increase by 2.5 million tonnes to 105.6 million tonnes. Assuming a normal North-East monsoon, agricultural growth in 2001-02 is expected to be significantly higher than the previous year.

3. While agricultural performance is encouraging, the position regarding revival of industrial sector and export growth in the first half of the current year is not favourable. According to the latest estimates released by the Central Statistical Organisation, growth rate of industrial production during April-August 2001 was lower at 2.2 per cent as against 5.6 per cent in the corresponding period of the previous year. The deceleration in growth was observed across the sectors. Manufacturing sector recorded a much lower growth rate of 2.5 per cent as compared with 6.1 per cent in the previous year. While basic goods, intermediate goods and consumer durables have shown lower growth during April-August 2001 as compared with the corresponding period of the previous year, capital goods sector continues to show a negative growth rate (- 8.0 per cent as against 4.3 per cent) reflecting a sluggish investment demand. The performance of the infrastructure industries, a stimulant for industrial activity, also remained at a low key. The composite index of six infrastructure industries, *viz.*, electricity, coal, steel, cement, crude petroleum and refinery products registered a substantially lower growth of 1.2 per cent during April-August 2001 as against 6.9 per cent in the corresponding period of the previous year. While cement, electricity and petroleum refinery products recorded lower growth rates than those in the corresponding period of the previous year, coal and crude petroleum showed negative growth rates. Export growth has also been negative. According to the latest information available, exports in US dollar terms during the period April-August 2001 declined by 2.3 per cent against a growth of 21.1 per cent in the corresponding period last year.

4. Taking into account the positive developments regarding the likely rate of growth in agriculture during the current year on the one hand, and the unfavourable behaviour of industrial and export sectors on the other, on balance, the projection of 6.0 to 6.5 per cent growth rate for the year 2001-02 now appears optimistic.

5. In view of the global uncertainty, and the impact of global slowdown on exports as well as domestic growth, a firm projection of revised growth rate for the year as a whole is difficult. According to the latest International Monetary Fund (IMF) projections, which may be revised downward again, the global growth rate during the current year is expected to be of the order of 2.6 per cent and almost all developing as well as industrialised countries are likely to show a substantially lower growth than projected a few months ago. Recent growth projections for the Indian economy made by the IMF, other international agencies as well as domestic research and monitoring agencies have also ranged widely from 4.5 to over 6.0 per cent. Balancing various factors, and assuming no further serious disruption in the world economic environment, at this stage, a projection in the range of 5.0 to 6.0 per cent growth rate in the current year may be reasonable for the purpose of credit and monetary management. India is likely to be one of the very few countries in the world which would show a growth rate of this order in the current year.

6. The relatively sombre outlook for industrial growth is reflected in the credit flow during the period April-October 5, 2001. The expansion of bank credit and other flows to the commercial sector from the banking system remained sluggish due to subdued industrial growth and depressed investment demand. Scheduled commercial banks' credit increased by 6.1 per cent (Rs.31,104 crore) upto October 5, 2001 as against an increase of 9.7 per cent (Rs.42,211 crore) in the corresponding period of the previous year. Food credit increased by Rs.10,211 crore as against Rs.7,193 crore in the previous year reflecting higher procurement operations. The increase in non-food bank credit by 4.4 per cent (Rs.20,894 crore) was lower as against an increase of 8.5 per cent (Rs.35,018 crore) in the corresponding period of the previous year. In late September and early October 2001, however, some pick-up in non-food bank credit is discernible.

7. The increase in scheduled commercial banks' investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP), etc., was 4.3 per cent (Rs.3,333 crore) (upto September 21, 2001) as compared with an increase of 4.6 per cent (Rs.2,873 crore) in the corresponding period of the previous year. Together with such investments, the increase in total flow of resources from scheduled commercial banks to the commercial sector was only 4.4 per cent (Rs.24,227 crore) as against 8.0 per cent (Rs.37,891 crore) in the corresponding period of the previous year. The year-on-year growth in resource flow was 12.0 per cent as against 20.2 per cent a year ago.

8. Scheduled commercial banks' investments in instruments issued by financial institutions and mutual funds this year declined by Rs.300 crore as against a decline of Rs.255 crore last year. Total resource flow to the commercial sector including capital issues, Global Depository Receipts (GDRs) and borrowings from financial institutions was Rs.64,734 crore during the financial year so far as compared with Rs.83,178 crore in the previous year. Most of the debt issues by both private corporates and public sector units are on private placement basis which has caused some regulatory concerns. (This issue is addressed in Part III of this Review).

9. The feedback on credit flows received from banks reveals that at a disaggregated level during April-August 2001, there was an increase in scheduled commercial banks' credit to agriculture, housing, consumer durables, personal loans, tourism, other textiles, pharmaceuticals, automobiles, construction and infrastructure. On the other hand, decline in credit was observed in petroleum, coal, cotton textiles, jute textiles, tobacco, vegetable oils, all engineering and

wholesale trade.

10. In the current financial year upto October 5, 2001, money supply (M_3) increased by 8.2 per cent (Rs.1,08,102 crore) as compared to 8.3 per cent (Rs.93,762 crore) in the corresponding period of the previous year. On an annual basis, growth in M_3 at 16.6 per cent was higher than the growth of 15.3 per cent a year ago. Aggregate deposits of scheduled commercial banks increased by 9.1 per cent (Rs.87,895 crore) as compared with an increase of 8.9 per cent (Rs.72,687 crore) in the corresponding period of the previous year. On an annual basis, growth in aggregate deposits at 18.6 per cent was higher than that of 15.4 per cent a year ago. In view of the adverse developments in the other segments of the financial market, the relative attractiveness of bank deposits seems to have increased. If the surge in deposit growth continues, it may pose a challenge to the banking system in deploying resources, particularly in the context of sluggishness in credit and investment demand.

11. Reserve money increased by 1.8 per cent (Rs.5,516 crore) in the current financial year upto October 12, 2001 as compared to an increase of 1.6 per cent (Rs.4,427 crore) in the corresponding period of the previous year. On the sources side, while net RBI credit to the Central Government showed a modest increase of 4.5 per cent (Rs.6,552 crore) as compared to an increase of 14.9 per cent (Rs.20,859 crore) in the corresponding period of the previous year, RBI's net foreign exchange assets increased significantly by 9.9 per cent (Rs.19,531 crore) in sharp contrast to a decline of 2.1 per cent (- Rs.3,469 crore) during the corresponding period of the previous year. RBI's subscriptions to primary issues of Central Government dated securities (Rs.21,679 crore) was more than offset by net open market sales (Rs.22,275 crore). There was also reduced reliance on standing facilities due to comfortable liquidity conditions. On the components side, while currency in circulation increased by 5.7 per cent (Rs.12,461 crore) as compared to 6.2 per cent (Rs.12,138 crore), bankers' deposits with RBI declined by 8.3 per cent (- Rs.6,766 crore) as against a decline of 9.8 per cent (- Rs.7,871 crore) reflecting the impact of reduction in Cash Reserve Ratio (CRR). On balance, the reserve money expansion is expected to remain moderate during 2001-02.

12. Annual inflation, as measured by variations in Wholesale Price Index (WPI), on a point-to-point basis, on October 6, 2001 was 3.2 per cent as against 7.4 per cent a year ago. Annual inflation, as measured by Consumer Price Index (CPI) for industrial workers on a point-to-point basis, was 5.2 per cent in August 2001 as against 4.0 per cent a year ago.

13. The contribution to inflation emanating from 'fuel, power, light and lubricants' subgroup (weight 14.2) was moderate at 5.7 per cent this year (compared to 31.4 per cent last year). The annual inflation rate, excluding the impact of price increases of this energy related sub-group was at 2.6 per cent. While prices of primary articles (weight 22.0) recorded an increase of 4.6 per cent, manufactured products (weight 63.7) registered an increase of 1.8 per cent. Among primary articles, the increase in prices was concentrated in a few articles such as fruits and vegetables, oilseeds and pulses. In manufactured products, the increase in prices of edible oils and cement was relatively high. The inflation outlook for the year appears comfortable as agricultural growth prospects remain positive, and foodgrain stocks are very high.

14. The Union Budget for 2001-02 placed the net and gross market borrowings of the Central Government respectively at Rs.77,353 crore and Rs.1,18,852 crore. Upto October 20, 2001, the

Central Government completed net market borrowings of Rs.66,647 crore and gross borrowings of Rs.96,251 crore. The government market borrowing programme during 2001-02 has been conducted by elongating the maturity pattern and at a lower cost. The weighted average maturity of borrowings was 13.9 years this year as against 10.6 years last year. The weighted average yield on government borrowings through dated securities was lower by nearly 100 basis points at 9.96 per cent this year as against 10.95 per cent last year. In its debt management, RBI continued to combine auction issues with acceptance by private placement of dated securities consistent with market conditions. The total private placement of dated securities with RBI during the current year so far was Rs.21,679 crore. In order to neutralise the monetary impact of private placements, RBI conducted outright open market operations (OMO) sales of government securities to the tune of Rs.27,359 crore (upto October 20, 2001).

15. Gross fiscal deficit of the Central Government at Rs.56,079 crore upto August 2001 was higher by about 54 per cent over the corresponding period of last year and constituted about one half of the budget estimate for the current year. Similarly, revenue deficit (Rs.43,640 crore) accounted for above 55 per cent of the budget estimate for the year as a whole. Gross fiscal deficit as a proportion of GDP so far has been higher at 2.3 per cent as against 1.7 per cent in the corresponding period of the previous year.

16. A steady increase in net foreign currency assets of the Reserve Bank combined with subdued real economic activity created a situation of excess liquidity during most part of the first half of the year. The Reserve Bank, therefore, had to actively manage liquidity not only through outright OMO sales of securities but also through its daily Liquidity Adjustment Facility (LAF). The average daily absorption through repo transactions under LAF amounted to about Rs.3,600 crore.

17. Scheduled commercial banks' investments in government securities this year (upto October 5, 2001) has been significantly large at Rs.43,664 crore as compared with Rs.25,636 crore in the corresponding period of the previous year. Commercial banks already hold government securities much in excess of the prescribed Statutory Liquidity Ratio (SLR), to the extent of Rs.1,29,450 crore, constituting 36.3 per cent of NDTL.

18. The overall interest rate structure which had come down substantially in the last two years, continued to show a softening trend. The prime lending rates (PLRs) of public sector banks, which were ranging between 11.75 and 13.00 per cent in September 2000, softened to 10.0-13.0 per cent in March 2001 and further to 10.0-12.5 per cent by mid-October 2001. As banks are permitted to lend to exporters and their prime customers at sub-PLR rates, the cost of bank borrowings to such corporates has come down even further. Long-term domestic deposit rates of public sector banks declined from 10.5 per cent in March 2001 to 9.5 per cent by mid-October 2001; however, at the shorter end there was a marginal increase by 25 basis points.

19. As announced in the annual policy Statement of April 2001, during the first half of the fiscal year, the Reserve Bank continued to provide appropriate liquidity through its repo operations. Barring a few days, the overnight call money rate remained around 7.0 per cent during the entire period, and the overall easy liquidity conditions were reflected in the response to daily repos conducted by RBI. The interest rate environment also remained fairly soft with yields on 10-year Government paper declining by about 100 basis points (on top of a decline of about 170 basis points in the previous two years). The weighted average discount rate on CP of 61 to 90-day

maturity declined from 11.74 per cent in end-September 2000 to 9.71 per cent in end-March 2001 and further to 8.58 per cent by end-September 2001. This constitutes a decline of as much as 3.16 percentage points in the discount rate on such paper over the past year.

External Developments

20. The world economy, which had slowed down considerably during the first eight months of the year 2001, experienced one of its worst shocks in the aftermath of the September 11 events in the US. All segments of the financial markets, particularly the equity markets, were badly affected. While global financial markets have stabilised in the past four weeks, the outlook for growth and recovery in the world economy remains highly uncertain. The outlook for growth in major industrialised countries as also the emerging economies has become adverse with estimated growth rates being scaled down. According to the latest World Economic Outlook brought out by the IMF, the downturn in the emerging markets of Asia is likely to continue for a longer period than that anticipated earlier. The advanced economies are expected to grow by only 1.3 per cent during 2001 as compared with 3.8 per cent last year. However, according to the IMF, India and China are expected to be less affected by this downturn. India is relatively insulated from this global slowdown because of its lower share of trade in GDP and service oriented and cost efficient information technology sector. Since these growth projections were made before September 11, it is likely that actual global growth will be even less than projected. The chances of world economy sliding into a recessionary phase are now believed to be much greater than that a few weeks ago.

21. India was also affected by the global economic slowdown and instability in financial markets. Equity markets, which had shown a fall of about 360 points between end-March and end-August 2001, declined further, and BSE Sensex, the Index of the Mumbai Stock Exchange, touched an eight year low on September 21, 2001. It has since gained 417 points to reach 3017 by October 19, 2001. There was net capital outflow of Foreign Institutional Investors (FIIs) by about US $ 179 million in September 2001. Foreign exchange markets also became volatile with the rupee showing a depreciation of 1.3 per cent *vis-à-vis* US dollar during the 10-day period of September 11-20, 2001. The consequent uncertainties affected the bond market, particularly the government securities market.

22. Adverse external developments after September 11, and their effect on India's financial markets, necessitated a quick response to provide appropriate liquidity and overall comfort to the markets. In order to stabilise domestic financial markets, RBI announced the following measures during the period September 15-25, 2001:

- On September 15, 2001, despite some emerging pressures in the forex market, RBI announced that it does not intend to presently shift its monetary policy stance in regard to keeping interest rates stable with adequate liquidity. RBI further assured the markets that it will be prepared to sell foreign exchange directly or indirectly, if it considers it necessary to do so, to meet any unusual supply-demand gap in view of the prevailing uncertainties.

- In view of the extraordinary circumstances in the government securities market, RBI opened a purchase window for select government securities on an auction basis.

- On September 20, 2001, in consultation with the Government of India, Indian companies were permitted to increase the FII investment limit upto the sectoral cap/statutory ceiling, as applicable.

- With effect from September 22, 2001, banks were allowed to finance stock brokers for margin trading for an initial period of 60 days (*i.e.,* up to November 22, 2001) in actively traded scrips which form part of the National Stock Exchange (NSE) Nifty and BSE Sensex within the overall existing ceiling of bank exposure to capital market.

- On September 24, 2001, in consultation with the Government of India, a special financial package was announced, for large value exports of six select products, which were internationally competitive and had high value addition.

- With effect from September 26, 2001, interest rates charged by scheduled commercial banks on pre-shipment and post-shipment rupee export credit were reduced by 1.0 percentage point for a period of six months (upto March 31, 2002).

23. The above measures had the desired effect of moderating possible panic reactions and reducing volatility in financial markets, particularly in money, forex and government securities markets. While financial markets are generally stable, liquidity is adequate, and interest rate environment is favourable, so far, there is no perceptible upturn in industrial output. This continues to be a matter of serious concern. It is to be hoped that as global markets gain back momentum after some time, it will have a favourable impact on the investment climate in India also.

24. The annual monetary policy Statements of last two years as well as mid-term Reviews have attempted to highlight the main lessons emerging from our experience in managing the external sector during periods of external and domestic uncertainties. The recent experience has once again highlighted the need for continuous vigilance and the importance of building adequate safety nets to withstand the effects of unexpected shocks and market uncertainties. In this context, India’s exchange rate policy of focusing on managing volatility with no fixed rate target, while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way, has stood the test of time. Despite several unexpected external and domestic developments, India’s external situation has remained satisfactory. RBI will continue to follow the same approach of watchfulness, caution and flexibility in regard to the forex market. It will continue to monitor closely, as in the past, the developments in the financial markets at home and abroad, and carefully coordinate its market operations with appropriate monetary, regulatory and other measures as considered necessary from time to time.

25. India’s foreign exchange reserves have increased sharply by over US $ 10 billion from US $ 34.9 billion as on October 20, 2000 to US $ 45.1 billion by October 19, 2001. India’s sustained efforts to build an adequate level of foreign exchange reserves in the last few years have also been fully vindicated by recent developments. As pointed out in previous policy Statements, the overall approach to the management of India’s foreign exchange reserves in recent years has reflected the changing composition of balance of payments, and has endeavoured to reflect the “liquidity risks” associated with different types of flows and other requirements. The policy for

reserve management is thus judiciously built upon a host of identifiable factors and other contingencies. Such factors, *inter alia,* include: the size of the current account deficit; the size of short-term liabilities (including current repayment obligations on long-term loans); the possible variability in portfolio investment and other types of capital flows; the unanticipated pressures on the balance of payments arising out of external shocks (such as, the impact of the East Asian crisis in 1997-98 or increase in oil prices in 1999-2000 or recent events in the US); and movements in the repatriable foreign currency deposits of Non-resident Indians (NRIs). Taking these factors into account, India's foreign exchange reserves are at present comfortable. However, there can be no cause for complacency. We must continue to ensure that, leaving aside short-term variations in reserve levels, the quantum of reserves in the long run is in line with the rate of growth in the economy, the share of external sector in the economy and the size of risk-adjusted capital flows. This will provide us with greater security against unfavourable or unanticipated developments of the type witnessed recently as well as during earlier years.

26. On account of global slowdown, exports have not done well during the current year. India's exports during the first five months of the current financial year at about US $ 17.1 billion registered a decline of 2.3 per cent over the corresponding period of the previous year. Imports increased by 2.5 per cent as against an increase of 13.8 per cent last year. Trade deficit in the first five months of the current financial year at US $ 4.6 billion was higher than that of US $ 3.7 billion in the same period last year. Oil imports declined by 6.1 per cent in US dollar terms as compared with a large increase of 78.7 per cent in the corresponding period of the previous year on account of moderation of international oil prices. Non-oil imports increased by 6.7 per cent during April-August 2001 as against a decline of 3.2 per cent in the corresponding period of the previous year. While the surplus on the non-oil account declined from US $ 2.9 billion to US $ 1.1 billion, the deficit on oil account decreased from US $ 6.5 billion during April-August 2000 to US $ 5.7 billion during April-August 2001. For the rest of the year, there is some uncertainty about the likely course of international oil prices. If the average oil prices for the rest of the financial year are assumed to be at US $ 25.0 per barrel, the oil import bill for 2001-02 will be in the range of US $ 17.5-18.0 billion as against actual imports of US $ 15.6 billion in the previous year. However, on present reckoning, it is expected that the current account deficit for the year 2001-02 will still be well below 2.0 per cent of GDP and no significant pressures on balance of payments are expected on this account.

27. A strong effort to accelerate the growth of exports is essential for long-term viability of balance of payments as well as for generation of income and employment in the economy. As mentioned earlier, as part of the efforts to provide support to exporters during the prevailing period of global uncertainty, the Reserve Bank advised reduction in ceiling interest rates on rupee export credit by 1.0 percentage point across the board for a period of six months. It may be emphasised that so far as interest cost to the exporters is concerned, taking into account forward premia, the effective interest cost on six-month rupee export credit is only 3.0-4.0 per cent (assuming a forward premia of 5.0 per cent), which is internationally competitive. Similarly, exporters are free to avail of foreign currency loans in the currency of their choice at internationally competitive rates. Foreign currency loans from banks in India can be availed of by exporters at LIBOR plus a maximum of 1.0 percentage point.

28. In the past three years, several measures have also been introduced to ensure timely delivery of credit to exporters at reasonable cost and removal of procedural hassles. It was announced in

the last annual policy Statement that a survey of exporters' satisfaction would be conducted through an independent agency. Accordingly, the work of the survey has been entrusted to National Council of Applied Economic Research (NCAER), New Delhi. NCAER has launched the survey on August 31, 2001 and has started interacting with bank officials and exporters/export organisations at various centres in the country.

29. In the recent period, procedures for financial transactions such as remittances, investments and maintenance of bank accounts, etc., for non-residents have been considerably simplified. Foreign direct investment (FDI) is permitted under the automatic route for most activities except in certain circumstances and for a very small negative list. Indian companies are allowed to increase the FII investment limit upto the sectoral caps/statutory ceilings as applicable. A number of steps have been taken to improve liquidity in the American Depository Receipt/ Global Depository Receipt (ADR/GDR) market and to give opportunity to Indian shareholders to divest their shareholding in the ADR/GDR market abroad. Indian companies wishing to make acquisitions of foreign companies or direct investment abroad in Joint Ventures/ Wholly Owned Subsidiaries can now invest upto US $ 50 million on an annual basis through automatic route with additional block allocation of foreign exchange subject to certain conditions.

30. Over a period, considerable flexibility has been given to the corporates to hedge their forex exposure in the market. Instruments available to the corporates for hedging their exchange risks include forward cover, currency options, foreign currency-rupee swaps, hedging of the loan exposures, etc. Banks are also allowed to hedge their asset-liability portfolio, after obtaining necessary policy approval in this regard from their top management.

31. It is, however, observed that sometimes a noticeable portion of the corporate foreign currency commitments tend to remain unhedged by the corporates on the basis of their perceptions of the market and these could impact the overall financial status of the corporates under severe uncertainties. It is, therefore, desirable for banks which have large exposures to such corporates to put in place a system for monitoring such unhedged external exposures. Illustratively, banks could consider introducing a periodical review of the unhedged portion of foreign currency exposures of the corporates whose total exposure is relatively large (say, above US $ 25 million or so) through a suitable reporting system.

32. The Reserve Bank will continue with its efforts to simplify procedures, reduce documentation requirements and further liberalise opportunities for productive investment in India by NRIs and others and by Indian corporates/entities abroad. Further suggestions from experts, corporates and market participants in these areas are welcome, and can be sent by e-mail at **helpnri@rbi.org.in** .

II. Stance of Monetary Policy for the Second Half of 2001-02

33. The annual policy Statement of April 2001 had indicated that under normal circumstances and barring emergence of any adverse and unexpected developments in domestic or external sectors, the overall stance of monetary policy for 2001-02 will be:

- Provision of adequate liquidity to meet credit growth and support revival of investment demand while continuing a vigil on movements in the price level.

- Within the overall framework of imparting greater flexibility to the interest rate regime in the medium-term, to continue the present stable interest rate environment with a preference for softening to the extent the evolving situation warrants.

34. During the first half of the year, as pointed out in the previous section, in the conduct of monetary policy, it was feasible to maintain adequate liquidity in the market, primarily through flexible operation of repos and reverse repos under LAF combined with OMO, when necessary. Notwithstanding a high level of market borrowing by the Government, it was also feasible to maintain a stable interest rate environment, with further softening of interest rates.

35. At the short end of the market, the average call money rate came down sharply from 8.6 per cent in early-April to 7.0 per cent in mid-October 2001. During this period, the LAF repo rate also came down from 7.0 per cent to 6.5 per cent. The CRR was reduced by 50 basis points to 7.5 per cent, effective May 19, 2001, augmenting lendable resources of the banking system by Rs.4,500 crore. Responding to these operations, the interest rates in other money market instruments also showed a declining trend. For example, the primary yield on 91-day Treasury Bills declined by 150 basis points from 8.5 per cent to 7.0 per cent between April and mid-October 2001. During the same period, primary yield on 364-day Treasury Bills fell by 168 basis points from 8.85 per cent to 7.17 per cent. The discount rates on CP also showed a similar trend. At the long end of the market, the secondary market yields on government paper in the range of 10-20 years have softened from 10.08-10.70 per cent in April to 9.12-9.92 per cent by mid-October 2001.

36. The decline in inflation rate since the mid-1990s, despite occasional supply and external shocks has had a positive impact on inflation expectations. Because of this, it has been possible to reduce nominal interest rates on a sustained basis despite a high level of fiscal deficit and other structural rigidities. While the risks of inflation are relatively low, as of now, in the context of ample liquidity already available in the system, RBI will continue to carefully manage the liquidity with a judicious mix of the range of instruments available with it.

37. Despite several uncertainties, the fundamentals of the economy as reflected in moderate inflation, stable and low interest rates, high foreign exchange reserves, large foodgrain stocks and competitive advantage of information technology related industries, are still strong. The prospects for agricultural growth during this year remain positive. Global and domestic inflationary outlook currently continues to be favourable. It is, therefore, proposed to continue with the overall stance of monetary policy announced in the April Statement for the remaining half of the current year and ensure that all legitimate requirements for credit are met consistent with price stability. Unless circumstances change unexpectedly, RBI will also endeavour to maintain the current interest rate environment.

38. The Bank Rate will continue to remain the principal signaling instrument in so far as RBI is concerned, providing directional guidance to the extent feasible, to general level of interest rates. The LAF rates would operate around the Bank Rate, with a flexible corridor, as more active operating instruments for day-to-day liquidity management and steering short-term interest rates.

39. While all efforts will be made to maintain the current stance of monetary policy, two caveats are necessary in order to ensure that banks and market participants do not take too complacent a

view on the current monetary and interest rate environment. First, in their portfolio management, banks, primary dealers (PDs) and other market participants must explicitly take into account that the interest rate environment can change quite dramatically within a very short period of time. The substantial decline in interest rates in the last couple of years has resulted in large gains, realised and unrealised, to holders of medium and long-term securities. It is of utmost importance that these gains are not frittered away or used for illiquid market operations. The time when market conditions are favourable is also the time to build adequate reserves to guard against any possible reversal of the interest rate environment in future due to unexpected developments. Difficulties faced by banks, PDs and other market operators in the first quarter of the last fiscal year, i.e., 2000-01, when interest rates had to be increased by RBI (in order to check volatility in the foreign exchange market consequent upon sharp and frequent increases in the international interest rates) provides a valuable lesson in this regard.

40. Second, it needs to be recognised that in view of certain structural characteristics of our financial system, the scope for further softening in lending rates by banks and other financial intermediaries is limited. Following are some of the factors which reduce downward flexibility in the interest rate structure in India:

- Banks, particularly public sector banks, continue to be the primary mobilisers of domestic financial savings (in addition to Provident Funds, Small Saving Schemes, and Life Insurance Corporation). Holders of term deposits in banks generally belong to fixed income groups and expect a reasonable nominal interest rate, in excess of the long-term rate of inflation. The recent reductions in deposit rates and return on small savings have caused widespread concern among depositors because of lack of other risk-free avenues for financial savings. This constrains the ability of banks to effect further reduction in their lending rates without affecting their deposit mobilisation and the growth of financial savings over the medium-term.

- Banks have been given the freedom to offer “variable” interest rates on longer-term deposits. However, for various reasons, the preference of depositors as well as the traditional practice with banks tended to favour fixed interest rates on term deposits.

This practice has effectively reduced the flexibility that banks have in lowering their lending rates in the short run, since the rates on the existing stock of deposits cannot be lowered.

- For public sector banks, the average cost of funds is over 7.0 per cent, and for many private sector banks, the average cost is even higher. The non-interest operating expenses generally work out to 2.5 to 3.0 per cent of total assets, putting pressure on the required spread over cost of funds.

Relatively high overhang of Non-Performing Assets (NPAs) pushes up further the lending rates.

- There is a persistent and large volume of market borrowing requirements of the Government giving an upward bias to the interest rate structure.

- In view of the above rigidities in cost, spread, and tenor of deposits, the link between variation in the RBI’s Bank Rate and the actual lending rates of banks, particularly at lower levels, is not as strong in India as in industrialised countries. PLRs of banks for commercial credit are entirely within the purview of the banks, and are not set by the Reserve Bank. Decisions in regard to interest rates, therefore, have to be taken by banks themselves in the light of various factors, including their own cost of funds, their transaction costs, interest rates ruling in the non-banking sector, etc.

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

III. Financial Sector Reforms and Monetary Policy Measures

42. The Reserve Bank has, in recent years announced various structural measures to strengthen the financial system and improve the functioning of the different segments of financial markets. The annual policy Statements and the mid-term Reviews assess the progress in these areas and also propose appropriate additional measures as necessary, in the light of experience and after appropriate consultations with banks, other financial institutions, and experts. As financial markets in the last few months have been affected by several uncertainties and some turbulence, it may be useful to review the impact of recent developments on long-term objectives of financial sector reforms before we deal with some of the specific measures.

Recent Financial Market Developments

43. Developments in equity market since March 2001, and involvement of a few banks in providing substantial support to a few stockbroking entities, contrary to RBI guidelines and normal prudential requirements, have raised concerns regarding the potential vulnerability in India's financial sector. Fortunately, so far as the banking sector is concerned, the unethical and unwarranted lending practices on a significant scale were confined to only a few relatively small private sector banks, and one fairly large Urban Co-operative Bank (UCB). As such, it was possible, through temporary and limited liquidity support measures, to avoid the "contagion" spreading from their activities in the equity market to the banking sector as a whole or to other important segments of the financial sector, particularly the money and government securities markets. Nevertheless, the recent experience in equity market, and its aftermath, have thrown up new challenges for the regulatory and supervisory system as well as for standards of corporate governance in banks.

44. First and foremost, it is essential to enforce all prudential norms and strengthen them further in order to minimise the possibility of contagion spreading from one segment of the market to another or from one defaulting institution to a number of inter-connected financial entities. The scope for "regulatory forbearance" has to be minimised in the event of emerging weaknesses in a financial institution (irrespective of whether its ownership is co-operative, public or private). In the past few years, the Reserve Bank has introduced a series of prudential measures for capital adequacy, income recognition and provisioning in respect of NPAs, disclosure and transparency in accounting, and risk containment. Certain additional legislative and other measures are also under consideration of the Government. It is of utmost importance that all deposit-taking financial intermediaries – irrespective of whether they are in the public sector or in the private sector, whether they are commercial banks or co-operative banks, whether they are non-banks or financial institutions – should fully adhere to the prudential guidelines.

45. The Reserve Bank recognises the need to strengthen its monitoring system for enforcement of prudential and risk management guidelines, and for taking swift action, wherever possible under relevant laws, against defaulting entities. Measures for off-site monitoring and inspection, particularly in respect of weak banks and co-operative institutions, have already been introduced. RBI proposes to further strengthen its monitoring and supervisory machinery and procedures, in consultation with banks and other financial institutions, as necessary.

46. As pointed out in the annual policy Statement of April 2001, the prudential norms and the regulatory system prescribed for UCBs have traditionally been relatively soft, in comparison with those for commercial banks. This is partly on account of historical reasons, and partly due to their size being generally small and the preferential treatment of cooperative structure in general. At present, three authorities are involved in regulatory and promotional aspects concerning UCBs – the Central Government (in case of banks having multi-state presence), State Governments and RBI. At times, this results in overlapping jurisdiction and difficulties in carrying out administrative/prudential measures with the required speed and stringency. The recent experience has also shown that irresponsible and unethical behaviour on the part of even a few co-operative banks in the country can have some contagion effect beyond the particular area or the State concerned and may cause severe harm to depositors, including smaller co-operative banks and impair confidence in the system. It is, therefore, necessary to ensure that prudential guidelines in respect of these banks are strengthened to protect public deposits, pending legal and institutional reforms.

47. The April 2001 policy Statement had, therefore, proposed some new prudential measures, particularly in regard to maintenance and safety of securities held under the prescribed SLR, lending against shares, and the degree of access to call money market. In order to minimise any immediate financial impact on UCBs, precautions were taken to introduce new prudential measures with a prospective date and allow sufficient time for UCBs to implement them in the interest of their members. Some State level apex co-operative banks have represented against these measures on the ground that they may affect their financial operations and reduce their flexibility.

48. The Reserve Bank welcomes the ongoing constructive dialogue with UCBs and their representative associations. It will be prepared to further improve/modify specific measures subject only to one condition, *i.e.*, providing an adequate, workable and transparent mechanism

for protection of public deposits held in the co-operative sector. Needless to say that a viable co-operative financial system has to be such that interests of both the “borrowing” entities as well as the “depositing ” public are protected. Past experience, even though confined to some errant co-operative banks, has made it abundantly clear that inter-bank co-operative deposits and lack of adequate secured liquid assets have substantially compromised the depositors’ interests. As a result, public confidence in the co-operative banking sector as a whole has also been shaken. In the interest of the growth of the co-operative sector itself, there is no option but to devise a viable and transparent system for reasonable protection of public deposits.

49. As mentioned earlier, three authorities (Central and State Governments and RBI) are presently involved in regulating, supervising and/or administering UCBs. There are as many as 2,084 UCBs of which 51 are scheduled and the rest are non-scheduled UCBs. In view of their large number as well as their dispersed and local character, their supervision and inspection pose special problems. At present, while accounts of UCBs are required to be audited by State Governments, there has been substantial delay in completing audit of a large number of UCBs. RBI conducts statutory inspections normally once in two years in respect of scheduled UCBs, once in two to three years in respect of non-scheduled UCBs, while the identified weak banks are inspected on annual basis. Several committees, including a high power committee set up by RBI in May 1999 under the Chairmanship of Shri K. Madhava Rao, have made wide-ranging recommendations for eliminating dual control and for improving the functioning of the co-operative banks. Most of these recommendations have been accepted by RBI, but recommendations requiring legislative action at the level of State Governments have yet to be implemented.

50. In order to overcome supervisory problems arising from the present three-pronged and multi-level institutional system (consisting of the Centre, States and RBI), the Reserve Bank has suggested setting up of a new Apex Supervisory Body for the entire urban co-operative banking sector. It has proposed that this Apex body could be under the control of a separate high-level supervisory Board consisting of representatives of the Central Government, State Governments, RBI as well as experts and it could be given the responsibility of inspection/and supervision of UCBs and ensuring their conformity with prescribed prudential, capital adequacy and risk-management norms. The Reserve Bank has also forwarded its detailed proposals to the Central Government for setting up the Apex Supervisory Body.

51. Recent events have also brought to the fore the need for Boards of banks and financial institutions to exercise proper vigilance and supervision over the functioning of commercial banking and other financial institutions. In recent years, as part of on-going financial sector reforms, much greater autonomy and powers have been entrusted to their Boards, to lay down effective internal guidelines and procedures for transparency, disclosure, risk and asset-liability management. Yet, it has been noticed that in some cases, the policy laid down by the Boards was either flouted with impunity or the Board itself had failed to lay down appropriate internal guidelines for minimising risks and over-lending to certain entities without adequate security. If problems of the type which have surfaced recently are to be avoided in the future, within the framework of a deregulated and liberal financial system, the role of Boards becomes crucial. The Reserve Bank proposes to set up a consultative group of directors of a select group of commercial banks and financial institutions to suggest, for consideration by the Government/RBI, measures that should be taken to strengthen the internal supervisory role of

Boards.

52. In the rest of this section, an attempt is made to review the progress in respect of various monetary and other measures announced in recent years, and to propose some further measures of immediate as well as long-term importance.

Monetary Measures

(a) Bank Rate

53. On the basis of a review of macroeconomic and monetary developments, the Bank Rate is being reduced by 0.50 percentage point from 7.0 per cent to 6.50 per cent with effect from the close of business today (October 22, 2001).

At this level, it is the lowest Bank Rate since May 1973.

(b) Cash Reserve Ratio **-** *Reduction and Rationalisation*

54. All scheduled commercial banks [excluding Regional Rural Banks (RRBs)] are, at present, required to maintain with the Reserve Bank of India a cash reserve ratio (CRR) of 7.5 per cent of their net demand and time liabilities (NDTL). While the statutory minimum requirement of CRR maintenance at 3.0 per cent is obligatory on the banks, additional CRR, ranging between 4.5 per cent and 12.0 per cent since 1981, has been imposed from time to time in order to reduce the overflow of liquidity due to excessive money supply in the economy. At the same time, over a period, various exemptions given to the banks on certain specific categories of liabilities for the CRR requirement resulted in the effective CRR being different from the prescribed level in respect of individual banks. The effective CRR for different banks vary depending upon the composition of their liabilities, and for the banking system as a whole, effective CRR, at present is of the order of 6.3 per cent. Exemptions and multiple prescriptions over time made in response to specific requirements have increased the complexity of CRR as an instrument of liquidity management. With a view to rationalising CRR prescription and moving towards the long-term goal of keeping CRR normally at the statutory level, important changes are proposed below in respect of the coverage as well as the level of CRR for the banking system: l It is proposed to reduce the CRR by 200 basis points to 5.50 per cent from 7.50 per cent of NDTL. Effective from the fortnight beginning November 3, 2001, CRR will be reduced to 5.75 per cent; and effective fortnight beginning December 29, 2001, the CRR will be reduced further to 5.50 per cent of NDTL.

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

55. It is expected that these changes will facilitate the development of a short term yield curve, develop money market, reduce the regulatory arbitrage between banks and non-banks, enhance the availability of lendable resources with the banks and improve the efficiency of indirect instruments in the conduct of monetary policy. At the present level of NDTL, the combined impact of the above two measures will result in augmenting lendable resources of the banking system by about Rs.8,000 crore (about Rs.6,000 crore effective from November 3, 2001).

56. It may, however, be emphasised that while the proposed CRR reduction is consistent with the medium term objective, and the current circumstances of relatively low level of economic activity and reasonable inflation, RBI will continue to use the CRR instrument in both directions for liquidity management in addition to other instruments (such as, the LAF).

c) Interest on Cash balances Maintained with RBI

57. All scheduled commercial banks (excluding Regional Rural Banks) are paid interest on eligible cash balances maintained with RBI under CRR requirement at the rate of 6.0 per cent per annum effective April 21, 2001 against 4.0 per cent earlier. In the annual policy Statement of April 2001, it was announced that at a subsequent stage, interest will be paid at the Bank Rate. Accordingly, with effect from fortnight beginning November 3, 2001, the interest paid on eligible cash balances will be at the Bank Rate *(i.e.*, 6.5 per cent).

Liquidity Adjustment Facility - Progress

58. The Liquidity Adjustment Facility (LAF), introduced since June 5, 2000, has emerged as an effective and flexible instrument for influencing liquidity on a day-to-day basis. A package of measures was announced in the annual policy Statement in April 2001 encompassing changes in operating procedures of LAF, a strategy for smooth transition of call money market to pure inter-bank market and a programme for rationalisation of liquidity support available to the system. A set of complementary measures in money and government securities markets was also introduced.

59. On the whole, this package of measures had a positive impact. The LAF has rendered the necessary flexibility to RBI to operate on liquidity and to some extent to signal interest rates in the short-term money market. The LAF operations, combined with strategic OMO, have evolved into the principal operating procedure of monetary policy of the Reserve Bank in the short-run. The effectiveness of LAF would be further strengthened as the system moves towards a pure inter-bank call/notice money market coupled with the growth of a deep and liquid repo/reverse repo market for non-bank participants. Effective May 2001, non-banks are permitted to lend upto 85 per cent of their average daily lending during 2000-01. This has not caused any strain on the market with average daily aggregate lending in call money market improving to Rs.19,600 crore during May-September 2001 compared to Rs.10,900 crore during the corresponding period of the previous year. Volatility in call money rates has also come down significantly. It is encouraging to note that the volume of repo operations by non-bank participants has been increasing in the recent period.

60. In the context of improving the effectiveness of LAF, it is reiterated that in addition to overnight repos, RBI will also have the discretion to introduce longer-term repos upto 14-day period as and when required.

Commercial Paper-Dematerialised Holding

61. RBI issued fresh guidelines for issuance of Commercial Paper on October 10, 2000 relaxing the terms and conditions and streamlining the procedures. As indicated in the annual policy Statement of April 2001, banks, Financial Institutions (FIs), PDs and Satellite Dealers (SDs) are now permitted to make fresh investments and hold CP only in dematerialised form, effective

June 30, 2001. In this context, Fixed Income Money Market and Derivatives Association of India (FIMMDA) circulated a "Report of FIMMDA Working Group on Primary Markets Relating to Market Conventions and Guidelines for Commercial Paper". After extensive discussions on legal and related issues with depositories and RBI and after considering suggestions received from corporates, members of FIMMDA and other market players, the operational guidelines in respect of CP in dematerialised form were made public by FIMMDA on June 29, 2001. Further, to facilitate conversion of physicals into demat, FIMMDA, in consultation with market participants, depositories and RBI, prepared the related guidelines and made them public on October 3, 2001. These guidelines seem to be working reasonably well, and no changes are being proposed at present.

Development of Government Securities Market

62. Following the announcement made in the Union Budget for 2001-02, certain measures were announced in the annual policy Statement for the development of government securities market. Progress in regard to these measures is reviewed below:

- As announced in the annual policy Statement, 14-day and 182-day Treasury Bills (TBs) have been withdrawn from the week beginning May 14, 2001. The notified amount of 91-day TBs has been simultaneously increased to Rs.250 crore. It has also been ensured that both the 91-day and 364-day TBs mature on the same day in order to facilitate the availability of adequate fungible stocks of TBs of varying maturities in the secondary market. Increased attractiveness of TBs is evident from the fact that no devolvement on the Reserve Bank has taken place in Treasury Bill auctions and the bid-coverage ratio, particularly with respect to 364-day TBs, has also improved. l A Negotiated Dealing System (NDS) is being introduced with a view to facilitating electronic bidding in auctions and secondary market transactions in government securities and dissemination of information on trades on a real-time basis. The technology infrastructure related to NDS has been tested with the involvement of all market participants, in Local Area Network (LAN) and Wide Area Network (WAN) environments. Parallel runs are expected in November 2001. l The Clearing Corporation of India Limited (CCIL) was registered on April 30, 2001 under the Companies Act, 1956 with the State Bank of India as the chief promoter. Initially, the CCIL will be clearing all transactions in government securities and repos reported on the NDS of RBI and also rupee/US dollar forex spot and forward deals. The operationalisation of CCIL, linked to the NDS, is expected to commence with a test run in November 2001.

- Necessary amendments to notification issued by the Government for introduction of uniform price auction format for auctions of dated securities are being proposed. With the approval of the Government, the new auction format will be introduced on an experimental basis.

- A scheme of retail participation, including the middle segment encompassing Provident Funds, trusts, etc., in the primary market for government securities on non-competitive basis has been finalised in consultation with market participants and the Technical Advisory Committee on Money and Government Securities Markets (TAC). The details of the scheme will be finalised soon.

- The Reserve Bank has prepared a consultative paper drawing a road map for developing

Separate Trading of Registered Interest and Principal of Securities (STRIPS). This is being placed on the RBI website inviting comments and suggestions from market participants.

Review of the Satellite Dealer System

63. The Satellite Dealer system was introduced in 1996 to serve as a second tier to PDs in the government securities market with the particular objective of promoting retail segment. The experience with SDs shows that in practice, SDs' role in retailing of government securities has remained very limited. Even as a complementary service, the SD system is perceived to result in higher transaction costs to retail investors. Many of them being broking firms with limited capital strength and having wider presence in non-government securities business have also raised some supervisory concerns.

64. In the light of the above experience, the Reserve Bank has decided to undertake a review of the SD system in close consultation with SDs, PDs and the TAC. The review will consider the role carved out for SDs in the development of retail market, particularly in the context of the expanding role of PDs, emerging alternative mechanism of retailing government securities on the screen-based trading in exchanges, and the supervisory concerns in monitoring SDs' operations. The review will examine the scope for establishing a better linkage between SDs and PDs and thereby improving the SD system as an effective distribution channel at a retail level for government securities.

Prudential Measures

(a) Credit Information Bureau

65. A mention was made in the annual policy Statement of April 2001 about the setting up of the Credit Information Bureau (CIB) to collect, process and share credit information on the borrowers among banks and FIs. With a view to strengthen the legal mechanism, a draft legislation covering, *inter alia,* responsibilities of the Bureau, rights and obligations of the member credit institutions and safeguarding of the privacy rights has been forwarded to the Government. Pending such amendments, as a first step towards activating CIB, it has been decided to initiate the process of collection and dissemination of some relevant information, within the existing legal framework.

66. In order to operationalise the process of collection and dissemination of the data on credit information by the CIB, RBI will constitute a Group drawing representation from CIB, Indian Banks' Association (IBA), select banks and FIs. The Group will examine the possibility of the CIB performing the role of collecting and disseminating information on the list of suit-filed accounts and the list of defaulters, including willful defaulters, which is presently handled by RBI. The Group will also examine the other aspects of information collection and dissemination, such as, the extent, periodicity and coverage including the feasibility of supplying such information online, to members in future. Ideally, it should also be possible to work out in future a 'query mode' to provide any additional information needed and considered appropriate, on specific requests from members, including particulars relating to directors in the defaulting companies, as long as it is legally permissible. The Group will study all these issues and submit a report in one month's time. The transfer of work will be notified separately, thereafter.

(b) Non-SLR Investments by Banks and Financial Institutions

67. It has been observed that, of the investments by banks, a significant proportion of the banks' investments in non-SLR securities is through the private placement route. The non-transparent practices in this market could be a matter of concern. RBI had accordingly issued guidelines in June 2001 regarding the due diligence to be undertaken, the disclosures to be obtained and the credit risk analysis to be made in regard to privately placed investments especially for unrated instruments. Banks have been advised to adopt an internal system of rating for issues of non-borrowers, whether rated or otherwise, and adopt prudential limits to mitigate adverse impact of concentration and illiquidity. Banks have also been advised to put in place proper risk management systems for capturing and analysing the risks so as to take timely remedial measures. A further review of non-SLR investments in the light of recent developments reveals that the ease of mobilising funds through privately placed debt issues could lead to the use of such funds for risky purposes other than what is disclosed in the offer document.

68. In order to contain the risks arising out of non-SLR investment portfolio of banks and FIs, in particular through the private placement route, it is proposed to issue further prudential guidelines to be observed by banks. These guidelines, *inter alia*, would cover: (i) the need for strengthening of internal rating systems, periodically tracking the rating changes in respect of issuers; (ii) fixing of prudential limits, with separate sub-limits for unrated, unquoted and privately placed instruments; (iii) review by Board on total investments/disinvestments, regulatory compliance, rating changes in respect of issuers and non-performing investments; and (iv) disclosures in 'Notes on Accounts' regarding issuer composition and non-performing investments. A draft of detailed operating guidelines are being issued separately, which will be finalised after further consultation with banks and FIs.

69. For effective risk management, it is necessary to put in place appropriate arrangements for collecting and sharing of information regarding amounts of debt raised by corporates from the market, including through CPs, etc. It is proposed to constitute a Working Group to evolve a framework for collecting and sharing by banks/FIs of information on private placement of debt with CIB as a convenor, and representatives, *inter alia,* of banks, FIs and RBI. The proposed Working Group will, *inter alia*, analyse the status in regard to existing stock of debt, and its use for the purpose of evolving suitable guidelines in this regard. The Group will give its report in one month.

70. There is also a need for dissemination of information on secondary market trades in privately placed debt and to this end, banks and FIs have already been advised that effective October 31, 2001, they will be permitted to make fresh investments and hold bonds and debentures, privately placed or otherwise, only in dematerialised form. Outstanding investments should also be converted into demat form by June 2002. Transactions in such bonds could be reported by the National Securities Depository Limited/ Central Depository Services Limited (NSDL/ CDSL), with whom transfers of title are reported. To enable the transparency of the trades including nomenclature of the bonds, amount traded and the price at which traded, banks and FIs could evolve a reporting mechanism and the NSDL/CDSL can in turn disseminate such information to the market.

71. The above arrangements would apply uniformly to all bonds issued by corporates, banks, FIs

and State and Central Government sponsored institutions directly or as Special Purpose Vehicles (SPVs). In regard to bonds guaranteed explicitly or implicitly through letters of comfort, etc., mere availability of such guarantee should not determine the credit decision, and banks and FIs should undertake due diligence on the intrinsic viability and bankability of projects financed through issuance of such bonds. This will go a long way in ensuring efficient use of resources made available by banks and FIs, besides ensuring their creditworthiness. Overall, any proposal of direct or indirect financing of government budgets, directly or through SPVs should be eschewed and proposals should be for specific monitorable projects, particularly in capital-intensive and high-cost sectors, including infrastructure. Components of financing and returns need to be well defined and assessed.

(c) Transparency and Accounting Standards

72. Over a period, banks were advised to disclose in the 'Notes on Accounts' in the balance sheet, the details of the maturity pattern of loans and advances, investments, deposits and borrowings, movements in NPAs, exposure to sensitive sectors, etc. As a further step in ensuring transparency and credibility of their financial positions, it has been decided that banks should furnish the following additional disclosures in the 'Notes on Accounts' in their balance sheets, from the year ending March 2002: (i) movement of provisions held towards NPAs and (ii) movement of provisions held towards depreciation on investments.

73. The Accounting Standards issued by the Institute of Chartered Accountants of India (ICAI) establish the standards which have to be complied with by corporate entities so as to ensure that they present a true and fair view of the financial position of the entity. These standards are periodically being revised by ICAI, consistent with international accounting standards. Certain difficulties in the adoption of the standards as finalised by the ICAI have been reported by banks. It has, therefore, been decided to set up a Working Group comprising representatives of ICAI, banks and RBI to identify the compliance as also gaps in compliance with the accounting standards and recommend steps to eliminate/ reduce the gaps.

Supervision and Monitoring

74. The Reserve Bank had introduced in 1999 off-site returns to monitor liquidity and interest rate risks on quarterly basis with the intention to finally move over to a fortnightly reporting system. The quarterly system has now stabilised. Further progress made in respect of certain announcements made in the annual policy Statement of April 2001 is reviewed below:

- The Basel Committee on Banking Supervision (BCBS) released the second set of consultative documents on New Capital Accord. RBI has forwarded its comments to Basel Committee, which have also been put on RBI website in May 2001.

- A scheme of Prompt Corrective Action (PCA), based on pre-determined trigger points, is planned as part of continued efforts to enhance the existing supervisory framework. The Reserve Bank, after examining the comments/suggestions received from scheduled commercial banks on the scheme, has sought the Government's views before implementation.

- In order to involve banks in the smooth switch-over to Risk-based Supervision (RBS) process, the Reserve Bank has released a discussion paper seeking comments/ suggestions of experts/public. The discussion paper highlights the initiatives and action required in setting up of a comprehensive risk management system, adoption of risk-based audit system, upgradation of management information and information technology systems, establishment of dedicated compliance units and resolving HRD and training related issues. It is planned to hold a pilot run of the RBS approach in due course.

Settlement of Non-Performing Assets

75. In July 1995, RBI had issued broad guidelines to scheduled commercial banks for compromise or negotiated settlement of NPAs. In May 1999, in order to facilitate settlement of NPAs in the small sector, the Reserve Bank issued guidelines for the constitution of Settlement Advisory Committees (SACs) in public sector banks. Banks had, however, represented that much progress could not be made in the recovery of NPAs despite setting up of SACs. Accordingly, in July 2000, in consultation with the Government, RBI had circulated simplified, non-discretionary and non-discriminatory guidelines to provide a one-time impetus to reduction of the stock of chronic NPAs by the recovery of dues relating to public sector banks which covered accounts upto Rs.5 crore in all sectors including the small scale sector, but excluded any cases of willful default, fraud or malfeasance. These guidelines specified the coverage of the scheme, the settlement formula including the amount and cut-off date, and the manner of payment of the settled dues.

76. The settlement scheme laid out by these guidelines was operative till June 2001 and all applications received upto this date were to be processed by September 30, 2001. Under this scheme, the public sector banks have recovered a total sum of Rs.2,192 crore in respect of 5.23 lakh accounts as on July 30, 2001.

77. Some representations have been received for further extension of the scheme. Given that the purpose of these guidelines was to provide an opportunity for "one-time settlement" within the specified time period, and sufficient time has already been provided, it is not proposed to extend this scheme. However, the broad framework provided for settlement in the 1995 guidelines will continue to be in place, and banks are free to design and implement their own policies for recovery and write-off incorporating compromise and negotiated settlements with the approval of their Boards, particularly for old and unresolved cases falling under the NPA category. In this respect, the experience with the one-time settlement scheme may also be taken into account. It is important, however, to ensure that any scheme formulated by bank Boards is simple, non-discriminatory and transparent so that all eligible cases are accorded equal treatment.

Urban Co-operative Banks

78. The annual policy Statement of April 2001 had announced a proposal to set up a new Apex Supervisory Body to take over the entire inspection/supervisory functions relating to scheduled and non-scheduled Urban Cooperative Banks (UCBs) in consultation with the Central Government. As a follow-up, after discussing various issues involved, RBI has submitted a draft Bill on setting up of a separate Supervisory Authority to the Central Government.

79. A Working Group constituted by the Reserve Bank to evolve asset-liability management (ALM) guidelines for UCBs has since submitted its Report. The Reserve Bank has circulated the Report to select UCBs for their comments. Based on the feedback, guidelines will be issued to scheduled UCBs. In order to strengthen the supervisory mechanism, RBI has since introduced off-site monitoring system for scheduled UCBs.

80. In the annual policy Statement of April 2001, the UCBs were advised not to entertain any fresh proposals for lending directly or indirectly against security of shares either to individuals or any other entity and that such loans to individuals which had already been disbursed upto permissible amounts should continue only till the contracted date. In response to representations received from UCBs and their federations, it is now proposed to allow UCBs to grant loans to individuals against security of shares, subject to the following parameters:

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

(ii) It is essential that before accepting shares as security, UCBs should put in place a risk management system.

UCBs should also have Audit Committee of their Boards of Directors and all the approved loan proposals should be placed before the Audit Committee at least once in two months. Details of loans sanctioned should be reported to the Board in the subsequent Board meeting. The Management and Audit Committees should ensure that all loans against shares are made only to those individuals who are not in any way connected with any stockbroking activity or stock-broking entity.

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

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

81. As per the annual policy Statement of April 2001, UCBs were required to achieve certain higher proportion of their SLR holding in the form of government and other approved securities as a percentage of their Net Demand and Time Liabilities (NDTL) by March 31, 2002. UCBs and their federations have represented that, in current market conditions, many smaller UCBs were facing genuine difficulties in adhering to the time schedule in achieving the prescribed levels of SLR holding. In response to these representations, it is proposed to modify the time-frame for achieving the prescribed levels of SLR holding in the following manner: It is possible that a number of UCBs in any of the categories have already achieved as on October 20, 2001 or were nearer to the target set for end-March or end-September 2002. Notwithstanding the revision in the time-frame as proposed above, such UCBs are advised not to bring down their present

level of SLR holding in government and other approved securities as a proportion of their NDTL.

SLR Investments of UCBs: Revised Time-frame

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

***** It may be clarified that so far as scheduled UCBs are concerned, with effect from April 1, 2003, the entire prescribed level of 25 per cent SLR holding has to be only in government and other approved securities.

82. The Reserve Bank has already issued guidelines relating to capital adequacy norms to be followed by UCBs. It is clarified that, under the existing guidelines, the scheduled UCBs are required to achieve the capital adequacy norms gradually by March 2004 and the non-scheduled UCBs by March 2005. This time-table provides sufficient time for UCBs to meet the prescribed capital adequacy requirements, and UCBs are urged to gradually build up their owned capital in the interest of their depositors.

Credit Delivery Mechanism

(a) "Loan System" for Delivery of Bank Credit

83. RBI had introduced a “Loan System” for delivery of bank credit in April 1995 prescribing the composition of working capital finance into loan and cash credit components. The “Loan System” has been extended in phases to cover larger number of borrowers and also a larger component of the working capital finance. At present, the “Loan System” is applicable to borrowers enjoying working capital limit of Rs.10 crore and above from the banking system; the loan component of the working capital limit of such borrowers has been fixed at a high level of not less than 80 per cent.

84. The “Loan System” was introduced to minimise the risks of cash and liquidity management on the part of the banking system, caused by volatile movements in cash credit component of working capital. In the current environment of short-term investment opportunities available to

both corporates and banks, banks will henceforth have the freedom to change the composition of working capital by increasing the cash credit component beyond 20 per cent, for working capital limits of Rs.10 crore and above, if they so desire. It is expected that banks will appropriately price each of the two components of working capital finance, taking into account the impact of such decisions on their cash and liquidity management.

(b) Consortium Arrangement for Food Credit

85. A Committee consisting of representatives of banks, RBI, Government of India and Food Corporation of India was constituted by the Reserve Bank for undertaking a review of the consortium arrangement for food credit. The Committee submitted its report in September 2001. The Report of the Committee is under consideration in consultation with the concerned agencies and the Government.

(c) Kisan Credit Cards

86. It has been observed that the introduction of Kisan Credit Cards (KCCs) Scheme for eligible agricultural farmers has proved to be successful. To accelerate the scheme to cover all eligible agricultural farmers within the next 3 years, the Reserve Bank has advised all banks about their targets to be achieved for 2001-02. During 2000-01, public sector banks had issued 23.90 lakh KCCs, close to the target and during the first quarter of 2001-02, they have issued 3.85 lakh KCCs.

Universal Banking

87. It may be recalled that the policy regarding approach to Universal Banking was enunciated in the annual policy Statement of April 2000. The salient operational and regulatory issues to be addressed by the financial institutions for conversion into a universal bank was also communicated by RBI through a circular dated April 28, 2001. While no formal proposal has so far been received by RBI from any financial institution for transformation into a universal bank, some of them have expressed their intent to move in this direction. The Reserve Bank welcomes the interest shown by some financial institutions in this regard and encourages them to formulate appropriate and detailed proposals for smooth conversion into universal banks, if they so wish. The Reserve Bank intends to process applications promptly in the light of considerations outlined in RBI's circular to FIs on approach to Universal Banking in April 2001.

88. In processing a specific proposal, the overwhelming consideration of the Reserve Bank will be to meet the strategic objectives of the concerned financial institution for meeting the varied needs of different categories of customers, while at the same time ensuring healthy competition in the financial system through transparent and equitable regulatory framework applicable to all the participants in banking business. It should, however, be recognised that the movement towards universal banking should foster stability and efficiency of the financial system, but by itself it cannot provide a viable or sustainable solution to the operational problems of individual institutions arising from low capitalisation, high level of NPAs, large asset–liability mismatches, liquidity, etc. While taking a flexible view on each application, the Reserve Bank will pay particular attention to the primary need to ensure safety of public deposits, especially of small depositors, and to promote the continued stability of the financial system as a whole, and of the

banking system in particular.

Non-Banking Financial Companies

89. The Reserve Bank had received applications for Certificate of Registration (CoR) from 36,505 Non-Banking Financial Companies (NBFCs), of which, 13,815 applications were approved and 18,355 were rejected as at the end of August 2001. Only 776 NBFCs have been permitted to accept public deposits, of which 27 NBFCs were holding public deposits of Rs.50 crore and above.

90. The companies whose applications for CoR have been rejected or the companies whose CoR has been cancelled, should continue to repay their deposits on due dates and dispose of their financial assets within three years. They are also advised to submit the returns at prescribed periodicity to RBI.

91. The ALM guidelines issued in June 2001 would become fully operational by March 31, 2002. The NBFCs were, however, advised to commence trial run of the ALM process for the half year ended September 30 and for the half year beginning October 2001. The NBFCs may bring to the notice of RBI any difficulties being faced by them for appropriate consideration.

92. As pointed out in earlier policy Statements, RBI places substantial importance to further development of the NBFC sector along prudent lines. NBFCs are in a position to deliver credit to the decentralised sector and to small borrowers at the local level in response to local requirements, particularly for financing of transport and other equipment. RBI has, therefore, been discussing with the informal Advisory Group of NBFCs, and also with various NBFC associations, the need to promote the formation of a Self Regulatory Organisation (SRO), particularly for the benefit of smaller NBFCs. So far, there has not been much progress by the NBFC sector in finalising a scheme for formation of SRO. RBI would continue with its efforts to encourage the NBFC sector to devise a viable mechanism for instituting a self regulatory system for this sector.

Technology Upgradation

93. In order to bring improvements in the payment and settlement system, some important measures taken by the Reserve Bank were announced in the annual policy Statement of April 2001. To facilitate banks to effectively participate in the payment and settlement systems and to provide a road map of the various payment system projects, a draft Payment System Vision Document was prepared; based on the feedback received from banks and comments of the members of apex bodies such as the National Payments Council, the Vision Document is being finalised. The other steps being taken up include the use of “imaging” of cheques as a precursor for cheque truncation, which would be facilitated by the recommendations of the Working Group on amendments to the Negotiable Instruments Act, 1881 and the introduction of internet banking services.

94. With a view to further improve the technology based infrastructure of banks and also enable them to effectively use the facilities offered by the Reserve Bank in the payment and settlement system, the following further measures are proposed:

- The Indian Financial Network (INFINET) is already available for use by all banks and common inter-bank applications are being implemented on this network. Banks have to take necessary steps to further strengthen their infrastructure base in respect of standardisation, high levels of security and communication and networking to make full use of these resources.

- If the benefits of the common inter-bank applications have to be fully realised, it is essential that connectivity of computers located at different branches of banks is achieved early. To begin with, it should be the endeavour of banks to achieve the goal of connectivity of commercially important centres. This will facilitate connectivity to the INFINET for achieving inter-city, inter-bank message transfer in a network environment on a real time basis.

- One of the systems provided by the Reserve Bank for quick, safe and secure movement of funds in an electronic mode is the Electronic Funds Transfer (EFT). At present, the scheme is available for transfer of funds across about 8,500 branches of banks located at major commercial centres. It is essential that concerted efforts are taken by banks to popularise the usage of this scheme which would result in quick funds transfer for clients, lesser reconciliation problems at banks and improve systemic efficiency.

Rationalisation of Current Account Facility by the Reserve Bank

95. Since banks having large network of branches are the eventual payment service providers to the rest of the non-banking community and also the essential conduits, apart from PDs, through which RBI effects its LAF and in the context of the recommendations of the Technical Group on phasing out of non-banks from call/ notice money market, a need was felt to rationalise/review the present policy of current account facility provided by RBI. Further, the operationalisation of the CCIL and the proposed implementation of NDS would also obviate the need for having current account with RBI by some of the non-bank entities. To look into all the above aspects, an internal Group was set up which has since submitted its Report. The Report has been placed on RBI’s website and a copy of the Report has also been sent to all the current account holders for their comments. These recommendations are also being examined by the Reserve Bank.

Legal Reforms

96. It may be recalled that in the annual policy Statement of April 2001, major legal reforms initiated in the banking sector covering areas such as security laws, Negotiable Instruments Act, fraud on banks, regulatory framework of banking, etc., were indicated. Further progress in regard to various initiatives for legal reforms is given below:

- The Working Group constituted by the Government for suggesting changes in the provisions of Negotiable Instruments Act, 1881, to bring it in conformity with the Information Technology Act, 2000 and also to examine the incorporation of electronic cheque, securitised certificates and other evolving products within the ambit of Negotiable Instruments Act has since submitted its recommendations to the Government in June 2001. The Group, *inter alia*, recommended the introduction of truncation of cheques and electronic cheques and suggested appropriate legal amendments.

- The Working Group on Asset Securitisation has drafted a Bill on Asset Securitisation which is under consideration of the Government.

- The draft legislation prepared by another Working Group constituted by the Government to examine the vesting of powers with banks and FIs for taking possession and sale of securities without intervention of the courts has been put on the RBI Website in August 2001 seeking comments from the public. The draft Bill is under the consideration of the Government.

- Proposals regarding amendments to the Reserve Bank of India Act, 1934, Banking Regulation Act, 1949, Government Securities Bill in replacement of the Public Debt Act, 1944, are currently under consideration of the Government.

- In order to improve the legal system relating to payments in India, the Legal Task Force of the National Payments Council submitted a set of recommendations for preparing a new legislation for regulating the payment systems in India. For drafting a legislation on Payment Systems in India, an international consultant and an eminent Indian draftsman have been appointed by RBI in consultation with the National Payments Council.

- An Expert Committee on Bank Frauds (Chairman: Dr.N.L. Mitra) submitted its Report to RBI in September 2001 which has been put on the RBI website. The Committee examined and suggested both the preventive and curative aspects of bank frauds. The important recommendations of the Committee include: a need for including financial fraud as a criminal offence and amendments to the Indian Penal Code by including a new chapter on financial fraud; amendments to the Indian Evidence Act to shift the burden of proof on the accused person and special provision in the Code of Criminal Procedure for transferring the properties involved in the financial fraud and confiscating unlawful gains; and preventive measures including the development of Best Code Procedures by banks and FIs. The Report is being examined by the Reserve Bank.

- Proposal to repeal the existing DICGC Act and replace it with a new Act is under consideration.

- Financial Companies Regulation Bill providing for a separate enactment in place of Chapter III B and Chapter III C of the Reserve Bank of India Act and amendments to Banking Companies (Acquisition and Transfer of Undertaking) Acts, 1970 and 1980 bringing down the equity holding of the Government in the nationalised banks and also for enabling financial restructuring of weak banks have been introduced in the Lok Sabha.

International Financial Standards and Codes

97. The annual policy Statement of April 2001 mentioned about the significant progress made by the Advisory Groups on International Financial Standards and Codes. All the Advisory Groups constituted by the Standing Committee on International Financial Standards and Codes have submitted their Reports to the Chairman of the Standing Committee and these reports are placed on RBI Website **www.rbi.org.in** for wider dissemination. Copies of the Reports are being sent to various experts, economists, professionals, academicians, banks and institutions for their comments. The Chairmen of individual Advisory Groups have been requested to explore the

possibility of organising seminars on the themes. The Standing Committee will also prepare its own report indicating, *inter alia*, the course of follow-up/reforms required and the regulatory agencies involved in such follow-up actions.