By Dr. D. Subbarao
Governor

# *Annual Policy Statement 2009-10 by Dr. D. Subbarao, Governor, Reserve Bank of India*

This annual policy statement for 2009-10 is set in the context of exceptionally challenging circumstances in the global economy. The crisis has called into question several fundamental assumptions and beliefs governing economic resilience and financial stability. What started off as turmoil in the financial sector of the advanced economies has snowballed into the deepest and most widespread financial and economic crisis of the last 60 years. With all the advanced economies in a synchronised recession, global GDP is projected to contract for the first time since the World War II, anywhere between 0.5 and 1.0 per cent, according to the March 2009 forecast of the International Monetary Fund (IMF). The World Trade Organisation (WTO) has forecast that global trade volume will contract by 9.0 per cent in 2009.

2. Governments and central banks around the world have responded to the crisis through both conventional and unconventional fiscal and monetary measures. These measures have been criticised for their size, timing, sequencing and design as also, more importantly, for their economic and ideological underpinnings. The most voluble criticism has been that 'purely national responses' are inadequate to address a virulent global crisis. In recognition of a pressing need for global co-ordination and co-operation, particularly in order to inspire the trust and confidence of economic agents around the world, leaders of the G-20 group of nations met twice in the last six months. At their recent meeting in early April 2009, the G-20 leaders collectively committed to take decisive, co-ordinated and comprehensive actions to revive growth, restore stability of

the financial system, restart the impaired credit markets and rebuild confidence in financial markets and institutions.

3. Despite some apprehensions prior to the meeting, the overall impact of the G-20 meeting in managing market perceptions has been positive. Even so, the global financial situation remains uncertain and the global economy continues to cause anxiety for several reasons. There is as yet no clear estimate of the quantum of tainted assets, and doubts persist on whether the initiatives underway are sufficient to restore the stability of the financial system. There is continued debate on the adequacy of the fiscal stimulus packages across countries, and their effectiveness in arresting the downturn, reversing job losses and reviving consumer confidence. Many major central banks have nearly or totally exhausted their conventional weaponry of calibrating policy interest rates and are now resorting to unconventional measures such as quantitative and credit easing. Given the erosion of the monetary policy transmission mechanism, there are concerns about when and to what extent monetary response, admittedly aggressive, will begin to have an impact on reviving credit flows and spurring aggregate demand.

4. Like all emerging economies, India too has been impacted by the crisis, and by much more than what was expected earlier. The extent of impact has caused dismay, mainly on two grounds: first, because our financial sector remains healthy, has had no direct exposure to tainted assets and its off-balance sheet activities have been limited; and second, because India's merchandise exports, at less than 15 per cent of GDP, are relatively modest. Despite these mitigating factors, the impact of the crisis on India evidences the force of globalisation as also India's growing two-way trade in goods and services and financial integration with the rest of the world.

5. After clocking annual growth of 8.9 per cent on an average over the last five years (2003-08), India was headed for a cyclical downturn in 2008-09. But the growth moderation has been much sharper because of the negative impact of the crisis. In fact, in the first two quarters of 2008-09, the growth slowdown was quite modest; the full impact of the crisis began to be felt post-Lehman in the third quarter, which recorded a sharp downturn in growth. The services sector, which has been our prime growth engine for the last five years, is slowing, mainly in construction, transport and communication, trade, hotels and restaurants sub-sectors. For the first time in seven years, exports have declined in absolute terms for five months in a row during October 2008-February 2009. Recent data indicate that the demand for bank credit is slackening despite comfortable liquidity in the system. Dampened demand has dented corporate margins while the uncertainty surrounding the crisis has affected business confidence. The index of industrial production (IIP) has been nearly stagnant in the last five months (October 2008 to February 2009), of which two months registered negative growth. Investment demand has also decelerated. All these indicators suggest that growth will moderate more than what had been expected earlier.

6. Despite the adverse impact as noted above, there are several comforting factors that have helped India weather the crisis.

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First, our financial markets, particularly our banks, have continued to function normally. Second, India's comfortable foreign exchange reserves provide confidence in our ability to manage our balance of payments notwithstanding lower export demand and dampened capital flows. Third, headline inflation, as measured by the wholesale price index (WPI), has declined sharply. Consumer price inflation too has begun to moderate. Fourth, because of mandated agricultural lending and social safety-net programmes, rural demand continues to be robust.

7. Both the Government and the Reserve Bank responded to the challenge of minimising the impact of crisis on India in co-ordination and consultation. The Reserve Bank shifted its policy stance from monetary tightening in response to the elevated inflationary pressures in the first half of 2008-09 to monetary easing in response to easing inflationary pressures and moderation of growth engendered by the crisis. The Reserve Bank's policy response was aimed at containing the contagion from the global financial crisis while maintaining comfortable domestic and forex liquidity. Taking a cue from the Reserve Bank's monetary easing, most banks have reduced their deposit and lending rates.

8. The Central Government launched three fiscal stimulus packages during December 2008-February 2009. These stimulus packages came on top of an already announced expanded safety-net programme for the rural poor, the farm loan waiver package and payout following the Sixth Pay Commission report, all of which too added to stimulating demand.

9. This annual policy statement for 2009-10 is organised in two parts. Part A covers *Monetary Policy* which provides an assessment of the *Macroeconomic and Monetary Developments* (Section I), the *Stance of Monetary Policy* (Section II) and *Monetary Measures* (Section III). Part B on *Developmental and Regulatory Policies* covers *Financial Stability* (Section I), *Interest Rate Policy* (Section II), *Financial Markets* (Section III), *Credit Delivery Mechanism and other Banking Services* (Section IV), *Prudential Measures* (Section V) *and Institutional Developments* (Section VI). This statement should be read and understood together with the analytical review of *Macroeconomic and Monetary Developments* released yesterday.

## Part A. Monetary Policy Statement 2009-10

## I. Macroeconomic and Monetary Developments

### *Global Outlook*

10. The global outlook has continued to deteriorate in the last quarter with projections for global growth in 2009 undergoing rapid downward revision. According to the IMF's March 2009 forecast, global growth is projected to shrink by 0.5 to 1.0 per cent in 2009 in contrast to an expansion of 3.2 per cent in 2008. Other projections are even more dire. The World Bank estimates global GDP to contract by 1.7 per cent and the OECD by as much as 2.7 per cent. In the US, economic activity has declined sharply, driven mainly by the decline in consumption and exports. The Euro area

too is in a severe and synchronised contraction. Reflecting sharp demand contraction, consumer price inflation has reached near zero in several advanced countries, raising concerns about sustained deflation on the way forward. The unemployment rate in the US has risen to 8.5 per cent, the highest since 1983. Unemployment rates in the Euro area, the UK and Japan too increased significantly. The WTO projects that global trade will shrink by 9.0 per cent in volume terms in 2009, down from an increase of 2.0 per cent in 2008. Between 1990 and 2007, global trade grew twice as fast as global GDP; in a sharp reversal of this 'trade as the engine of growth' paradigm, in 2009 global trade is projected to shrink twice as much as global GDP.

11. In advanced countries, substantial injection of liquidity and successive cuts in the policy rates have resulted in the softening of short-term interest rates, particularly in the overnight segment. However, the transmission to the credit market has been impaired, suggesting that the process of deleveraging is incomplete, asset prices have yet to stabilise and that credit spreads need to narrow further. Banks and financial institutions are still in the process of recognising losses arising out of off-balance sheet exposures. This raises concerns about the extent of required recapitalisation, and this uncertainty is inhibiting fresh lending. Most importantly, the global financial system is yet to recover the forfeited trust and confidence. Under the G-20 initiative, efforts are underway to strengthen the global financial architecture and restore the global growth momentum through co-ordinated actions.

### *Emerging Market Economies*

12. The IMF projects that the GDP growth of EMEs will decelerate to a range of 1.5-2.5 per cent in 2009, down from 6.1 per cent in 2008. This downturn is clear evidence that the forces of globalisation are too strong for the decoupling hypothesis to work. Even across EMEs, there are wide variations: several countries are likely to post negative growth, while significant positive contributions are expected from China and India. The crisis spread from advanced countries to EMEs, as is now clear, through both trade and finance channels. The slump in export demand and tighter trade credit caused deceleration in aggregate demand; reversal of capital flows led to equity market losses and currency depreciations; global liquidity tightening resulted in lower external credit flows to EMEs; and market rigidities and erosion of confidence led to widening of credit spreads. Like advanced countries, EMEs too responded to the challenge of managing the crisis through fiscal and monetary actions, but these measures will not have full impact until the global situation stabilises and trade and credit flows are restored. The G-20 commitment to desist from all forms of protectionism and to maintain open trade and investment regimes is a source of comfort to EMEs in an otherwise discouraging external environment.

### *Domestic Outlook*

13. Economic activity in India slowed down in Q1 and Q2 of 2008-09 as compared with over 9.0 per cent growth in the previous three years. However, growth decelerated sharply in Q3 following the failure of Lehman Brothers in mid-September 2008

and knock-on effects of the global financial crisis on the Indian economy. Consequently, the growth rate during the first three quarters (April-December) of 2008-09 slowed down significantly to 6.9 per cent from 9.0 per cent in the corresponding period of the previous year (Table 1). The advance estimates of the Central Statistical Organisation (CSO) released in February 2009 have placed the real GDP growth for 2008-09 at 7.1 per cent.

14. The last Annual Policy Statement of the Reserve Bank released in April 2008 placed real GDP growth for 2008-09 in the range of 8.0-8.5 per cent. Around that time, the IMF had projected the global growth to be at 3.7 per cent in 2008. As the year progressed and the crisis unfolded, economic prospects globally deteriorated rapidly and at home in India in Q3 2008-09. Beginning July 2008, the IMF made frequent reductions in its growth forecasts for 2008. The Reserve Bank too reflected the deteriorating outlook by revising downward its growth projection for India for 2008-09 to 7.5-8.0 per cent in the Mid-Term Review (October 2008) and further down to 7.0 per cent with a downward bias in the Third Quarter Review (January 2009). The downside risks have since materialised and the GDP growth for 2008-09 is now projected to turn out to be in the range of 6.5 to 6.7 per cent.

### *Agriculture*

15. The second advance estimates of the Ministry of Agriculture released in February 2009 have placed total foodgrains production in 2008-09 at 227.9 million tonnes, lower than the production of 230.8 million tonnes in the previous year. Subsequent information on good sowing for *rabi* crops and the trend in procurement suggests that agricultural production during 2008-09 may turn out to be better than earlier anticipated.

### *Industry*

16. During 2008-09 so far (April-February), industrial growth based on the index of industrial production (IIP), decelerated to 2.8 per cent, down by more than two-third from 8.8 per cent in the corresponding period of the previous year. While IIP growth was 5.0 per cent in the first half of 2008-09, the average growth in the following five months was insignificant (0.2 per cent). There, however, have been some incipient positive signs. Although the IIP contracted by 1.2 per cent in February 2009, machinery and equipment (other than transport

**Table 1: Real GDP Growth (%)**

| Sector | Q1 (April-June) | | Q2 (July-September) | | Q3 (October-December) | | April-December | |
|---|---|---|---|---|---|---|---|---|
| | 2007-08 | 2008-09 | 2007-08 | 2008-09 | 2007-08 | 2008-09 | 2007-08 | 2008-09 |
| Agriculture | 4.4 | 3.0 | 4.4 | 2.7 | 6.9 | -2.2 | 5.5 | 0.6 |
| Industry | 8.5 | 5.2 | 7.5 | 4.7 | 7.6 | 0.8 | 7.9 | 3.5 |
| Services | 10.7 | 10.2 | 10.7 | 9.6 | 10.1 | 9.5 | 10.5 | 9.7 |
| **Overall** | **9.1** | **7.9** | **9.1** | **7.6** | **8.9** | **5.3** | **9.0** | **6.9** |

**Source:** Central Statistical Organisation (CSO).

equipment) exhibited double digit growth. In terms of use-based classification, capital goods production too registered double digit growth.

### *Demand Components of GDP*

17. Private consumption and investment demand decelerated during Q3 of 2008-09. Government consumption demand, however, registered a sharp increase, reflecting the partial payout of the Sixth Pay Commission Award and other fiscal stimulus measures. As a result, the share of government consumption demand in GDP increased significantly. Deceleration in net exports growth in the successive quarters of 2008-09 had an adverse impact on the overall GDP growth (Table 2).

### *Corporate Performance*

18. After registering robust growth during the five year period 2003-08, the performance of the private non-financial corporate sector deteriorated in the first three quarters of 2008-09. Sales growth of companies, which continued to be strong in Q1 and Q2, decelerated sharply in Q3 of 2008-09. Net profits, which recorded an average annual growth of over 40 per cent during 2003-08, recorded a significantly lower growth in the first quarter of 2008-09. In the second quarter, net profits declined, although gross profits continued to increase, *albeit* marginally. In the third quarter, even gross profits declined sharply (Table 3). Profit margins were eroded by higher input costs, increased interest outgo, significant drop in non-sales income and losses on foreign currency related transactions. While moderation in internal accruals has an adverse effect on corporate investment, decline in input prices and reduction in borrowing costs may have a favourable impact on profitability going forward.

### *Business Confidence*

19. The Industrial Outlook Survey of the Reserve Bank for January-March 2009 indicates a further worsening of perception for the Indian manufacturing sector. The

**Table 2: Demand Components of GDP**

| Item | 2008-09 Advance Estimates | 2008-09 | | |
|---|---|---|---|---|
| | | Q1 | Q2 | Q3 |
| | **y-o-y Growth Rate (%)** | | | |
| Private Final Consumption Expenditure | 6.8 | 7.7 | 6.9 | 5.4 |
| Government Final Consumption Expenditure | 16.8 | 7.1 | 7.9 | 24.6 |
| Gross Fixed Capital Formation | 8.9 | 10.1 | 15.1 | 5.3 |
| Net Exports | -60.5 | -231.5 | -63.8 | -54.2 |
| | **Share in GDP (%)** | | | |
| Private Final Consumption Expenditure | 57.0 | 59.8 | 58.0 | 59.5 |
| Government Final Consumption Expenditure | 10.6 | 10.3 | 8.7 | 10.0 |
| Gross Fixed Capital Formation | 32.1 | 32.3 | 35.3 | 31.0 |
| Net Exports | -6.5 | -2.5 | -10.7 | -7.5 |

**Source:** Central Statistical Organisation (CSO).

| Table 3: Private Corporate Sector – Growth Rates (%) | | | | | |
|---|---|---|---|---|---|
| Item | 2006-07 | 2007-08 | 2008-09 | | |
| | | | Q1 | Q2 | Q3 |
| Sales | 26.5 | 18.3 | 29.3 | 31.8 | 9.5 |
| Expenditure | 24.7 | 18.4 | 33.5 | 37.5 | 12.6 |
| Gross Profits | 44.7 | 22.8 | 11.9 | 8.7 | -26.7 |
| Net Profits | 44.0 | 26.2 | 6.9 | -2.6 | -53.4 |

overall business and financial sentiment, which touched a seven-year low in the preceding quarter, slid below the neutral 100 mark, for the first time since the compilation of the index began in 2002. According to the survey, the demand for working capital finance during January-March 2009 from external sources dropped due to slowdown in business, even as the availability of finance eased. The business confidence surveys conducted by other agencies are also consistent with these findings.

### *Lead Indicators*

20. In terms of lead indicators of the economy, economic activity in several services sectors has been moderating. Cargo handled at major ports, passengers handled at airports, railway freight traffic and arrival of foreign tourists registered lower/negative growth. Strong rural demand, lagged impact of monetary and fiscal stimuli, softening of domestic input prices, investment demand from brown-field projects and some restructuring initiatives are expected to have a positive impact on industrial production in the months ahead.

### *Inflation*

21. Headline inflation, as measured by year-on-year variations in the wholesale price index (WPI), decelerated sharply from its intra-year peak of 12.91 per cent on August 2, 2008 to 0.26 per cent by March 28, 2009. In terms of relative contribution to the fall in WPI inflation since August 2008, mineral oils and basic metals (combined weight 15.3 per cent in WPI) together accounted for over 83 per cent of the decline reflecting global trend in commodity prices. The prices of food articles, however, are still ruling high. The inflation based on various consumer price indices (CPIs) continues to be near double-digit level mainly reflecting a firm trend in prices of food articles (Table 4). WPI inflation declined further to 0.18 per cent as on April 4, 2009.

22. The analysis of the last four years suggests that WPI inflation and CPI inflation moved, by and large, in tandem till April 2007. Thereafter, inflation measured in WPI and CPI tended to diverge. However, the divergence in the recent period has been unusually high reflecting the volatilities in commodity prices which have a higher weight in WPI (Chart 1). With the decline in WPI inflation, CPI inflation is expected to moderate in the coming months. For its overall assessment of inflation outlook for policy purposes, the Reserve Bank continuously monitors the full array of price indicators.

### *Fiscal Scenario*

23. The finances of the Central Government in 2008-09 deviated significantly from the Budget Estimates (BE). Higher revenue expenditure together with lower revenue receipts led to a sharp increase in the revenue and fiscal deficits. The deviation of deficit indicators from the targets stipulated under the Fiscal

**Table 4: Annual Inflation Rate (%)**

| Wholesale Price Index (WPI) | March 29, 2008 (y-o-y) | March 28, 2009 (y-o-y) |
|---|---|---|
| WPI - All Commodities | 7.75 | 0.26 |
| WPI - Primary Articles | 9.68 | 3.46 |
| WPI - Food Articles | 6.54 | 6.31 |
| WPI - Fuel Group | 6.78 | -6.11 |
| WPI - Manufactured Products | 7.34 | 1.42 |
| WPI - Manufactured Food Products | 9.40 | 7.51 |
| WPI - Excluding Fuel | 8.01 | 2.01 |
| WPI - Excluding Food Articles and Fuel | 8.38 | 0.95 |
| **Consumer Price Index (CPI)** | **February 2008 (y-o-y)** | **February 2009 (y-o-y)** |
| CPI - Industrial Workers | 5.47 | 9.63 |
| CPI - Agricultural Labourers | 6.38 | 10.79 |
| CPI - Rural Labourers | 6.11 | 10.79 |
| CPI - Urban Non-manual Employees # | 4.84 | 10.38 |

# : Pertains to January.

Responsibility and Budget Management (FRBM) Rules was on account of several fiscal stimulus measures undertaken by the Government to boost aggregate demand. The financing gap was met by enhancement of market borrowings (Table 5).

24. Because of the fiscal stimulus packages as also additional post-budget items of expenditure, Central Government's borrowing during 2008-09 was substantially above the initial budget estimates. In fact, the actual net borrowing was more than two and half times the initial budget estimate (Table 6).

25. The net amount raised by the government by way of dated securities, additional Treasury Bills and MSS de-sequestering aggregated Rs.2,98,536 crore during 2008-09. In addition, special securities (oil and fertiliser bonds) issued

**Chart 1: Inflation Rates - WPI and CPI-IW**

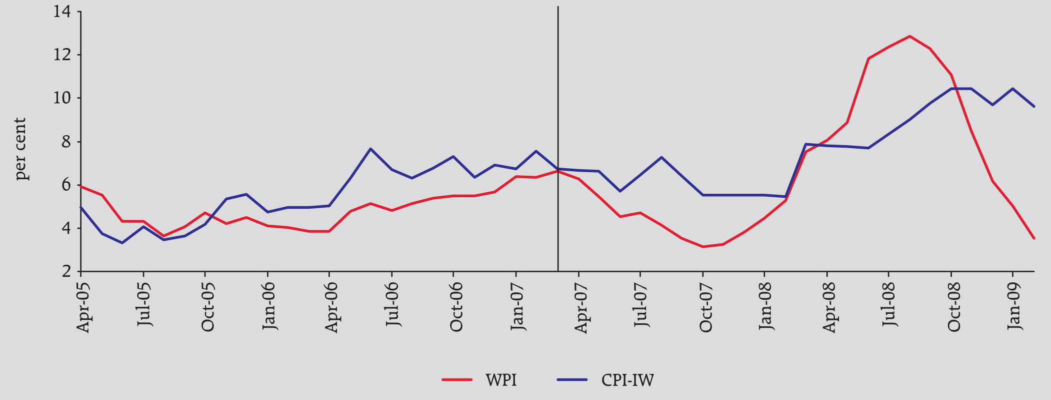


**Table 5: Fiscal Position of the Central Government: 2008-09**

| Item | Amount (Rs. crore) | | Difference (per cent) |
|---|---|---|---|
| | Budget Estimates | Revised Estimates | |
| 1. Revenue Receipts | 6,02,935 | 5,62,173 | -6.8 |
| 2. Capital Receipts | 1,47,949 | 3,38,780 | 129.0 |
| *of which*: Market Loans | 1,00,571 | 2,61,972 | 160.5 |
| 3. Non-Plan Expenditure | 5,07,498 | 6,17,996 | 21.8 |
| 4. Plan Expenditure | 2,43,386 | 2,82,957 | 16.3 |
| 5. Revenue Expenditure | 6,58,119 | 8,03,446 | 22.1 |
| 6. Capital Expenditure | 92,765 | 97,507 | 5.1 |
| 7. Revenue Deficit | 55,184 (1.0) | 2,41,273 (4.4) | 337.2 |
| 8. Fiscal Deficit | 1,33,287 (2.5) | 3,26,515 (6.0) | 145.0 |

**Notes** : (i) The receipts are net of repayments.
(ii) Figures in parentheses are percentages to GDP.
**Source:** Interim Budget 2009-10 of the Central Government.

by the Central Government outside the market borrowing programme amounted to Rs.95,942 crore in 2008-09. As against the initial estimate of Rs.47,044 crore, the State Governments raised a net amount of Rs.1,03,766 crore during 2008-09 (Table 7). The combined market borrowings of the Central and State Governments in 2008-09 were nearly two and half times their net borrowings in 2007-08. Even as the increase in borrowing was large and abrupt, it was managed in a non-disruptive manner through a combination of measures such as unwinding under the market stabilisation scheme (MSS), open market operations and easing of monetary conditions. The weighted average yield of Central Government dated securities issued during 2008-09 was lower at 7.69 per cent as compared with 8.12 per cent in the preceding year. The weighted average maturity of these securities was 13.80 years, which was lower than 14.90 years in 2007-08.

**Table 6: Central Government Borrowings: 2008-09**

(Rs. crore)

| Item | BE (February 2008) | RE (March 2009) | Actual |
|---|---|---|---|
| Gross Borrowing * | 1,76,453 | 3,42,769 | 3,18,550 |
| Net Borrowing | 1,13,000 | 3,29,649 | 2,98,536 |

* Pertains to dated securities and 364-day Treasury Bills.

26. Reflecting the continued need for fiscal stimulus in 2009-10, the borrowing requirements of both the Central and State Governments are estimated to be higher as compared with 2008-09 (Table 8).

27. According to the borrowing calendar released for the first half (April-September) of 2009-10, net market borrowings of the Central Government are likely to be of the order of Rs.2,07,364 crore. However, after adjusting for MSS unwinding and the Reserve Bank's support by way of open

**Table 7: Net Market Borrowings of the Central and State Governments**

(Rs.crore)

| Item | 2007-08 | 2008-09 |
|---|---|---|
| **A. Central Government** | **1,08,998** | **2,98,536** |
| i. Dated Securities | 1,10,671 | 2,16,972 |
| ii. Additional 364-day T-Bills | -1,167 | 13,345 |
| iii. Additional 182-day T-Bills | -76 | 10,995 |
| iv. Additional 91-Day T-Bills | -431 | 45,224 |
| v. MSS De-sequestering | 0 | 12,000 |
| **B. State Governments** | **56,224** | **1,03,766** |
| **Total (A+B)** | **1,66,895** | **4,02,302** |
| ***Memo Items:*** | | |
| *i. Special Securities Issued outside the Market Borrowing Programme* | 38,050 | 95,942 |
| *ii. Net Issuances under MSS* | 1,05,691 | -81,781 |

market operations, net supply of fresh securities is expected to be of the order of Rs.85,364 crore. Although the fresh supply of securities will be higher than the first half of the last year, it will be of much lower order as compared with the first half of 2007-08 (Table 9).

28. Keeping in view the large budgeted government market borrowing in 2009-10 coming on top of a substantial expansion in market borrowing in 2008-09, it was important for the Reserve Bank to provide comfort to the market so that the borrowing programme is conducted in a non-disruptive manner. Accordingly, the Reserve Bank simultaneously indicated its intention to purchase government securities under open market operations (OMO) for an indicative amount of Rs.80,000 crore during the first half of 2009-10.

**Table 8: Borrowings of the Central and State Governments: 2009-10**

(Rs. crore)

| Item | 2008-09 | 2009-10 |
|---|---|---|
| **Central Government** | | |
| Gross Market Borrowings | 3,18,550 | 3,98,552 |
| Net Market Borrowings | 2,98,536 | 3,08,647 * |
| **State Governments** | | |
| Net Market Borrowings | 1,03,766 | 1,26,000 ** |
| **Total Net Market Borrowings** | **4,02,302** | **4,34,647** |

* Interim Budget Estimates.

** Estimated. The State Governments have been allowed an additional 0.5 per cent of Gross State Domestic Product (GSDP) as a part of the fiscal stimulus package.

29. To contain the growth slowdown during 2008-09, the Central Government announced three fiscal stimulus measures during December 2008-February 2009. The Government had also provided additional expenditure of Rs.1,48,093 crore (2.7 per cent of GDP) through two supplementary demands for grants during October-December 2008. The total revenue loss due to tax reductions amounted to Rs.8,700 crore (0.2 per cent of GDP) in 2008-09 and Rs.28,100 crore (0.5 per cent of GDP) in 2009-10. The additional stimulus measures during 2008-09 work out to about 2.9 per cent of GDP. Furthermore, the revenue collection was adversely impacted by the economic slowdown. Consequently, the Interim Budget for 2009-10 revised the estimates for 2008-09 – revenue deficit to 4.4 per cent and the fiscal deficit to 6.0 per cent of GDP as against the budget estimates of 1.0 per cent and 2.5 per cent, respectively. In addition, special bonds amounting to 1.8 per cent of GDP were issued to oil marketing companies and fertiliser companies during 2008-09.

30. As per the Interim Budget 2009-10, the revenue deficit and the fiscal deficit are projected to decline only moderately to 4.0 per cent and 5.5 per cent, respectively during 2009-10. The Government in its

**Table 9: Central Government Borrowings: First Half of the Fiscal Year (Dated Securities)**

(Rs. crore)

| Item | First Half (April-September) Borrowings | | |
|---|---|---|---|
| | 2007-08 | 2008-09 | 2009-10 |
| **Gross Market Borrowings** | **97,000** | **1,06,000** | **2,41,000** |
| Less: Repayments | 30,554 | 44,028 | 33,636 |
| **Net Market Borrowings** | **66,446** | **61,972** | **2,07,364** |
| Less: OMO Purchases | 0 | 0 | 80,000 |
| Less: MSS Unwinding* | 0 | 0 | 42,000 |
| Add: MSS Issuances (net)* | 69,077 | 5,263 | 0 |
| **Net Supply of Fresh Securities** | **1,35,523** | **67,235** | **85,364** |

* Includes dated securities and Treasury Bills.

macroeconomic framework statement, indicated that in view of the compelling need to adjust the fiscal policy to take care of exceptional circumstances through which the economy is passing, the fiscal consolidation process has to be put on hold temporarily. The process of fiscal consolidation should resume once there is an improvement in economic conditions.

31. Currently available information indicates that the consolidated budgeted revenue surplus of the States in 2008-09 may not materialise. Consequently, the consolidated fiscal deficit of the States is expected to rise to around 3.0 per cent of GDP. The combined fiscal deficit of the Central and State Governments during 2008-09 would be about 9.0 per cent of GDP. Accounting for special securities issued by the Central Government outside the market borrowing programme, the combined fiscal deficit works out to about 10.8 per cent of GDP. While some of the increase in the revenue and fiscal deficits is on account of post-budget expenditure commitments such as payment of arrears resulting from the Sixth Pay Commission Award, a substantial increase is also due to the economic downturn arising from the impact of the global financial crisis. Although the fiscal stimulus packages have meant deviation from the roadmap laid out by the FRBM Act, reversing the consolidation process of the last several years, they were warranted under the prevailing circumstances. It is critically important, however, that the Centre and States re-anchor to a revised FRBM mandate once the immediacy of the crisis is behind us.

### *Monetary Conditions*

32. Growth in key monetary aggregates – reserve money (RM) and money supply ($M_3$) – in 2008-09 reflected the changing liquidity positions arising from domestic and global financial conditions and the monetary policy response. Reserve money variations during 2008-09 largely reflected the increase in the currency in circulation and reduction in the cash reserve ratio (CRR) of banks.

33. As indicated in the Third Quarter Review, reduction in the CRR has three

inter-related effects on reserve money. First, it reduces reserve money as bankers' required cash deposits with the Reserve Bank fall. Second, the money multiplier rises. Third, with the increase in the money multiplier, M3 expands with a lag. While the initial expansionary effect is strong, the full effect is felt in 4-6 months. Reflecting these changes, the year-on-year increase in reserve money in 2008-09 was much lower than in the previous year. However, adjusted for the first round effect of CRR reduction, deceleration in reserve money growth was less pronounced. The annual M3 growth in 2008-09, though lower compared with the previous year, was also below the trajectory projected in the Third Quarter Review of January 2009 (Table 10).

34. Monetary management during 2008-09 was dominated by the response to the spillover effects of global financial crisis and the need to address slackening of domestic demand conditions, especially during the third quarter. As the Reserve Bank had to provide foreign exchange liquidity to meet the demand from importers and contain volatility in the foreign exchange market arising out of capital outflows by foreign institutional investors (FIIs), its net foreign exchange assets (NFEA) declined. This had an overall contractionary effect on rupee liquidity. The Reserve Bank addressed this issue by providing rupee liquidity through expansion of net domestic assets (NDA) by (i) conventional open market operations; (ii) special 14-day term repo facility for banks; (iii) buy-back of securities held under the market stabilisation scheme; (iv) special market operations, including the purchase of oil bonds; (v) enlargement of export credit refinance window; (vi) special refinance facility for banks for addressing the liquidity concerns of NBFCs, mutual funds and housing finance companies; (vii) special refinance facility for financial institutions (SIDBI, NHB and Exim Bank); and (viii) funding to NBFCs through a special purpose vehicle (SPV). Thus, a notable feature of monetary operations during the second half of 2008-09 was the substitution of foreign assets by domestic assets. Consequently, liquidity conditions have remained comfortable since mid-November 2008 as reflected in the LAF window being generally in the absorption mode and the call/notice rate remaining near or below the lower bound of the LAF corridor consistent with the stance of monetary policy.

**Table 10: Annual Variations in Monetary Aggregates**

(Per cent)

| Item | Annual Variations | |
|---|---|---|
| | 2007-08 | 2008-09 |
| Reserve Money | 31.0 | 6.4 |
| Reserve Money (adjusted for CRR changes) | 25.3 | 19.0 |
| Currency in Circulation | 17.2 | 17.0 |
| Money Supply (M3) | 21.2 | 18.4 |
| M3 (Policy Projection) | 17.0-17.5 * | 19.0 ** |
| Money Multiplier | 4.33 | 4.82 |

* Policy projection for the financial year as indicated in the Annual Policy Statement 2008-09 (April 2008).

** Policy projection for the financial year as indicated in the Third Quarter Review of Monetary Policy 2008-09 (January 2009).

### *Credit Conditions*

35. During 2008-09, the growth in non-food bank credit (year-on-year basis) decelerated from a peak of 29.4 per cent in

October 2008 to 17.5 per cent by March 2009. At this rate, non-food credit expansion was lower than that of 23.0 per cent in 2007-08 as also the indicative projection of 24.0 per cent set in the Third Quarter Review of January 2009. The intra-year changes in credit flow could be attributed to several factors. First, the demand for bank credit increased sharply during April-October 2008 as corporates found that their external sources of credit had dried up, and shifted that demand to domestic credit. Second, there was a sharp increase in credit to oil marketing companies by Rs.36,208 crore during April-October 2008 as compared with a decline of Rs.1,146 crore in the corresponding period of the previous year. In the subsequent period, however, the demand for credit moderated reflecting the slowdown of the economy in general and the industrial sector in particular. Working capital requirements had also come down because of decline in commodity prices and drawdown of inventories by the corporates. The demand for credit by oil marketing companies also moderated. In addition, substantially lower credit expansion by private and foreign banks also muted the overall flow of bank credit during the year (Table 11).

36. Commercial banks' investment in SLR securities, adjusted for LAF, declined marginally from 28.4 per cent of NDTL in March 2008 to 26.7 per cent in March 2009.

37. According to the data at a disaggregated level drawn from 49 banks accounting for 95.0 per cent of total bank credit, the year-on-year growth in bank credit to industry as of February 2009 was broadly similar to that in the previous year. While credit flow to agriculture and real estate was significantly higher, it was lower for housing. As a result, industry's share in total credit flow increased significantly in 2008-09 (Table 12).

38. Significant variations have also been observed in the flow of credit to different

**Table 11: Bank Group-wise Growth in Deposits and Credit**

(Per cent)

| Bank Group | As on March 28, 2008 (y-o-y) | As on March 27, 2009 (y-o-y) |
|---|---|---|
| | **Deposits** | |
| Public Sector Banks | 22.9 | 24.1 |
| Foreign Banks | 29.1 | 7.8 |
| Private Sector Banks | 19.9 | 8.0 |
| **Scheduled Commercial Banks*** | 22.4 | 19.8 |
| | **Credit** | |
| Public Sector Banks | 22.5 | 20.4 |
| Foreign Banks | 28.5 | 4.0 |
| Private Sector Banks | 19.9 | 10.9 |
| **Scheduled Commercial Banks*** | 22.3 | 17.3 |

* Including RRBs.

**Table 12: Annual Sectoral Flow of Credit**

| Sector | As on February 15, 2008 (y-o-y) | | | As on February 27, 2009 (y-o-y) | | |
|---|---|---|---|---|---|---|
| | Amount (Rs. crore) | % share in total | Variations (per cent) | Amount (Rs. crore) | % share in total | Variations (per cent) |
| Agriculture | 34,013 | 9.2 | 16.4 | 52,742 | 13.0 | 21.5 |
| Industry | 1,67,819 | 45.2 | 25.9 | 2,13,261 | 52.5 | 25.8 |
| Real Estate | 11,361 | 3.1 | 26.7 | 34,533 | 8.5 | 61.4 |
| Housing | 26,930 | 7.3 | 12.0 | 19,012 | 4.7 | 7.5 |
| NBFCs | 20,979 | 5.7 | 48.6 | 26,651 | 6.6 | 41.7 |
| **Overall Credit** | **3,71,053** | **100.0** | **22.0** | **4,06,304** | **100.0** | **19.5** |

**Notes:** 1. Credit growth for February 2008 is calculated with outstanding as on February 15, 2008 to obtain variation over comparable 26-week data.
2. Data are provisional.

sectors by the three broad bank groups during 2008-09. Credit growth by public sector banks to industry accelerated in 2008-09. However, credit growth to personal loans and services decelerated. Credit by all the three bank groups to real estate accelerated significantly, while that to small enterprises decelerated (Table 13).

**Table 13: Sectoral Deployment of Credit: Bank Group-wise**

| Item | Variation (y-o-y) (%) | | | | | |
|---|---|---|---|---|---|---|
| | Public Sector Banks | | Private Sector Banks* | | Foreign Banks* | |
| | As on February 15, 2008 | As on February 27, 2009 | As on February 15, 2008 | As on February 27, 2009 | As on February 15, 2008 | As on February 27, 2009 |
| **Non-food Gross Bank Credit (1 to 4)** | **22.3** | **23.9** | **19.0** | **9.1** | **28.8** | **1.6** |
| **1. Agriculture and Allied Activities** | **19.3** | **19.2** | **- 1.3** | **39.0** | **NA** | **NA** |
| **2. Industry** | **23.2** | **31.0** | **35.2** | **7.4** | **35.0** | **6.5** |
| **3. Personal Loans** | **15.6** | **11.6** | **8.5** | **7.4** | **14.5** | **-8.1** |
| *of which:* | | | | | | |
| Housing | 13.2 | 10.0 | 13.5 | 4.9 | - 2.1 | -4.4 |
| **4. Services** | **28.6** | **24.4** | **28.5** | **4.5** | **41.2** | **6.9** |
| *of which:* | | | | | | |
| Real Estate Loans | 47.9 | 79.1 | 6.9 | 13.9 | - 36.0 | 40.5 |
| Non-Banking Financial Companies | 53.0 | 44.8 | 14.0 | 38.1 | 64.0 | 20.8 |
| ***Memo Item*** | | | | | | |
| Small Enterprises** | 49.0 | 36.7 | 209.5 | 23.2 | 190.4 | 59.5 |

* The share of some private sector banks and foreign banks in total bank credit to agriculture and small scale enterprises is small.

** Includes small manufacturing and service enterprises.

NA: Not Available.

**Note:** See also footnotes to Table 12.

### *Total Flow of Resources to the Commercial Sector*

39. The flow of resources from non-bank sources to the commercial sector throughout 2008-09 was lower than that in the previous year, reflecting depressed domestic and international capital market conditions. However, till mid-January 2009, higher bank credit growth compensated for the decline in resources from non-banks. Beginning from the fortnight ended January 16, 2009, non-food bank credit growth turned lower than the previous year. Reflecting moderation in both bank credit and funds from other sources, the total flow of resources to the commercial sector from banks and other sources during 2008-09 was significantly lower than that in the previous year (Table 14).

### *Interest Rates*

40. Since mid-September 2008, the Reserve Bank has cut the repo rate by 400 basis points and the reverse repo rate by 250 basis points. The CRR was also reduced by 400 basis points of NDTL of banks (Table 15).

**Table 14: Flow of Financial Resources to the Commercial Sector**

(Rs. crore)

| Item | 2007-08 | 2008-09 |
|---|---|---|
| From Banks | 4,44,807 | 4,14,902 |
| From Other Sources* | 3,35,698 | 2,64,138 |
| **Total Resources** | **7,80,505** | **6,79,040** |

* Includes borrowings from financial institutions and NBFCs as well as resources mobilised from the capital market and by way of ECBs, FCCBs, ADRs/GDRs, FDI and short-term credit as per the latest available data, adjusted for double counting.

**Note:** Data in this table also include gross investments by LIC in corporate debt and infrastructure and social sector, which were not included in the corresponding table presented in Third Quarter Review, January 2009.

**Table 15: Monetary Easing by the Reserve Bank since mid-September 2008**

(Per cent)

| Instrument | As at | | Extent of Reduction (basis points) |
|---|---|---|---|
| | Mid-September 2008 | Early March 2009 | |
| Repo Rate | 9.00 | 5.00 | 400 |
| Reverse Repo | 6.00 | 3.50 | 250 |
| Cash Reserve Ratio @ | 9.00 | 5.00 | 400 |

@ Percentage of NDTL.

41. Taking cues from the reduction in the Reserve Bank's policy rates and easy liquidity conditions, all public sector banks, most private sector banks and some foreign banks have reduced their deposit and lending rates. The reduction in the range of term deposit rates between October 2008 - April 18, 2009 has been 125-250 basis points by public sector banks, 75-200 basis points by private sector banks and 100-200 basis points by five major foreign banks. The reduction in the range of BPLRs was 125-225 basis points by public sector banks, followed by 100-125 basis points by private sector banks and 100 basis points by five major foreign banks (Table 16).

**Table 16: Reduction in Deposit and Lending Rates (October 2008 - April 2009*)**

(Basis points)

| Bank Group | Deposit Rates | Lending Rates (BPLR) |
|---|---|---|
| Public Sector Banks | 125-250 | 125-225 |
| Private Sector Banks | 75-200 | 100-125 |
| Five Major Foreign Banks | 100-200 | 0-100 |

* As on April 18, 2009.

**Table 17: Movements in Deposit and Lending Rates**

(Per cent)

| Interest Rates | October 2008 | March 2009 | April* 2009 | Variation** (basis points) |
|---|---|---|---|---|
| **Term Deposit Rates** | | | | |
| **Public Sector Banks** | | | | |
| a) Up to 1 year | 2.75-10.25 | 2.75-8.25 | 2.75-8.00 | 0-225 |
| b) 1 year up to 3 years | 9.50-10.75 | 8.00-9.25 | 7.00-8.75 | 200-250 |
| c) Over 3 years | 8.50-9.75 | 7.50-9.00 | 7.25-8.50 | 125-125 |
| **Private Sector Banks** | | | | |
| a) Up to 1 year | 3.00-10.50 | 3.00-8.75 | 3.00-8.50 | 0-200 |
| b) 1 year up to 3 years | 9.00-11.00 | 7.50-10.25 | 7.50-9.50 | 150-150 |
| c) Over 3 years | 8.25-11.00 | 7.50-9.75 | 7.50-9.25 | 75-175 |
| **Five Major Foreign Banks** | | | | |
| a) Up to 1 year | 3.50-9.50 | 2.50-8.00 | 2.50-8.00 | 100-150 |
| b) 1 year up to 3 years | 3.60-10.00 | 2.50-8.00 | 2.50-8.00 | 110-200 |
| c) Over 3 years | 3.60-10.00 | 2.50-8.00 | 2.50-8.00 | 110-200 |
| **BPLR** | | | | |
| Public Sector Banks | 13.75-14.75 | 11.50-14.00 | 11.50-13.50 | 125-225 |
| Private Sector Banks | 13.75-17.75 | 12.75-16.75 | 12.50-16.75 | 100-125 |
| Five Major Foreign Banks | 14.25-16.75 | 14.25-15.75 | 14.25-15.75 | 0-100 |

* As on April 18, 2009.
** Variation of April 18, 2009 over October 2008.

42. The reduction in deposit rates was more pronounced in respect of deposits of up to three year maturity. The range of BPLRs of public sector banks, private sector and five major foreign banks declined between October 2008 and April 18, 2009 (Table 17).

43. The reduction in BPLRs by most public sector banks was in the range of 125-200 basis points, followed by 50-150 basis points reduction by most private sector banks and 50 basis points reduction by foreign banks (Table 18).

**Table 18: Reduction in BPLR by SCBs – Frequency Distribution (April 18, 2009 over October 2008)**

(Number of banks)

| Bank Group | 25 bps | 50 bps | 75 bps | 100 bps | 125 bps | 150 bps | 175 bps | 200 bps | 225 bps | 250 bps | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Public Sector Banks | – | – | 1 | – | 8 | 8 | 2 | 7 | – | 1 | **27 (27)** |
| Private Sector Banks | 1 | 7 | 3 | 2 | 1 | 2 | – | – | 1 | – | **17 (22)** |
| Foreign Banks | – | 4 | 1 | 1 | – | – | – | 2 | – | – | **8 (28)** |

**Note:** Figures in parentheses indicate total number of banks operating in India.

44. The efficacy of the monetary transmission mechanism hinges on the extent and the speed with which changes in the central bank's policy rate are transmitted through the term-structure of interest rates across markets. While the response to policy changes by the Reserve Bank has been faster in the money and government securities markets, there has been concern that the large and quick changes effected in the policy rates by the Reserve Bank have not fully transmitted to banks' lending rates. During the second half of 2008-09, while the Reserve Bank has reduced its lending rate (repo rate) by 400 basis points, most banks have lowered their lending rate in the range of 50-150 basis points.

45. The adjustment in market interest rates in response to changes in policy rates gets reflected with some lag. However, the transmission to the credit market is somewhat slow on account of several structural rigidities. In this context, banks have brought out the following constraints in their discussions with the Reserve Bank. First, the administered interest rate structure of small savings acts as a floor to deposit interest rates. Without reduction in deposit rates, banks find it difficult to reduce lending rates exclusively on policy cues. Second, while banks are allowed to offer 'variable' interest rates on longer-term deposits, depositors have a distinct preference for fixed interest rates on such deposits which results in an asymmetric contractual relationship. In a rising interest rate scenario, while depositors retain the flexibility to prematurely withdraw their existing deposits and re-deploy the same at higher interest rates, banks have to necessarily carry these high cost deposits till their maturity in the downturn of the interest rate cycle. Third, during periods of credit boom as in 2004-07, competition among banks for wholesale deposits often hardens deposit interest rates, thereby further increasing the cost of funds. Fourth, the linkage of concessional administered lending rates, such as for agriculture and exports, to banks' BPLRs makes overall lending rates less flexible. Fifth, the persistence of large volumes of market borrowing by the government hardens interest rate expectations. From the real economy perspective, however, for monetary policy to have demand-inducing effects, lending rates will have to come down.

46. The changes in BPLR do not fully reflect the changes in the effective lending rates. During the pre-policy consultations with the Reserve Bank, banks pointed out that lending rates should not be assessed only in terms of reduction in BPLRs since as much as three-quarters of lending is at rates below BPLR which includes lending to agriculture, export sector, and well-rated companies, including PSUs. The weighted average lending rate, which was 11.9 per cent in 2006-07, increased to 12.3 per cent (provisional) in 2007-08. According to the information collected from select banks, the average yield on advances, a proxy measure of effective lending rate, in 2008-09 was around 10.9 per cent. As most of the commercial banks have cut their BPLRs in the second half of 2008-09, the effective lending rate towards the end of 2008-09 could be even lower than 10.9 per cent. Nevertheless, it may be noted that current deposit and lending rates are now higher than in 2004-2007, although the policy rates are now lower than in that period. This is reflective of the hysteresis in the system.

Reduction in public sector banks deposit rates in 1-3 year maturity from 9.50-10.75 per cent in October 2008 to 7.00-8.75 per cent by April 2009 has not been commensurate with the moderation in inflation. Judging from the experience of 2004-07, deposit rates can be lower and should come down.

47. Notwithstanding the above factors, there is still a scope for banks to reduce their lending rates. Pointing to the current WPI inflation rate near zero, some have argued that real lending rates are very high. The point-to-point variations in WPI exaggerate the level of real interest rate due to divergence between various price indices as also the inflation expectations. Notwithstanding computational challenges, even when inflation is taken as 4.0-4.5 per cent based on the underlying trend, real lending rates would still appear to be high. Banks, therefore, must strive to reduce their lending rates further.

### *Financial Markets*

48. Since October 2008, interest rates have declined across the term structure in the money and government securities markets (Table 19). The call/notice rates have remained near or below the lower bound of the LAF corridor from November 2008. While the secondary market yield on the 10-year government security touched an intra-year low of 5.11 per cent on December 30, 2008, it then generally increased in the wake of the large market borrowing programme of the Government, reaching 7.08 per cent on March 30, 2009. The yield has subsequently declined on account of substantial easing of liquidity and reduction in inflation.

49. During 2008-09, the rupee, with significant intra-year variation, generally depreciated against major currencies except pound sterling on account of widening of trade and current account deficits as well as capital outflows. During the current fiscal year (up to April 17, 2009), the rupee has generally remained steady (Chart 2).

50. During 2008-09, equity markets weakened in tandem with global stock markets, reflecting general deterioration in sentiment, FII outflows, slowdown in industrial growth and lower corporate

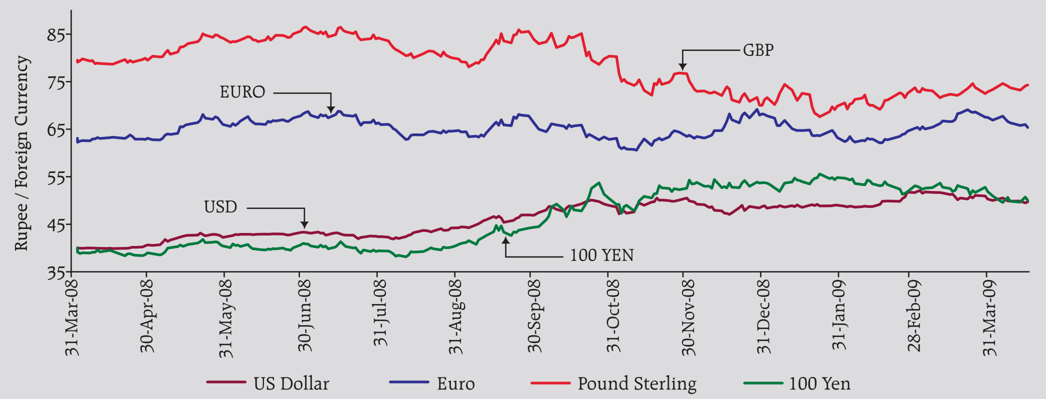
**Table 19: Interest Rates - Monthly Average**

(Per cent)

| Segment/Instrument | March 2008 | October 2008 | January 2009 | March 2009 | April 17, 2009 |
|---|---|---|---|---|---|
| Call Money | 7.37 | 9.90 | 4.18 | 4.17 | 3.47 |
| CBLO | 6.37 | 7.73 | 3.77 | 3.60 | 2.60 |
| Market Repo | 6.72 | 8.40 | 4.27 | 3.90 | 2.86 |
| Commercial Paper | 10.38 | 14.17 | 9.48 | 9.79 | 7.00 |
| Certificates of Deposit | 10.00 | 10.00 | 7.33 | 6.73# | 4.00 |
| 91-day Treasury Bills | 7.33 | 7.44 | 4.69 | 4.77 | 4.09 |
| 10-year Government Security | 7.69 | 7.80 | 5.82 | 6.57 | 6.41 |

# Pertains to mid-March 2009.

Chart 2: Exchange Rate Movements




profits. The BSE Sensex declined to 8160 on March 9, 2009 from a peak of 20873 recorded on January 8, 2008; it closed higher at 11023 on April 17, 2009.

### *External Sector*

51. India's current account deficit (CAD) widened during 2008-09 (April-December) in comparison with the corresponding period of the previous year. As net capital inflows declined sharply, the overall balance of payments (BoP) position turned negative resulting in drawdown of reserves (Table 20).

**Table 20: India's Balance of Payments**

(US $ billion)

| Item | April-December | |
|---|---|---|
| | 2007-08 | 2008-09 |
| Exports | 113.6 | 133.5 |
| Imports | 182.9 | 238.9 |
| Trade Balance | -69.3 | -105.3 |
| Invisibles, net | 53.8 | 68.9 |
| Current Account Balance | -15.5 | -36.5 |
| Capital Account* | 82.7 | 16.1 |
| Change in Reserves# | -67.2 | 20.4 |

* Including errors and omissions.
\# On a BoP basis (*i.e.*, excluding valuation):
(-) indicates increase; (+) indicates decrease.

52. The overall approach to the management of India's foreign exchange reserves takes into account the changing composition of the balance of payments and endeavours to reflect the 'liquidity risks' associated with different types of flows and other requirements. As capital inflows during 2007-08 were far in excess of the normal absorptive capacity of the economy, there was substantial accretion to foreign exchange reserves by US$ 110.5 billion. As capital inflows reduced sharply, the foreign exchange reserves declined by US$ 53.7 billion from US$ 309.7 billion as at end-March 2008 to US$ 256.0 billion by end-December 2008, including valuation losses. Excluding valuation effects, the decline was US$ 20.4 billion during April-December 2008. India's foreign exchange reserves were US$ 252.0 billion as at end-March 2009 which increased to US$ 253.0 billion by April 10, 2009.

## II. Stance of Monetary Policy

53. The policy responses in India since September 2008 have been designed largely to mitigate the adverse impact of the global financial crisis on the Indian economy. The conduct of monetary policy had to contend with the high speed and magnitude of the external shock and its spill-over effects through the real, financial and confidence channels. The evolving stance of policy has been increasingly conditioned by the need to preserve financial stability while arresting the moderation in the growth momentum.

54. The thrust of the various policy initiatives by the Reserve Bank has been on providing ample rupee liquidity, ensuring comfortable dollar liquidity and maintaining a market environment conducive for the continued flow of credit to productive sectors. The key policy initiatives taken by the Reserve Bank since September 2008 are set out below:

*Policy Rates*

- The policy repo rate under the liquidity adjustment facility (LAF) was reduced by 400 basis points from 9.0 per cent to 5.0 per cent.
- The policy reverse repo rate under the LAF was reduced by 250 basis points from 6.0 per cent to 3.5 per cent.

*Rupee Liquidity*

- The cash reserve ratio (CRR) was reduced by 400 basis points from 9.0 per cent of net demand and time liabilities (NDTL) of banks to 5.0 per cent.
- The statutory liquidity ratio (SLR) was reduced from 25.0 per cent of NDTL to 24.0 per cent.
- The export credit refinance limit for commercial banks was enhanced to 50.0 per cent from 15.0 per cent of outstanding export credit.
- A special 14-day term repo facility was instituted for commercial banks up to 1.5 per cent of NDTL.
- A special refinance facility was instituted for scheduled commercial banks (excluding RRBs) up to 1.0 per cent of each bank's NDTL as on October 24, 2008.
- Special refinance facilities were instituted for financial institutions (SIDBI, NHB and Exim Bank).

*Forex Liquidity*

- The Reserve Bank sold foreign exchange (US dollars) and made available a forex swap facility to banks.
- The interest rate ceilings on non-resident Indian (NRI) deposits were raised.
- The all-in-cost ceiling for the external commercial borrowings (ECBs) was raised. The all-in-cost ceiling for ECBs through the approval route has been dispensed with up to June 30, 2009.
- The systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI) were permitted to raise short-term foreign currency borrowings.

*Regulatory Forbearance*

- The risk-weights and provisioning requirements were relaxed and restructuring of stressed assets was initiated.

55. A detailed listing of various policy measures undertaken by the Reserve Bank since September 2008 is set out in Annex I.

## *Liquidity Impact*

56. The actions of the Reserve Bank since mid-September 2008 have resulted in augmentation of actual/potential liquidity of over Rs.4,22,000 crore. In addition, the permanent reduction in the SLR by 1.0 per cent of NDTL has made available liquid funds of the order of Rs.40,000 crore for the purpose of credit expansion (Table 21).

57. The liquidity situation has improved significantly following the measures taken by the Reserve Bank. The overnight money market rates, which generally hovered above the repo rate during September-October 2008, have softened considerably and have generally been close to or near the lower bound of the LAF corridor since early November 2008. Other money market rates such as discount rates of CDs, CPs and CBLO softened in tandem with the overnight money market rates. The LAF window has been in a net absorption mode since mid-November 2008. The liquidity problem faced by mutual funds has eased considerably. Most commercial banks have reduced their benchmark prime lending rates. The total utilisation under the recent refinance/liquidity facilities introduced by the Reserve Bank has been low as the overall liquidity conditions remain comfortable (Table 22). However, their availability has provided comfort to the banks/FIs, which can fall back on them in case of need.

58. The Reserve Bank has multiple instruments at its command such as repo and reverse repo rates, cash reserve ratio (CRR), statutory liquidity ratio (SLR), open market operations, including the market stabilisation scheme (MSS) and the LAF, special market operations, and sector-specific liquidity facilities. In addition, the Reserve Bank also uses prudential tools to modulate flow of credit to certain sectors consistent with financial stability. The availability of multiple instruments and flexible use of these instruments in the implementation of monetary policy has

**Table 21: Actual/Potential Release of Primary Liquidity – since Mid-September 2008**

| Measure/Facility | Amount (Rs. crore) |
|---|---|
| 1. CRR Reduction | 1,60,000 |
| 2. Unwinding/Buyback/De-sequestering of MSS Securities | 97,781 |
| 3. Term Repo Facility | 60,000 |
| 4. Increase in Export Credit Refinance | 25,512 |
| 5. Special Refinance Facility for SCBs (Non-RRBs) | 38,500 |
| 6. Refinance Facility for SIDBI/NHB/EXIM Bank | 16,000 |
| 7. Liquidity Facility for NBFCs through SPV | 25,000* |
| **Total (1 to 7)** | **4,22,793** |
| ***Memo:*** Statutory Liquidity Ratio (SLR) Reduction | 40,000 |

* Includes an option of Rs.5,000 crore.

**Table 22: Utilisation of Various Liquidity Facilities Available from the Reserve Bank – As on April 16, 2009**

| Refinance Facility | Availability of Facility: Terminal Dates | Amount (Rs. crore) | | Outstanding as per cent of Limit |
|---|---|---|---|---|
| | | Limit | Outstanding | |
| i) Export Credit Refinance Facility | Standing Facility | 36,446 | 590 | 1.6 |
| ii) Special Refinance Facility for Scheduled Commercial Banks (excluding RRBs) | 30.09.2009 | 38,429 | 1,380 | 3.6 |
| iii) Special Term Repo Facility to Banks (for funding to MFs, NBFCs and HFCs) | 30.09.2009 | 60,000 | 90 | 0.2 |
| iv) Refinance Facility to SIDBI | 31.03.2010 | 7,000 | 5,819 | 83.1 |
| v) Refinance Facility to NHB | 31.03.2010 | 4,000 | 3,220 | 80.5 |
| vi) Refinance Facility to EXIM Bank | 31.03.2010 | 5,000 | 2,800 | 56.0 |
| vii) Liquidity Facility for NBFCs through SPV Route | 30.06.2009 | 25,000* | 750 | 3.0 |
| **Total (i to vii)** | | **1,75,875** | **14,649** | **8.3** |
| ***Memo Item:*** | | | | |
| Forex Swap Facility to Banks | 31.03.2010 | For tenor up to three months | 1,030 | – |

* The total support from the Reserve Bank is limited to Rs.20,000 crore with an option to raise it by a further Rs.5,000 crore.

enabled the Reserve Bank to modulate the liquidity and interest rate conditions amidst uncertain global macroeconomic conditions.

## *Growth Projection*

59. The India Meteorological Department in its forecast of South-West monsoon expects a normal rainfall at 96 per cent of its long period average for the current year. The fiscal and monetary stimulus measures initiated during 2008-09 coupled with lower commodity prices could cushion the downturn in the growth momentum during 2009-10 by stabilising domestic economic activity to some extent. However, any upturn in the growth momentum is unlikely in view of the projected contraction in global demand during 2009, particularly decline in trade. While domestic financing conditions have improved, external financing conditions are expected to remain tight. Private investment demand is, therefore, expected to remain subdued. On balance, with the assumption of normal monsoon, for policy purpose, real GDP growth for 2009-10 is placed at around 6.0 per cent.

## *Inflation Projection*

60. On account of slump in global demand, pressures on global commodity prices have abated markedly around the world. The sharp decline in prices of crude oil, metals, foodgrains, cotton and cement has influenced inflation expectations in most

parts of the world. This is also reflected in the domestic WPI inflation reaching close to zero. Prices of manufactured products have decelerated sharply, while that of the fuel group have contracted, though inflation on account of food articles still remains high. Keeping in view the global trend in commodity prices and domestic demand-supply balance, WPI inflation is projected at around 4.0 per cent by end-March 2010.

61. The WPI inflation, however, is expected to be in the negative territory in the early part of 2009-10. However, this should not be interpreted as deflation for policy purposes. This expected negative inflation in India has only statistical significance and is not a reflection of demand contraction as is the case in advanced economies. This transitory WPI inflation in negative zone may not persist beyond the middle of 2009-10. The consumer price inflation as reflected in various indices is expected to moderate from its present high level but would continue to remain in positive territory through 2009-10 unlike WPI inflation. Moreover, it may also be noted that the sharp decline in WPI inflation has not been commensurately matched by a similar decline in inflation expectations.

62. It would be the endeavour of the Reserve Bank to ensure price stability and anchor inflation expectations. Towards this objective, the Reserve Bank will, as always, continue to take into account the behaviour of all the price indices and their components. The conduct of monetary policy would continue to condition and contain perception of inflation in the range of 4.0-4.5 per cent so that an inflation rate of around 3.0 per cent becomes the medium-term objective, consistent with India's broader integration into the global economy and with the goal of maintaining self-accelerating growth over the medium-term.

### *Monetary Projection*

63. Monetary and credit aggregates have witnessed deceleration since their peak levels in October 2008. The liquidity overhang emanating from the earlier surge in capital inflows has substantially moderated in 2008-09. The Reserve Bank is committed to providing ample liquidity for all productive activities on a continuous basis. As the upside risks to inflation have declined, monetary policy has been responding to slackening economic growth in the context of significant global stress. Accordingly, for policy purposes, money supply ($M_3$) growth for 2009-10 is placed at 17.0 per cent. Consistent with this, aggregate deposits of scheduled commercial banks are projected to grow by 18.0 per cent. The growth in adjusted non-food credit, including investment in bonds/debentures/ shares of public sector undertakings and private corporate sector and CPs, is placed at 20.0 per cent. Given the wide dispersion in credit growth noticed across bank groups during 2008-09, banks with strong deposit base should endeavour to expand credit beyond 20.0 per cent. As always, these numbers are provided as indicative projections and not as targets.

### *Overall Assessment*

64. The global financial and economic outlook continues to be unsettled and uncertain. The latest assessment by major international agencies projecting sharp contraction in global trade volumes in 2009 has exacerbated the uncertainty. The

current assessments project little chance of global economic recovery in 2009. Despite large scale recapitalisation, write-offs and asset substitutions, sizeable chunks of assets of systemically important banks and financial institutions remain impaired. It is also not clear if the deleveraging process is complete. In such a scenario, external financing conditions for emerging market economies may continue to remain tight and constrain their growth prospects.

65. Governments and central banks all over the world have responded to the ongoing global financial crisis by initiating several large, aggressive and unconventional measures. There is, however, a contentious debate on whether these measures are adequate and appropriate and when, if at all, they will start showing the desired results. There is a separate debate on whether the measures taken so far, responding as they are to short-term compulsions, are eroding long-term sustainability. Many difficult issues will need to be addressed going forward. There is unprecedented co-ordinated policy action on monetary, fiscal, regulatory and institutional reforms to address the ongoing financial and economic crisis and strengthen the international financial architecture. In this context, the initiatives by the leaders of the G-20 announced in April 2009 to: (i) restore confidence, growth, and jobs; (ii) repair the financial system to restore lending; (iii) strengthen financial regulation to rebuild trust; (iv) fund and reform the international financial institutions to overcome the crisis and prevent future ones; (v) promote global trade and investment and reject protectionism to underpin prosperity; and (vi) build an inclusive, green and sustainable recovery, should help overcome the uncertainty surrounding the financial and economic outlook.

66. Here in India, there are several immediate challenges facing the economy which would need to be addressed going forward. First, after five years of high growth, the Indian economy was headed for a moderation in the first half of 2008-09. However, the growth slowdown accentuated in the third quarter of 2008-09 on account of spillover effects of international developments. While the moderation in growth seems to have continued through the fourth quarter of 2008-09, it has been cushioned by quick and aggressive policy responses both by the Reserve Bank and the Government. Notwithstanding the contraction of global demand, growth prospects in India continue to remain favourable compared to most other countries. While public investment can play a critical role in the short-term during a downturn, private investment has to increase as the recovery process sets in. A major macroeconomic challenge at this juncture is to support the drivers of aggregate demand to enable the economy to return to its high growth path.

67. The second challenge going forward is meeting the credit needs of the non-food sector. Although, for the year 2008-09 as a whole, credit by the banking sector expanded, the pace of credit flow decelerated rapidly from its peak in October 2008. This deceleration has occurred alongside a significant decline in the flow of resources from non-bank domestic and external sources. The deceleration in total resource flow partly reflects slowdown in

demand, drawdown of inventories by the corporates and decline in commodity prices. The expansion in credit, however, has been uneven across sectors. There is, therefore, an urgent need to boost the flow of credit to all productive sectors of the economy, particularly to MSMEs, to aid the process of economic recovery. The Reserve Bank continues to maintain and will maintain ample liquidity in the system. It should be the endeavour of commercial banks to ensure that every creditworthy borrower is financed at a reasonable cost while, at the same time, ensuring that credit quality is maintained.

68. It may be noted that bank credit had accelerated during 2004-07. This, combined with significant slowdown of the economy in 2008-09, may result in some increase in NPAs. While it is not unusual for NPAs to increase during periods of high credit growth and downturn in the economy, the challenge is to maintain asset quality through early actions. This calls for a focused approach, due diligence and balanced judgment by banks.

69. Third, the Reserve Bank was able to manage the large borrowing programme of the Central and State Governments in 2008-09 in an orderly manner. The market borrowings of the Central and State Governments are expected to be higher in 2009-10. Thus, a major challenge is to manage the large government borrowing programme in 2009-10 in a non-disruptive manner. Large borrowings also militate against the low interest rate environment that the Reserve Bank is trying to maintain to spur investment demand in keeping with the stance of monetary policy. The Reserve Bank, therefore, would continue to use a combination of monetary and debt management tools to manage government borrowing programme to ensure successful completion of government borrowings in a smooth manner. The Reserve Bank has already announced an OMO calendar to support government market borrowing programme through secondary market purchase of government securities. During the first half of 2009-10, planned OMO purchases and MSS unwinding will add primary liquidity of about Rs.1,20,000 crore which, by way of monetary impact, is equivalent to CRR reduction of 3.0 percentage points. This should leave adequate resources with banks to expand credit.

70. Fourth, another challenge facing the Indian economy is to restore the fiscal consolidation process. The fiscal stimulus packages by the Government and some other measures have led to sharp increase in the revenue and fiscal deficits which, in the face of slowing private investment, have cushioned the pace of economic activity. However, it would be a challenge to unwind fiscal stimulus in an orderly manner and return to a path of credible fiscal consolidation. In this context, close monitoring of the performance of the economy and the proper sequencing of the unwinding process would have to be ensured.

71. Fifth, a continued challenge is to preserve our financial stability. The Reserve Bank would continue to maintain conditions which are conducive for financial stability in the face of global crisis. A sound banking sector, well-functioning financial markets and robust payment and settlement infrastructure are the pre-requisites for financial stability. The banking sector in

India is sound, adequately capitalised and well-regulated. By all counts, Indian financial and economic conditions are much better than in many other countries of the world. The single factor stress tests carried out as part of the report of the Committee on Financial Sector Assessment (CFSA) (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) have revealed that the banking system in India can withstand significant shocks arising from large potential changes in credit quality, interest rate and liquidity conditions. These stress tests for credit, market and liquidity risk show that Indian banks are generally resilient.

72. Sixth, the Reserve Bank has injected large liquidity in the system since mid-September 2008. It has reduced the CRR significantly and instituted some sector-specific facilities to improve the flow of credit to certain sectors. The tenure of some of these facilities has been extended to provide comfort to the market. While the Reserve Bank will continue to support all the productive requirements of the economy, it will have to ensure that as economic growth regains momentum, the large liquidity injected in the system is withdrawn in an orderly manner. It is worth noting that even as the monetary easing by the Reserve Bank has potentially made available a large amount of liquidity to the system, at the aggregate level this has not been out of line with our monetary aggregates unlike in many advanced countries. As such, the challenge of unwinding will be less daunting for India than for other countries.

73. Finally, we will have to address the key challenge of ensuring an interest rate environment that supports revival of investment demand. Since October 2008, as the inflation rate has decelerated and the policy rates have been reduced, market interest rates have also come down. However, the reduction in interest rates across the term structure and across markets has not been uniform. Given the cost plus pricing structure, banks have been slow in reducing their lending rates citing high cost of deposits. In this context, it may be noted that the current deposit and lending rates are higher than in 2004-07, although the policy rates are now lower. Reduction in deposit rates affects the cost only at the margin since existing term deposits continue at the originally contracted cost. So lending rates take longer to adjust. Judging from the experience of 2004-07, there is room for downward adjustment of deposit rates. With WPI inflation falling to near zero, possibly likely to get into a negative territory, *albeit* for a short period, and CPI inflation expected to moderate, inflationary risks have clearly abated. The Reserve Bank's current assessment is that WPI inflation could be around 4.0 per cent by end-March 2010. Banks have indicated that small savings rate acts as a floor to banks' deposit interest rate. It may, however, be noted that small savings and bank deposits are not perfect substitutes. Banks should not, therefore, be overly apprehensive about reducing deposit interest rates for fear of competition from small savings, especially as the overall systemic liquidity remains highly comfortable. There is scope for the overall interest rate structure to move down within the policy rate easing already effected by the Reserve Bank. Further action on policy rates is now being taken to reinforce this process.

### *Policy Stance*

74. On the basis of the above overall assessment, the stance of monetary policy in 2009-10 will broadly be as follows:

- Ensure a policy regime that will enable credit expansion at viable rates while preserving credit quality so as to support the return of the economy to a high growth path.
- Continuously monitor the global and domestic conditions and respond swiftly and effectively through policy adjustments as warranted so as to minimise the impact of adverse developments and reinforce the impact of positive developments.
- Maintain a monetary and interest rate regime supportive of price stability and financial stability taking into account the emerging lessons of the global financial crisis.

75. Over the last several months, the Reserve Bank has been actively engaged in policy action to minimise the impact of the global crisis on India. The policy response of the Reserve Bank has helped in keeping our financial markets functioning in a normal manner and in arresting the growth moderation. The Reserve Bank will continue to maintain vigil, monitor domestic and global developments, and take swift and effective action to minimise the impact of the crisis and restore the economy to a high growth path consistent with price and financial stability.

## III. Monetary Measures

### *Bank Rate*

76. The Bank Rate has been retained unchanged at 6.0 per cent.

### *Repo Rate*

77. It is proposed:

- to reduce the repo rate under the Liquidity Adjustment Facility (LAF) by 25 basis points from 5.0 per cent to 4.75 per cent with immediate effect.

### *Reverse Repo Rate*

78. It is proposed:

- to reduce the reverse repo rate under the LAF by 25 basis points from 3.5 per cent to 3.25 per cent with immediate effect.

79. The Reserve Bank has the flexibility to conduct repo/reverse repo auctions at a fixed rate or at variable rates as circumstances warrant.

80. The Reserve Bank retains the option to conduct overnight or longer term repo/ reverse repo under the LAF depending on market conditions and other relevant factors. The Reserve Bank will continue to use this flexibly including the right to accept or reject tender(s) under the LAF, wholly or partially, if deemed fit, so as to make efficient use of the LAF in daily liquidity management.

### *Cash Reserve Ratio*

81. The cash reserve ratio (CRR) of scheduled banks has been retained unchanged at 5.0 per cent of net demand and time liabilities (NDTL).

### *First Quarter Review*

82. The First Quarter Review of Monetary Policy for 2009-10 will be undertaken on July 28, 2009.

## Part B. Developmental and Regulatory Policies 2009-10

83. The key objective of financial sector policies is to aid the process of economic growth consistent with price and financial stability. In this context, the Reserve Bank has been focusing on improving credit delivery, developing financial markets and promoting financial inclusion. Internationally, the financial intermediation process has got significantly affected by the ongoing financial crisis. Consequently, various international bodies and financial intermediaries have been contemplating changes in the financial regulatory architecture to restore normalcy in the functioning of global financial markets and strengthen financial stability. There is a great deal of thinking going on about the appropriate design of the regulatory framework that encourages credit flow while mitigating risks. Domestically, although there has been some slowdown in credit growth, particularly in the second half of 2008-09, the banking system remains inherently sound and the financial markets including inter-bank markets are functioning normally. Nevertheless, the unfolding of the global financial crisis underscores the need for further strengthening of regulation and supervision even as India remains outside the epicentre of the global crisis.

### I. Financial Stability

84. The current crisis has triggered several initiatives in an unprecedented co-ordinated manner at the global level with a view to resolving the crisis and strengthening the international financial architecture (Box).

85. While India has been a part of the global initiative, recently a comprehensive assessment of the Indian financial sector has been conducted by the Committee on Financial Sector Assessment (CFSA) (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) constituted by the Government of India, in consultation with the Reserve Bank. The Committee submitted its report to the Finance Minister on March 25, 2009 at New Delhi. The Report was also released to the public on March 30, 2009 and placed on the Reserve Bank's website. While the Committee found India's financial sector to be broadly sound and resilient, it also identified specific concerns. The Committee has made several recommendations towards furthering financial sector development over the medium term.

86. Keeping in view both international and domestic initiatives in the financial sector, it is proposed:

- to constitute a Task Force to look into all the issues that have arisen with regard to the G-20 Working Groups and the report of the CFSA and suggest follow-up actions relevant for the Reserve Bank in the domestic context on an on-going basis, for every quarter;
- in consultation with all regulators and the Government to consider the setting up of a Working Group to implement the recommendations of the CFSA;
- to set up a Financial Stability Unit in the Reserve Bank drawing upon inter-disciplinary expertise from supervisory, regulatory, statistics, economics and financial markets departments for carrying out periodic stress testing and for preparing financial stability reports.

**Box: International Co-operation - Recent Initiatives**

Several international initiatives have been taken in the recent period for formulating proposals for strengthening the financial system. The major initiatives in this regard include the following:

- Several reports have been released recently such as the Financial Stability Forum's (now Financial Stability Board) Report on 'Enhancing Market and Institutional Resilience', the Geneva Report on 'The Fundamental Principles of Financial Regulation', Larosiere Report on 'The High Level Group on Financial Supervision in the EU' and the Turner Review on 'Regulatory Response to the Global Banking Crisis'.
- The G-20 countries have also taken several initiatives. In the summit held in Washington in November 2008, the G-20 countries laid down an action plan and constituted four Working Groups, *viz.,* (i) Enhancing Sound Regulation and Strengthening Transparency; (ii) Reinforcing International Co-operation and Promoting Integrity in Financial Markets; (iii) Reform of the IMF; and (iv) The World Bank and other Multilateral Development Banks (MDBs). The first group on Enhancing Sound Regulation and Strengthening Transparency was co-chaired by Dr. Rakesh Mohan, Deputy Governor, Reserve Bank of India along with Mr. Tiff Macklem of Canada. The status for India with regard to the recommendations of this group in set out in Annex II.
- The leaders of the G-20 again met in London on April 2, 2009 and laid down the 'Global Plan for Recovery and Reform'.
- Drawing mainly from the recommendations of the group on Enhancing Sound Regulation and Strengthening Transparency, the G-20 also made a declaration for strengthening the financial system. The declaration agreed to make far reaching reforms in the areas of expanding the membership of international bodies, international co-operation, prudential regulations, scope of regulations, compensation, tax havens and non-co-operative jurisdictions, accounting standards and credit rating agencies.
- With a view to increasing international co-operation, the Financial Stability Forum (FSF), rechristened as Financial Stability Board (FSB), has been expanded to include more emerging market economies and its mandate has been broadened. India has been invited to join the FSB as a member. Alongside the current mandate of the FSF – to assess vulnerabilities affecting the financial system and identify and oversee action needed to address them – the FSB will advise on market developments and monitor best practices in meeting regulatory standards, among others.
- The Basel Committee on Banking Supervision (BCBS) has also been expanded and India has been invited to nominate a member to the Committee. Accordingly, Smt. Usha Thorat, Deputy Governor, Reserve Bank of India has been nominated as a member of the BCBS.
- A Group of 30 (G-30) released the report on 'Financial Reform – A Framework for Financial Stability' on January 15, 2009 to strengthen prudential regulations and supervision.

## II. Interest Rate Policy

### *(a) BPLR System: Review*

87. Consequent to the Mid-Term Review of October 2005, the Indian Banks' Association (IBA) issued guidelines for determination of benchmark prime lending rate (BPLR) by banks for appropriate pricing of credit. Over time, however, the system of BPLR has evolved in such a manner that it has lost its relevance as a meaningful reference rate as bulk of loans is advanced below BPLR. Furthermore, this impedes the smooth transmission of monetary signals and makes the loan pricing system non-transparent. It has, therefore, become necessary to review the current procedures and processes of pricing of credit. Accordingly, it is proposed:

- to constitute a Working Group to review the present BPLR system and suggest changes to make credit pricing more transparent. The Working Group would consult all the stakeholders and submit its report by end-August 2009.

*(b) Payment of Interest on Savings Bank Account on a Daily Product Basis*

88. At present, interest on savings bank accounts is calculated on the minimum balances held in the accounts during the period from the 10th day to the last day of each calendar month. Several banks have suggested that interest on savings bank accounts may be calculated either on the minimum balances in the deposit accounts during the period from the first to the last day of each calendar month or on a daily product basis. The matter was referred to the IBA, which was of the view that payment of interest on a daily product basis would be feasible only when computerisation in banks is completed. In view of the present satisfactory level of computerisation in commercial bank branches, it is proposed that:

- payment of interest on savings bank accounts by scheduled commercial banks (SCBs) would be calculated on a daily product basis with effect from April 1, 2010.

Modalities in this regard will be worked out in consultation with banks.

## III. Financial Markets

### *Money Market*

*(a) Special Refinance Facility: Extension*

89. A special refinance facility was introduced on November 1, 2008 under Section 17(3B) of the Reserve Bank of India Act, 1934 to provide funding to scheduled commercial banks (excluding regional rural banks) up to 1.0 per cent of their net demand and time liabilities (NDTL) as on October 24, 2008 at the repo rate. It is proposed:

- to extend this special refinance facility up to March 31, 2010.

*(b) Special Term Repo Facility: Extension*

90. The Reserve Bank introduced a special 14-day term repo facility for banks in September 2008 through relaxation in the maintenance of SLR up to 1.5 per cent of their NDTL, to enable them to meet the liquidity requirements of mutual funds (MFs), non-banking financial companies (NBFCs) and housing finance companies (HFCs). The auctions for the special 14-day term repo are conducted on a daily basis. On a review, it is proposed:

- to extend the time for availability of this special term repo facility to banks up to March 31, 2010;
- to conduct these 14-day term repo auctions on a weekly basis.

*(c) Export Credit Refinance: Review*

91. With a view to providing flexibility in the liquidity management of banks, the limit of the standing liquidity facility to banks in terms of export credit refinance (ECR) under Section 17(3A) of the RBI Act was raised from 15.0 per cent of the eligible outstanding rupee export credit as on the preceding fortnight to 50.0 per cent in November 2008. It is proposed:

- to review the ECR limit in March 2010.

### *(d) Money Market Mutual Funds*

92. The liquidity stress recently faced by mutual funds, particularly the money market mutual funds (MMMFs), was caused primarily on account of mobilisation of significant resources from large corporates and banks with redemption facilities on par with current accounts of banks. In this regard, the Securities and Exchange Board of India (SEBI) has taken several measures to mitigate the liquidity risks. In view of the systemic implications of the activities of such funds, it is proposed:

- to identify and address the macro-prudential concerns arising from the current framework in consultation with SEBI.

### *(e) Interest Rate Futures*

93. The Technical Advisory Committee (TAC) for Money, Foreign Exchange and Government Securities Markets had released the report of the Working Group on Interest Rate Futures (Chairman: Shri V. K. Sharma) in August 2008. The Working Group had recommended, *inter alia,* the introduction of a physically settled contract based on a 10-year notional coupon bearing government bond. The Reserve Bank has already permitted banks to take trading positions in interest rate futures (IRFs). The RBI-SEBI Standing Technical Committee has completed the preparatory work and an exchange traded IRFs contract on the 10-year notional coupon bearing government bond is expected to be launched shortly.

## *Government Securities Market*

### *(a) Central Government Securities*

### *(i) Floating Rate Bonds*

94. The floating rate bonds (FRBs) issued by the Government of India till September 2004 were linked to the cut-off yields of the 364-day Treasury Bills (TBs), which led to certain issues relating to the pricing of FRBs in the secondary market. Reflecting this experience and in consultation with market participants and the Technical Advisory Committee on Money, Foreign Exchange and Government Securities Markets, the structure has been revised. The revised structure contemplates that: (i) the auction will be conducted through the 'price based' process as against the 'spread based' process earlier; and (ii) the base yield for FRBs will be linked to the primary market cut-off yield of the 182-day TBs. The revised structure is expected to simplify the methodology for pricing of FRBs in the secondary market. The revised issuance structure for FRBs has been built into the negotiated dealing system (NDS) auction format being developed by the Clearing Corporation of India Limited (CCIL).

95. The indicative calendar for the issuance of Central Government securities provides for the issuance of FRBs. Accordingly:

- any new issuance of floating rate bonds would be in terms of the revised issuance structure.

### *(ii) Auction Process of Government of India Securities*

96. As indicated in the Mid-Term Review of October 2008, the recommendations of the Internal Working Group (Chairman: H.R. Khan) involving the Reserve Bank such as reduction of the time gap between bid submission and declaration of auction results have already been implemented. The other recommendations of the Working Group such as: (i) withdrawal of the facility of bidding in physical form and submission of competitive bids only through the NDS;

and (ii) submission of a single consolidated bid on behalf of all its constituents by the bank/primary dealer (PD) in respect of non-competitive bids will be implemented after the amendments in the specific notification and in the scheme for non-competitive bidding facility by the Government of India.

### *(iii) Ways and Means Advances to the Government of India: Status*

97. The Reserve Bank, in consultation with the Government of India, has revised the extant limits for the Ways and Means Advances (WMA) for the financial year 2009-10. As per the revised arrangements, the WMA limits will continue to be fixed on a half-yearly basis, and are placed at Rs.20,000 crore for the first half and Rs.10,000 crore for the second half of 2009-10. The applicable interest rate on WMAs and overdrafts will, as it is the practice now, continue to be linked to the repo rate. The Reserve Bank of India, however, retains the flexibility to revise the limits in consultation with the Government of India, taking into consideration the prevailing circumstances.

## *(b) Debt Management for State Governments*

### *(i) Non-Competitive Bidding in the Auction of State Development Loans (SDLs): Status*

98. In order to widen the investor base and enhance the liquidity for SDLs, a scheme for non-competitive bidding in the auction of SDLs was notified by all the State Governments on July 20, 2007. Subsequent to the announcement in the Mid-Term Review of October 2008, the necessary system changes required to handle non-competitive bidding in the auction of SDLs have been carried out in the NDS auction platform developed by the CCIL.

99. The scheme for non-competitive bidding in SDLs will be operationalised during the current financial year.

### *(ii) Ways and Means Advances Limits for the State Governments: Status*

100. The State-wise limits of normal WMA for the year 2009-10 have been kept unchanged at the limits set for the year 2008-09. Accordingly, the aggregate normal WMA limit for State Governments is placed at Rs.9,925 crore, including the WMA limit of Rs.50 crore for the Government of the Union Territory of Puducherry. All other terms and conditions of the scheme remain unchanged.

## *(c) Development of Market Infrastructure*

### *(i) Separate Trading for Registered Interest and Principal of Securities (STRIPS)*

101. Stripping is the process of converting periodic coupon payments and the principal of an existing Government security into tradable zero-coupon securities, *i.e.*, separate trading for registered interest and principal of securities (STRIPS). The availability of STRIPS across the term structure will aid the development of a sovereign zero-coupon yield curve. As indicated in the Annual Policy Statement of April 2008, all operational arrangements for the introduction of STRIPS are ready. The required software development, critical for the introduction of STRIPS, has been carried out as part of the public debt office – NDS (PDO-NDS) platform maintained by the Reserve Bank. Furthermore, in order to ensure sufficient volume/liquidity in STRIPS and considering the fungibility of

coupon STRIPS, securities have been identified that will be eligible for stripping/ reconstitution by the market participants. Accordingly:

- draft guidelines prepared in consultation with the market participants are being placed on the Reserve Bank's website for comments and feedback by end-May 2009. With the finalisation of the guidelines, STRIPS will be launched during the current financial year.

*(ii) Revision of Repo Accounting*

102. The accounting norms on repo transactions prescribed by the Reserve Bank in 2003, treated repo as a set of two independent outright transactions. Consequent upon the amendment in 2006 to the Reserve Bank of India Act, 1934, repo has been defined as an instrument for borrowing funds by selling securities. Accordingly, it was proposed to revise the accounting guidelines to capture the economic essence of repo as a collateralised lending and borrowing instrument and not as outright sale and purchase. Accordingly, it is proposed:

- to issue revised guidelines on repo accounting, taking into account comments on the draft guidelines earlier placed on the Reserve Bank's website, by end-June 2009 for implementation from April 1, 2010.

*(iii) Multi-modal Settlements in Government Securities: Status*

103. As indicated in the Annual Policy Statement of April 2008, a new settlement mechanism (Multi-modal Settlement) through commercial banks has been put in place to facilitate entities such as mutual funds (MFs), which do not hold a current account with the Reserve Bank, to directly participate in the government securities market. Under the new mechanism, while settlement of the securities leg continues to take place in the SGL account maintained with the Reserve Bank, the funds leg will settle through the 'designated settlement banks' (DSBs) appointed by the CCIL. The guidelines in the matter were issued on June 2, 2008. From June 30, 2008 onwards, secondary market transactions in government securities undertaken by MFs are being settled only through this mechanism.

104. The facility of multi-modal settlements can also be availed of by other non-bank entities such as insurance companies, pension funds and co-operative banks which do not maintain a current account with the Reserve Bank.

*(iv) Clearing and Settlement of OTC Rupee Interest Rate Derivatives: Status*

105. As indicated in the Mid-Term Review of October 2008, the CCIL has operationalised a clearing and settlement arrangement for over-the-counter (OTC) rupee interest rate derivatives on a non-guaranteed basis since November 27, 2008. As at end-March 2009, 13 members have decided to participate in the non-guaranteed settlement of OTC rupee interest rate derivatives. The trade reporting platform for OTC rupee interest rate derivatives is already functional.

*(v) Settlement of OTC Trades in Corporate Bonds*

106. For facilitating settlement of OTC corporate bond transactions in real-time

gross settlement (RTGS) system on a DvP-I basis (*i.e.*, on a trade-by-trade basis), it has been decided, in consultation with the SEBI, to allow the clearing houses of the exchanges to have a transitory pooling account facility with the Reserve Bank. Under the proposed settlement mechanism, the buyer of securities will transfer the funds through his bank to this transitory account through RTGS. The clearing house will thereafter transfer the securities from the seller's account to the buyer's account and effect the release of funds from the transitory account to the seller's account.

### *Foreign Exchange Market*

#### *(a) ECBs: Extension of Relaxation of all-in-cost Ceilings*

107. As per extant ECB policy, the all-in-cost ceilings for ECBs are: LIBOR plus 300 bps for ECBs with average maturity period of three years and up to five years; and LIBOR plus 500 bps for ECBs with average maturity of more than five years. However, these all-in-cost ceilings have been dispensed with up to June 30, 2009 subject to the condition that ECB proposals above the prescribed all-in-cost ceilings, irrespective of the amount of the borrowing, will come under the approval route. Considering the continuing tightness of credit spreads in the international markets, it is proposed:

- to extend the relaxation in all-in-cost ceilings until December 31, 2009.

#### *(b) Liberalisation of the Policy on Buyback of FCCBs*

108. Recognising the benefits accruing to the Indian companies as well as to the economy, the policy on the premature buyback of FCCBs was liberalised in December 2008. The proposals for buyback of FCCBs by Indian companies are being considered both under the approval and automatic routes, provided buyback is financed out of their foreign currency resources held in India or abroad and/or out of fresh ECBs raised in conformity with the current ECB norms and out of internal accruals up to US $ 50 million of the redemption value per company. The entire procedure for buyback of FCCBs is required to be completed by December 31, 2009 and details of the buyback are also required to be reported to the Reserve Bank.

109. In terms of the extant norms, the Reserve Bank has been considering, under the approval route, proposals from Indian companies for buyback of FCCBs, out of internal accruals, up to US $ 50 million redemption value per company, at a minimum discount of 25 per cent on the book value. Up to April 15, 2009, the Reserve Bank has approved 18 proposals for buyback of FCCBs involving US $ 765 million with the discount ranging from 25 per cent to 50 per cent.

110. The current policy has been reviewed. Keeping in view the benefits accruing to Indian companies, it is proposed to increase the total amount of permissible buyback, out of internal accruals, from US$ 50 million of the redemption value per company to US $ 100 million, by linking the higher amount of buyback to larger discounts. Accordingly:

- Indian companies may, henceforth, be permitted, under the approval route, to buy back FCCBs out of internal accruals with a minimum discount of 25 per cent of book value for redemption amount of up to US $ 50 million, 35 per cent of book value for redemption amount more than US $ 50 million and up to 75 million; and 50 per cent of book value for redemption amount more than US $ 75 million and up to US $ 100 million.

### (c) *Loans against Non-resident Deposits*

111. As per the extant norms, Authorised Dealer Category–I and authorised banks are permitted to grant loans up to Rs.20 lakh against the security of funds held in NR(E)RA and FCNR(B) deposits. On a review, it is proposed:

- to enhance the cap of Rs.20 lakh to Rs.1 crore with immediate effect.

### (d) *Currency Futures*

112. Since the launch of the first currency futures exchange in September 2008, currency futures contracts are being traded in three recognised exchanges. The average daily volume of currency futures contracts traded on all the exchanges increased from Rs.260 crore in September 2008 to Rs.2,181 crore in December 2008 and further to Rs.5,235 crore in March 2009. The functioning of the exchanges continues to be reviewed by the RBI-SEBI Standing Technical Committee. On the recommendation of the Committee, the position limits on the clients and trading members have been doubled from US $ 5 million and US $ 25 million respectively to US $ 10 million and US $ 50 million. However, the upper limits of 6 per cent and 15 per cent of the total open interest on the clients and trading members remain unchanged. The position limit for banks continues at 15 per cent of total open interest or US $ 100 million, whichever is higher.

## IV. Credit Delivery Mechanism and Other Banking Services

### (a) *Credit Flow to the MSE Sector*

113. As indicated in the Mid-Term Review of October 2008, the Reserve Bank appointed a Working Group on Rehabilitation of Sick SMEs (Chairman: Dr. K.C. Chakrabarty). The Working Group made several significant recommendations pertaining not only to the issue of rehabilitation of sick SMEs but also to the larger issues of credit flow to the SME sector and other developmental issues. While the recommendations on which action is to be initiated by the Government of India, State Governments and SIDBI are being forwarded to them, it is proposed:

- to issue guidelines to banks based on the recommendations of the Group, by April 30, 2009.

114. Having regard to the need to accelerate the credit flow to the micro and small enterprises (MSEs) sector so critical for employment, output and exports, it is proposed:

- to ask the Standing Advisory Committee on MSEs to review the Credit Guarantee Scheme so as to make it more effective.

### (b) *Rural Co-operative Banks*

#### (i) *Licensing of Co-operatives*

115. The Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) has observed that there is a need to draw up a roadmap for ensuring that only licensed banks operate in the co-operative space.

The Committee further suggested the need for a roadmap to ensure that banks which fail to obtain a licence by 2012 should not be allowed to operate. This will expedite the process of consolidation and weeding out of non-viable entities from the co-operative space. Accordingly, it is proposed:

- to work out a roadmap for achieving this objective in a non-disruptive manner in consultation with NABARD.

*(ii) Revival of Rural Co-operative Credit Structure: Status*

116. As indicated in the Annual Policy Statement of April 2008, the Government of India approved a package for revival of the short-term rural co-operative credit structure based on the recommendations of the Task Force on Revival of Rural Co-operative Credit Institutions (Chairman: Prof. A. Vaidyanathan). So far, 25 States have executed Memoranda of Understanding (MoUs) with the Government of India and the NABARD, as envisaged in the package. Eight States have made necessary amendments in their Co-operative Societies Acts. An aggregate amount of Rs. 4,740 crore has been released by the NABARD as the Government of India's share for recapitalisation of primary agricultural credit societies (PACS) in eight States as on February 28, 2009. Eight State Governments have released their shares of Rs.459 crore for recapitalisation of PACS. The National Implementing and Monitoring Committee (NIMC), set up by the Government of India, is guiding and monitoring the implementation of the revival package on an all-India basis.

*(c) Regional Rural Banks*

*(i) Capital to Risk-weighted Assets Ratio for RRBs*

117. The Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) has suggested a phased introduction of capital to risk-weighted assets ratio (CRAR) in the case of RRBs, along with the recapitalisation of RRBs after consolidation of these entities. It is, therefore, proposed:

- to introduce CRAR for RRBs in a phased manner, taking into account the status of recapitalisation and amalgamation. A time-table for this purpose would be announced in consultation with NABARD.

*(ii) Assistance to RRBs for Adoption of ICT Solutions for Financial Inclusion: Status*

118. The Report of the Working Group on Defraying Costs of ICT Solutions for Regional Rural Banks (Chairman: Shri G. Padmanabhan) was placed on the Reserve Bank's website in August 2008 for comments from public. The Group has, *inter alia,* noted that apart from the North-Eastern region and Jammu and Kashmir, there are 204 districts in several States which have been identified by the Committee on Financial Inclusion (Chairman: Dr. C. Rangarajan) as areas where there is a high level of financial exclusion. It is, therefore, suggested that these areas could also be considered for special treatment. With a view to enabling RRBs to adopt IT based solutions for financial inclusion, it is proposed:

- to work out, in consultation with NABARD, the manner of providing assistance to RRBs adopting ICT solutions for financial inclusion in districts identified as having high level of exclusion by the Committee on Financial Inclusion.

*(iii) Amalgamation of RRBs*

119. Consequent upon the amalgamation of 156 RRBs into 45 new RRBs sponsored by 20 banks in 17 States, the total number of RRBs declined from 196 to 86 as at end-March 2009 (which includes a new RRB set up in the Union Territory of Puducherry). The amalgamation process is almost complete.

*(iv) Recapitalisation of RRBs*

120. The Union Budget 2007-08 announced that RRBs, which have a negative net worth, would be recapitalised in a phased manner. As on March 31, 2009, 26 RRBs have been fully recapitalised with an amount of Rs. 1,783 crore and one RRB has been partially recapitalised with an amount of Rs.13 crore. The process of recapitalisation has been completed except in respect of one RRB in the State of Uttar Pradesh.

*(v) Scheduling of Amalgamated RRBs*

121. Out of 45 amalgamated RRBs, 25 RRBs have been included in the Second Schedule to the RBI Act, 1934 while 76 erstwhile RRBs have been excluded from the Second Schedule in terms of the notification dated September 22, 2008 published in the Gazette of India dated November 15, 2008.

*(vi) Branch Licensing: Further Liberalisation*

122. The Mid-Term Review of October 2008 proposed to allow RRBs greater flexibility in opening new branches as long as they made profits and their financials improved. The RRBs have obtained 345 licenses for opening branches in the financial year 2008-09 and have opened 316 branches in the same period.

*(vii) Technology Upgradation of RRBs*

123. As indicated in the Mid-Term Review of October 2008, the recommendation of the Working Group (Chairman: Shri G. Srinivasan) to prepare a roadmap for migration to core banking solutions (CBS) by RRBs, was forwarded to all sponsor banks in October 2008 for implementation. The Report has, among others, set September 2011 as the target date for all RRBs to move towards CBS. Also, all RRB branches opened after September 2009 are required to be CBS compliant from day one. In March 2009, sponsor banks were advised to give their feedback/status on implementation of the recommendations of the report in respect of RRBs sponsored by them.

### *(d) Delivery of Credit to Agriculture and other Segments of the Priority Sector*

*(i) Kisan Credit Card Scheme*

124. The Kisan Credit Card (KCC) scheme, introduced in 1998-99 to enable farmers to purchase agricultural inputs and draw cash for their production needs, was revised to provide adequate and timely finance for meeting the comprehensive credit requirements of farmers under a single window, with flexible and simplified procedure, adopting a whole farm approach. During 2008-09 (up to December 2008), public sector banks (PSBs) issued 3.9 million KCCs with sanctioned limits aggregating Rs.23,366 crore. Since the inception of the scheme, PSBs have issued 35.08 million KCCs with sanctioned limits aggregating Rs.1,77,607 crore.

*(ii) Rural Infrastructure Development Fund*

125. The Interim Budget 2009-10 announced the continuation of financing of rural infrastructure projects for 2009-10 by way of RIDF XV which would be set up with NABARD with a corpus of Rs.14,000 crore, and a separate window under RIDF XV for rural roads component of Bharat Nirman Programme with a corpus of Rs.4,000 crore.

126. Consequent upon the announcement made in the Union Budget 2008-09, several funds were set up such as: (i) Short-Term Co-operative Rural Credit (STCRC) (Refinance) Fund with the NABARD with a corpus of Rs.5,000 crore; (ii) MSME (Refinance) Fund and MSME (Risk Capital) Fund with the Small Industries Development Bank of India (SIDBI) with corpus of Rs.1,600 crore and Rs.1,000 crore; and (iii) Rural Housing Fund with the National Housing Bank (NHB) with corpus of Rs.1,000 crore. The Annual Policy Statement of April 2008 announced that the shortfall in achievement of 10 per cent sub-target for lending to weaker sections by domestic scheduled commercial banks will also be taken into account for the purpose of allocating amounts for contribution to the Rural Infrastructure Development Fund (RIDF) maintained with the NABARD or funds with other financial institutions, as specified by the Reserve Bank, with effect from April 2009.

127. Consequent upon the announcement of measures by the Reserve Bank on November 15, 2008 to sustain the growth momentum in the employment-intensive sectors of micro and small enterprises and housing, the corpus of MSME (Refinance) Fund and Rural Housing Fund was enhanced by Rs.2,000 crore (to Rs.3,600 crore) and by Rs.1,000 crore (to Rs.2,000 crore), respectively. As on March 31, 2009 various scheduled commercial banks have placed deposits of Rs.4,622 crore in STCRC (Refinance) Fund, Rs.3,326 crore in MSME (Refinance) Fund, Rs.250 crore in MSME (Risk Capital) Fund and Rs.1,760 crore in Rural Housing Fund.

### (e) Interest Subvention Relief to Farmers

128. The Union Budget 2008-09 announced continuation of the interest subvention scheme for short-term crop loans, introduced in 2006-07. The rate of subvention was increased from 2 per cent to 3 per cent for 2008-09. The Interim Budget 2009-10 announced that the Government of India would also continue to provide interest subvention in 2009-10 to ensure that farmers get short-term crop loans up to Rs.3 lakh at 7.0 per cent per annum.

### (f) Micro-finance

129. The self-help group (SHG)-bank linkage programme has emerged as the major micro-finance programme in the country and is being implemented by commercial banks, RRBs and co-operative banks. As on March 31, 2008 3.6 million SHGs had outstanding bank loans of Rs.17,000 crore, an increase of 25 per cent over March 31, 2007 in respect of number of SHGs credit linked. During 2007-08, banks financed 1.2 million SHGs for Rs.8,849 crore. As at end-March 2008, SHGs had 5 million savings accounts with banks for Rs.3,785 crore.

### (g) Financial Inclusion

*(i) Pilot Project of State Level Bankers' Committee (SLBCs) for 100 per cent Financial Inclusion*

130. So far, 344 districts have been identified by SLBCs for 100 per cent financial inclusion. Of these, 175 districts in 21 States and 7

Union Territories have reported having achieved the target. All districts of Haryana, Himachal Pradesh, Karnataka, Kerala, Uttarakhand, Goa, Chandigarh, Puducherry, Daman & Diu, Dadra & Nagar Haveli and Lakshadweep have reported having achieved the target of 100 per cent financial inclusion.

131. As indicated in the Mid-Term Review of October 2008, the findings of the external agencies entrusted with conducting evaluation studies in achieving the target of 100 per cent financial inclusion in 26 districts were placed on the Reserve Bank's website for wider dissemination. Based on the findings, banks were advised in January 2009, among other things, to (i) ensure provision of banking services nearer to the location of the no-frills account holders through a variety of channels; (ii) provide General Credit Card (GCC)/small overdrafts along with no-frills accounts to encourage the account holders to actively operate the accounts; (iii) conduct awareness drives so that the no-frills account holders were made aware of the facilities offered; (iv) review the extent of coverage in districts declared as 100 per cent financially included; and (v) efficiently leverage on the technology enabled financial inclusion solutions currently available.

*(ii) Special Task Force in North-Eastern Region*

132. As indicated in the Mid-Term Review of October 2008, a scheme of providing financial support to banks by the Reserve Bank for setting up banking facilities (currency chests, extension of foreign exchange and Government business facilities) at centres, in the North-Eastern region (NER), which are not found to be commercially viable by banks, was formulated, provided the State Governments made available necessary premises and other infrastructural support. The Government of Meghalaya has agreed to the proposal of providing premises and security, and bids have been received by PSBs and RRBs for setting up branches at centres identified by the State Government and are being processed. Action is being intitiated in respect of other States in NER where requests have been received.

*(iii) Setting up of Credit Counselling Centres on a Pilot Basis*

133. So far, banks have reported setting up or proposing to set up 123 credit counselling centres in various States of the country. The feedback received in this regard indicated that most of these centres were in effect set up as extensions of the bank branches and engaged in promotion of bank specific products. Accordingly, a model scheme on financial literacy and credit counselling centres (FLCCs) was formulated and communicated to all scheduled commercial banks and RRBs with the advice to set up the centres as distinct entities maintaining an arm's length from the bank so that the FLCC's services are available to even other banks' customers in the district.

*(iv) Setting up of Rural Self Employment Training Institutes*

134. The Reserve Bank has issued guidelines, framed by the Government of India, to the SLBC convenor banks to set up at least one Rural Self Employment Training Institute (RSETI) in each district by 2010. These institutions will train at least one youth in a family below poverty line (BPL) in various fields and enhance capacity building. In all,

134 RSETIs have been set up as on December 31, 2008. A target for opening of 100 RSETIs by banks was set for the year 2008-09 and a grant of Rs. one crore per RSETI has been earmarked by the Planning Commission for setting up the institutes. The Regional Offices of the Reserve Bank have been advised to monitor the progress of setting up of RSETIs under their jurisdiction on a quarterly basis.

### (h) High Level Committee on Lead Bank Scheme

135. As announced in the Mid-Term Review of the Annual Policy Statement for the year 2007-08, a High Level Committee (Chairperson: Smt. Usha Thorat) with members drawn from various financial institutions, banks and Chief Secretaries of select States was constituted to review the Lead Bank Scheme. The Committee had several rounds of discussions with different State Governments, banks and other stakeholders, including academicians, micro-finance institutions (MFIs) and non-governmental organisations (NGOs). The Committee's draft report will be placed on the Reserve Bank's website by May 15, 2009.

### (i) Amendment to Banking Ombudsman Scheme 2006

136. The scope of the Banking Ombudsman Scheme, 2006 was widened to include, *inter alia*, deficiencies arising out of internet banking. Under the amended Scheme, customers can lodge complaints against banks for non-adherence to the provisions of the fair practices code for lenders or the code of bank's commitment to customers issued by the Banking Codes and Standards Board of India (BCSBI).

## V. Prudential Measures

### (a) Further Relaxations in the Branch Authorisation Policy

137. The current branch authorisation policy requires banks to have a medium-term plan in respect of branch expansion. The request for opening of off-site ATMs was also required to be a part of such plans. On a review, it is proposed:

- to allow scheduled commercial banks (SCBs) to set up off-site ATMs without prior approval subject to reporting.

138. With respect to branch authorisation policy, it is proposed:

- to constitute a Group to review the extant framework of branch authorisation policy with a view to providing greater flexibility, enhanced penetration and competitive efficiency consistent with financial stability.

### (b) Presence of Foreign Banks in India: Review

139. In February 2005, the Government of India and the Reserve Bank released the 'Roadmap for Presence of Foreign Banks in India' laying out a two-track and gradualist approach aimed at increasing the efficiency and stability of the banking sector in India. One track was the consolidation of the domestic banking system, both in private and public sectors, and the second track was the gradual enhancement of the presence of foreign banks in a synchronised manner. The roadmap was divided into two phases, the first phase spanning the period March 2005 - March 2009, and the second phase beginning April 2009 after a review of the experience gained in the first phase.

140. In view of the current global financial market turmoil, there are uncertainties surrounding the financial strength of banks around the world. Further, the regulatory and supervisory policies at national and international levels are under review. In view of this, it is considered advisable, for the time being, to continue with the current policy and procedures governing the presence of foreign banks in India. The proposed review will be taken up after due consultation with the stakeholders once there is greater clarity regarding stability, recovery of the global financial system, and a shared understanding on the regulatory and supervisory architecture around the world.

### (c) *Mitigating Procyclicality: Use of Floating Provisions*

141. The G-20 Working Group on Enhancing Sound Regulation and Strengthening Transparency has recommended, as a part of measures to mitigate procyclicality, that capital buffers above minimum requirements and loan loss provisions should be built up in good times in order to enhance the ability of the regulated financial institutions to withstand large shocks. This would require modification in the Reserve Bank's circular of June 22, 2006. The Reserve Bank has been encouraging banks to build floating provisions as a buffer for the possible stress on asset quality later. It is proposed:

- to issue further detailed guidelines on mitigating procyclicality later this year after FSB, BCBS and Committee on Global Financial System (CGFS) finalise their recommendations in this regard.

### (d) *Credit Rating Agencies*

142. In India, all credit rating agencies are registered with the SEBI. The Reserve Bank has accorded accreditation to four SEBI registered credit rating agencies for the limited purpose of using their ratings for assigning risk weights within the framework of the Basel II Accord. Since the Indian banking system has migrated to the Basel II framework, there is a need to review the performance of the credit rating agencies for continuation of the accreditation, especially by looking at the latest data relating to cumulative default rate and transition matrix of the rating agencies. Accordingly:

- the Reserve Bank will liaise with SEBI on the issue of rating agencies' adherence to Code of Conduct Fundamentals of the International Organisation of Securities Commissions (IOSCO).

### (e) *Liquidity Risk*

143. In terms of the asset liability management, liquidity of banks in India is tracked through traditional maturity or cash flow mismatches. The Reserve Bank has examined the issue of banks establishing a more robust liquidity risk management framework that is well integrated into the bank-wide risk management process by adopting global liquidity planning. In this context, banks will be required to integrate their various foreign currency assets and liabilities positions from their branch operations in India with the rupee asset liability position. Accordingly, it is proposed:

- to prepare a draft circular detailing the modalities for adopting the integrated liquidity risk management system as also the guidance note on 'Liquidity Risk Management' based on Basel Committee's 'Principles for Sound Liquidity Risk Management and Supervision' brought out in September 2008 as well as other international best practices which would be placed on the Reserve Bank's website by June 15, 2009.

### *(f) Financial Inclusion: Relaxing Eligibility Criteria for Banking Correspondents*

144. With the objective of achieving greater financial inclusion and increasing the outreach of the banking sector, banks were permitted, to use the services of NGOs/MFIs set up as societies, trusts, Section 25 companies, post offices, co-operative societies and more recently retired bank employees, ex-servicemen and retired government employees as banking correspondents (BCs). Scaling up the BC model is a challenge. It is, therefore, proposed:

- to constitute a Working Group to examine the experience to date of the business correspondent (BC) model and suggest measures, to enlarge the category of persons that can act as BCs, keeping in view the regulatory and supervisory framework and consumer protection issues.
- to increase the maximum distance criterion for the operation of the BC for rural, semi-urban and urban areas from the existing 15 kms. to 30 kms.

### *(g) Risk Weights for Exposure to Central Counterparties*

145. A central counterparty (CCP) is an entity that interposes itself between counterparties to contracts traded within one or more financial markets, becoming the legal counterparty such that it is the buyer to every seller and the seller to every buyer. The CCIL has been acting as a CCP for banks in various segments of the financial market. Similarly, contracts like interest rate futures and currency futures, which are traded on the stock exchanges, are also settled through the clearing houses attached to these exchanges.

146. Banks settling trades through CCIL/ stock exchanges have two types of exposures to these CCPs. First, on account of the on-balance sheet and off-balance sheet transactions undertaken through the CCP; and second, the exposure on account of deposits/collateral kept with the CCPs to meet the margin requirements. It has been decided to lay down the norms for capital adequacy treatment of such exposures. Accordingly:

- the exposures on account of derivatives/ securities financing transactions trades outstanding against all the CCPs, will be assigned zero exposure value, as it is presumed that the CCPs' exposures to their counterparties are fully collateralised on a daily basis, thereby providing protection for the central counterparty's credit risk exposures;
- the margin amounts/collaterals maintained with the CCPs will attract risk weights appropriate to the nature of the CCP. For CCIL, the risk weight will be 20 per cent and for other CCPs, it will be according to the ratings assigned to these entities as per the New Capital Adequacy Framework.
- the above prescription will be subject to review on an on-going basis by the

Reserve Bank about the adequacy of margin, quality of collateral and risk management systems of the clearing house/CCP.

### (h) Private Pool of Capital

147. It has been observed that Indian banks have recently been engaged in sponsoring and managing private pools of capital such as venture capital funds and infrastructure funds. The G-30 Report on 'Financial Reform – A Framework for Financial Stability' released on January 15, 2009, observed that large, systemically important banking institutions should be restricted in undertaking proprietary activities that present particularly high risks and serious conflicts of interest. Sponsorship and management of commingled private pools of capital (that is, hedge and private equity funds in which the banking institutions own capital is commingled with client funds) should ordinarily be prohibited and large proprietary trading should be limited by strict capital and liquidity requirements. Therefore, there is need for banks to have greater awareness of the risks inherent in such activities and limit such exposures commensurate with their risk management and available capital. Keeping in view the reputational risk involved in such activities, the Reserve Bank had mandated maintenance of certain level of economic capital in some of the cases approved in the recent past. It is now proposed:

- to issue a paper on prudential issues in banks' floating and managing private pools of capital for eliciting public comments which will form the basis for finalising regulatory guidelines by September 30, 2009.

### (i) Stress Testing

148. In the Mid-Term Review of October 2008, it was indicated that the Reserve Bank would be upgrading the stress testing guidelines. Subsequently, the BCBS has issued a paper on 'Principles for Sound Stress Testing Practices and Supervision' in January 2009 for comments. The paper draws lessons for banks and supervisors emerging from the financial crisis and addresses weaknesses in stress testing, including the specific areas of risk mitigation and risk transfer. In this context, the CFSA has recommended that there is a need for the banks themselves to carry out such periodic stress testing. It is proposed to upgrade the stress testing guidelines once BCBS finalises the paper based on comments received.

### (j) Securitisation of Bank Loans

149. The securitisation framework in India is considered to be reasonably prudent and has been able to minimise the incentives that have led to the problems which surfaced in the current crisis. It has come to the Reserve Bank's notice that some banks have securitised loans immediately after originating or purchasing these from other banks. Banks are also dividing the total loan for one project into different tranches and securitising a few tranches even before the total disbursement is complete, thus passing on the project implementation risk also to the investors. It is, therefore, proposed:

- to prescribe a minimum lock-in-period and minimum retention criteria for securitising the loans originated and purchased by banks.

*(k) Certificate of Registration to Credit Information Companies*

150. In response to the Reserve Bank's press release of April 18, 2007 inviting applications for grant of Certificate of Registration from companies desirous of entering into the business of credit information under the Credit Information Companies (Regulation) Act, 2005, 13 applications were received. A High Level Advisory Committee (Chairman: Dr. R.H. Patil) set up by the Reserve Bank screened the applications and recommended the names of four applicants for issue of Certificate of Registration. Accordingly, 'in principle' approvals have been issued to these four applicants.

## VI. Institutional Developments

### *Payment and Settlement Systems*

*(a) Final Guidelines for Prepaid Payment Instruments in India*

151. The enactment of the Payment and Settlement Systems Act, 2007 has brought the payment systems involved in the issuance of prepaid payment instruments under the regulatory jurisdiction of the Reserve Bank. The Reserve Bank had earlier placed the draft guidelines for issuance/operation of such instruments in public domain for wider dissemination and feedback. Taking into account the comments received from various entities within and outside the country, it is now proposed:

- to permit SCBs which comply with the eligibility criteria to issue all categories of prepaid payment instruments;
- eligible non-bank entities, including NBFCs, will be permitted to issue semi-closed instruments, which can be used to purchase all types of goods and services at an identified network of establishments.

The operating guidelines in this regard are being issued separately.

*(b) Consolidation of Information Technology Systems: Data Centres*

152. The Reserve Bank has set up data centres which were made operational in the second half of 2008. The state-of-the-art data centres provide for a high level of availability of information technology (IT) systems and ensure optimum business continuity management. The critical payment and settlement systems of the Reserve Bank are now operated using the systems at the data centres. Adequate disaster recovery drills are conducted at periodic intervals. While all participating member banks have been able to ensure full participation in these drills by operating from their disaster recovery (DR) sites, there are a few banks which have not been able to meet this objective. In view of the critical importance of such drills and in order to achieve overall systemic efficiency:

- banks are urged to ensure full compliance of these requirements.

*(c) Adequacy of the Fallback Arrangements for Managed IT Systems*

153. Currently, a number of banks have resorted to the retention of service providers to manage their IT-based operational requirements. It has, therefore, become imperative that banks have adequate plans/systems in place so as to manage risks arising out of such outsourcing arrangements. These risks arise on account

of excessive dependence of the system on a single entity (concentration risk), inadequate systems (operational risks) as also on account of failure of these service providers. The Reserve Bank has already issued comprehensive outsourcing guidelines in November 2006. The risk management aspects detailed therein are of particular relevance to a technology service provider. Hence, it is proposed that:

- banks should undertake a comprehensive review of all such outsourced arrangements including on-site inspections of critical service providers and ensure that adequate fallback arrangements are put in place.

### (d) Network Based Operations: RBI Supported Systems

154. The Reserve Bank has taken steps to make the application systems [NDS, real time gross settlement (RTGS), centralised funds management system (CFMS) and structured financial messaging solution (SFMS)] provided by it to operate in an network based environment using the Multi Protocol Label Switching (MPLS). The MPLS approach by using a meshed network topology provides increased redundancies *vis-a-vis* a point to point connectivity at cheaper costs without impacting the security aspects. Accordingly:

- banks are advised to migrate to the MPLS system on a time bound basis.

### (e) Recent Developments

#### (i) Electronic Payment Systems

155. The coverage of bank branches under the electronic payment network, *viz.,* the RTGS and the National Electronic Funds Transfer (NEFT) has increased significantly. While the NEFT network has increased to 54,200 branches at end-March 2009, the RTGS network has increased to 55,000 branches. The RTGS handles, on an average, 80,000 transactions per day, with a peak of 1,28,295 transactions processed as on March 30, 2009.

#### (ii) National Electronic Clearing Service

156. The volume of transactions through national electronic clearing service (NECS), introduced in September 2008, is also increasing. With a view to moving towards the centralised NECS system, the electronic clearing service (ECS) (credit) in Mumbai has been merged with the NECS. As such no separate local ECS clearing is operative in Mumbai.

#### (iii) National Financial Switch

157. The national financial switch (NFS) membership/volume is steadily on the increase. As on March 31, 2009 the NFS network covered a total of 38,714 automated teller machines (ATMs) of 34 banks. On an average, a daily volume of 8,90,180 transactions (of which 2,56,156 transactions pertained to balance enquiry and 6,34,024 pertained to cash withdrawal) were routed through the NFS in March 2009 as against a daily volume of 2,67,598 transactions in March 2008. Furthermore, on an average, the daily value settled through the NFS was around Rs.45 crore in March 2009 as against Rs.26 crore in March 2008. Since April 1, 2009 customers have the facility of using ATM of any bank for cash withdrawal, free of cost, thereby making ATMs national payment outlets rather than bank-specific outlets. This measure has seen a surge in transactions in the NFS network with a peak of 1.1 million transactions on a single day on April 11, 2009.

*(iv) Mobile Payments*

158. As indicated in the Mid-Term Review of October 2008, the operative guidelines for mobile payments were issued on October 8, 2008. So far, 19 banks have obtained permission from the Reserve Bank to provide mobile payment facilities to their customers.

*(v) Rationalisation of Charges for Payment Systems*

159. The Reserve Bank has rationalised various charges for payment systems. Accordingly, service charges levied for transfer of funds under outward RTGS transactions shall not exceed Rs.25 for transactions of Rs.1 lakh and up to Rs.5 lakh, and Rs.50 for transactions of Rs.5 lakh and above. Similarly, for outward NEFT transactions, service charges levied shall not exceed Rs.5 for transfer of funds up to Rs.1 lakh and Rs.25 for transactions of Rs.1 lakh and above.

160. The Reserve Bank has also prescribed maximum charges which could be levied for collection of outstation cheques under which the service charges would not exceed Rs.50 for cheque value up to Rs.10,000. A maximum charge of Rs.100 would be levied for cheque value of Rs.10,000 – Rs.100,000. The service charge would not exceed Rs.150 of cheque value Rs.100,001 and above.

*(vi) Cheque Truncation System*

161. The cheque truncation system (CTS) pilot project was operationalised in Delhi in February 2008 and more than 90 per cent of the cheque volume of Delhi clearing house is now processed through the CTS. The Reserve Bank continues to take steps towards extending the CTS across the country and accordingly, it has been decided to set up the CTS in Chennai.

*(f) The Payment and Settlement Systems Act, 2007*

162. As indicated in the Mid-Term Review of October 2008, the process of issuing authorisation to persons to operate various payment systems has commenced following the notification of the Payment and Settlement Systems Act, 2007 in August 2008. In terms of the Act, all payment system providers/operators including credit card issuing companies and entities engaged in money transfer activity would require authorisation.

## *Urban Co-operative Banks*

*(a) Area of Operations of UCBs*

163. In order to facilitate the growth of well-functioning urban co-operative banks (UCBs) in States, which enter into Memorandum of Understanding (MoU), it is proposed:

- to permit extension of area of operation of Tier II UCBs in Grade I to the entire State of registration with the prior approval of the Reserve Bank.

*(b) Review of Regulatory and Supervisory Framework: UCBs*

164. UCBs are presently on Basel I capital framework with surrogate (additional risk-weight) capital charge on market risks. The Advisory Panel on Financial Regulation and Supervision to the Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla), which looked into the present regulatory and supervisory framework for UCBs, has observed that it would be premature for full migration of UCBs to Basel II at this juncture. However, it recommended assigning duration based

capital charge for market risk for scheduled UCBs that are systemically important and comparable in size to medium-sized commercial banks. Furthermore, the Panel recommended: (i) a review of the existing internal control systems, risk management systems, asset liability management (ALM) and disclosure norms for UCBs; and (ii) the issue of appropriate guidelines. Accordingly, it is proposed:

- to review the existing instructions and issue appropriate guidelines to UCBs on internal controls, risk management systems, ALM and disclosure norms;
- to apply capital charge for market risks in respect of large-sized and systemically important UCBs with effect from April 1, 2010.

### (c) Vision Document for UCBs

165. The Vision Document for UCBs envisaged signing of MoU with the State and Central Governments for harmonisation of dual regulation and supervision of UCBs and setting up of Task Force on Urban Co-operative Banks (TAFCUB) for identification of viable UCBs for their rehabilitation and non-viable UCBs for their non-disruptive exit. Subsequent to the release of the Vision Document in public domain in March 2005, the Reserve Bank has entered into MoUs with 25 State Governments (nine entered during April 2008 to March 2009). As of date, 99 per cent of UCBs and 99 per cent of deposits of the UCB sector are covered under MoU arrangements. The number of UCBs in Grade III and IV, signifying various degrees of sickness, has since declined to 496 as on March 31, 2008 from 725 as on March 31, 2005. Till March 31, 2009 licences had been cancelled or rejected in respect of 85 banks and 31 unlicensed banks in MoU States have been issued banking licences. Since the recommencement of new branch authorisation, 232 licences have been issued for opening of branches by UCBs in MoU States. The initiatives for voluntary mergers and amalgamations of weak UCBs for bringing consolidation in the sector were also carried forward and new policy guidelines on mergers were announced. Sixty-eight mergers between healthy and weak banks have been effected so far. In view of the improved financial condition and enhanced regulatory and supervisory jurisdiction of the Reserve Bank, additional business opportunities were opened up for well-functioning multi-state UCBs and UCBs in MoU States.

### (d) Information Technology Support to UCBs

166. Based on the recommendations of the Working Group which looked into ways of supporting IT initiatives of the UCBs, IDRBT is being asked to facilitate UCBs availing of Core Banking Platform on an Application Service Provider (ASP) model. With this, the UCBs will be able to put in place cost-effective, modern technology so as to render better customer service and sound regulatory compliance.

## Non-Banking Financial Companies

### (a) CRAR for NBFCs-ND-SI

167. The Mid-Term Review of October 2008 had indicated that the CRAR for NBFCs-ND-SI would be raised from 10 per cent to 12 per cent by March 31, 2009 and further to 15 per cent by March 31, 2010. Taking into account the difficulty in raising equity

capital in the current economic environment, it has been decided:

- to defer the implementation of CRAR of 12 per cent to March 31, 2010 and of 15 per cent to March 31, 2011.

### *(b) Time-frame for Realisation of Assets by Securitisation Companies/ Reconstruction Companies*

168. In terms of the extant guidelines, securitisation companies (SCs)/ reconstruction companies (RCs) are required to realise the financial assets within a specified time-frame, which shall not in any case exceed five years from the date of acquisition of financial assets. Requests for extending the time frame in this regard are being examined. As an *interim* measure, it is proposed:

- to give an extension of two more years for realisation of the assets in respect of the security receipts (SRs) issued by SCs/ RCs which have completed five years.

### *(c) Repossession of Vehicles by NBFCs*

169. The issue of repossession of vehicles in the event of non-payment of interest and/or principal of loans given by NBFCs has recently come into focus, and some courts have also ruled in this regard. The Reserve Bank has already advised NBFCs to put in place a Fair Practices Code with the approval of their boards which, *inter alia*, covers recovery of loans. The issue has been discussed with the industry participants and in view of certain queries raised, it is further clarified that:

- NBFCs must have a built-in repossession clause in the contract/loan agreement with the borrower which must be legally enforceable. To ensure transparency, the terms and conditions of the contract/loan agreement should contain detailed provisions in this regard.

A circular to NBFCs to this effect is being issued separately.

### *(d) Special Liquidity Facility for Eligible NBFCs-ND-SI*

170. The Central Government had announced an arrangement for providing liquidity support to eligible NBFCs-ND-SI for meeting the temporary liquidity mismatches through the Industrial Development Bank of India Stressed Asset Stabilisation Fund (IDBI SASF) Trust, which has been notified as special purpose vehicle for undertaking this operation. The facility is meant exclusively for meeting the temporary liquidity mismatches of the NBFCs and not for asset growth.

171. The facility was available for eligible paper issued by NBFCs up to March 31, 2009 with an overall ceiling of Rs.20,000 crore, which was subsequently extended for eligible paper for a further period of three months till June 30, 2009. The facility has been availed to the extent of Rs.750 crore till date.

## *Second Quarter Review*

172. The next review of the Annual Statement on Developmental and Regulatory Policies will be undertaken as part of the second quarter review of monetary policy on October 27, 2009.

**Mumbai**

**April 21, 2009**

## Annex I
## Policy Measures by the Reserve Bank of India: September 2008 Onwards

*September 2008*

- A firm assurance to meet any demand-supply gaps of foreign exchange in the domestic foreign exchange market.
- A second LAF was re-introduced on a daily basis.
- Interest rate ceilings on FCNR(B) and NR(E)RA deposits were increased by 50 basis points each to LIBOR/swap rates minus 25 basis points and LIBOR/swap rates plus 50 basis points respectively.
- As a temporary measure, scheduled banks were allowed to avail of additional liquidity support under the LAF to the extent of up to one per cent of their net demand and time liabilities from their SLR portfolio and seek waiver of penal interest.

*October 2008*

- The CRR was reduced by 250 basis points from 9.0 per cent to 6.5 per cent effective from the fortnight beginning October 11, 2008.
- A 14-day special repo facility for a notified amount of Rs.20,000 crore was instituted to alleviate liquidity stress faced by mutual funds, and banks were allowed temporary use of SLR securities for collateral purposes by an additional 0.5 per cent of NDTL exclusively for this purpose.
- Commercial banks and all-India term lending and refinancing institutions were allowed to lend against and buy back certificates of deposit (CDs) held by mutual funds.
- The Reserve Bank temporarily provided a sum of Rs.25,000 crore as the first instalment under the Agricultural Debt Waiver and Debt Relief Scheme to scheduled banks and NABARD immediately, pending Parliamentary sanction and consequent release of funds by the Central Government.
- Interest rate ceilings on FCNR(B) and NR(E)RA deposits were increased further by 50 basis points each to LIBOR/swap rates plus 25 basis points and LIBOR/swap rates plus 100 basis points respectively.
- Banks were permitted to borrow funds from their overseas branches and correspondent banks to the extent of 50 per cent of their unimpaired Tier-I capital or US $ 10 million, whichever is higher.
- The Reserve Bank announced that it would institute special market operations to meet the foreign exchange requirements of public sector oil marketing companies against oil bonds when they become available.
- On October 20, 2008 the repo rate under the LAF was reduced by 100 basis points to 8.0 per cent.
- The systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI) were permitted to raise short-term foreign currency borrowings.
- External commercial borrowings (ECBs) up to US $ 500 million per borrower per financial year were permitted for rupee expenditure and/or foreign currency expenditure for permissible end-uses

**Annex I**
**Policy Measures by the Reserve Bank of India: September 2008 Onwards** *(Contd.)*

under the automatic route. Further, the all-in-cost ceiling for ECBs of average maturity period of three years and up to five years was raised to 300 basis points, and over five years, to 500 basis points above 6-month LIBOR.

*November 2008*

- The repo rate under the LAF was reduced by 50 basis points to 7.5 per cent with effect from November 3, 2008.
- The CRR was reduced by 100 basis points from 6.5 per cent to 5.5 per cent of NDTL.
- The statutory liquidity ratio (SLR), which was relaxed on a temporary basis earlier, was made permanent and reduced to 24 per cent of NDTL effective November 8, 2008.
- In order to provide further liquidity comfort, a special refinance facility for scheduled commercial banks (excluding RRBs) up to 1.0 per cent of each bank's NDTL as on October 24, 2008 was introduced under Section 17(3B) of the Reserve Bank of India Act, 1934 up to a maximum period of 90 days.
- On October 15, 2008 the Reserve Bank introduced a 14-day special repo facility allowing banks to avail additional liquidity support exclusively for the purpose of meeting the liquidity requirements of mutual funds to the extent of 0.5 per cent of their NDTL. Subsequently, this facility was extended for NBFCs and the relaxation in the maintenance of the SLR was enhanced to the extent of up to 1.5 per cent of their NDTL.
- Buy-back of MSS dated securities was announced to provide another avenue for injecting liquidity to be calibrated with the market borrowing programme of the Government of India.
- The special term repo facility introduced for the purpose of meeting the liquidity requirements of MFs and NBFCs, was extended till end-March 2009. Banks can avail of this facility either on an incremental basis or on a rollover basis within the entitlement of up to 1.5 per cent of their NDTL.
- Interest rate ceilings on FCNR(B) and NR(E)RA deposits were further raised by 75 basis points each to LIBOR/swap rates plus 100 basis points and LIBOR/swap rates plus 175 basis points respectively.
- Housing finance companies (HFCs) registered with the National Housing Bank (NHB) were permitted to raise short-term foreign currency borrowings under the approval route.
- The Reserve Bank permitted Indian corporates to prematurely buy back their FCCBs at prevailing discounted rates.
- The period of entitlement of the first slab of pre-shipment rupee export credit was extended from 180 days to 270 days.
- The aggregate limit of export credit refinance (ECR) facility for scheduled banks (excluding RRBs) was enhanced from 15 per cent to 50 per cent of the outstanding export credit eligible for refinance.
- SIDBI and the NHB were allocated Rs. 2000 crore and Rs.1000 crore respectively against banks' estimated shortfall in priority sector lending in March 2009.

**Annex I**

**Policy Measures by the Reserve Bank of India: September 2008 Onwards** *(Contd.)*

- Banks were encouraged to use the special refinance facility under Section 17(3B) of the Reserve Bank of India Act, 1934 for the purpose of lending to micro and small enterprises.
- The provisioning requirements for all types of standard assets were reduced to a uniform level of 0.40 per cent, except in the case of direct advances to the agricultural and SME sectors which continue to attract provisioning of 0.25 per cent, as hitherto.
- Risk weights on banks' exposures to all unrated claims on corporates, claims secured by commercial real estate and claims on NBFCs-ND-SI were reduced to 100 per cent from 150 per cent.
- The special refinance facility under Section 17(3B) of the Reserve Bank of India Act, 1934 introduced on November 1, 2008 was extended up to June 30, 2009.
- The special term repo facility was expanded to enable banks to accommodate the funding needs of HFCs. The facility was extended up to June 30, 2009.
- On November 7, 2008 Indian public and private sector banks that have foreign branches or subsidiaries were provided a forex swap facility of tenor up to three months with the Reserve Bank. Further, for funding the swap, banks were allowed to borrow under the LAF for the corresponding tenor at the prevailing repo rate. This facility was subsequently extended up to June 30, 2009.
- The period of entitlement of the first slab of post-shipment rupee export credit was extended from 90 days to 180 days.

*December 2008*

- The repo rate under the LAF was reduced by 100 basis points from 7.5 per cent to 6.5 per cent and the reverse repo rate by 100 basis points from 6.0 per cent to 5.0 per cent, effective December 8, 2008.
- A refinance facility was introduced for SIDBI, NHB and EXIM Bank for Rs. 7,000 crore, Rs.4,000 crore and Rs.5,000 crore respectively. This facility will be available up to March 31, 2010.
- Authorised Dealers Category-I banks were permitted to consider applications for premature buy-back of FCCBs from their customers.
- Loans granted by banks to HFCs for on-lending for housing up to Rs.20 lakh per dwelling unit were classified under priority sector.
- Commercial real estate exposures restructured up to June 30, 2009 were allowed to be treated as standard assets. As a one-time measure, the second restructuring done by banks of exposures (other than exposures to commercial real estate, capital market exposures and personal/consumer loans) up to June 30, 2009 was also made eligible for concessional regulatory treatment.
- The prescribed interest rate as applicable to post-shipment rupee export credit (not exceeding BPLR minus 2.5 percentage points) was extended to overdue bills up to 180 days.

*January 2009*

- The repo rate under the LAF was reduced by 100 basis points from 6.5 per cent to 5.5 per cent with effect from January 5, 2009.

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**Policy Measures by the Reserve Bank of India: September 2008 Onwards** *(Contd.)*

- The reverse repo rate under the LAF was reduced by 100 basis points from 5.0 per cent to 4.0 per cent with effect from January 5, 2009.
- The CRR was reduced from 5.5 per cent to 5.0 per cent of NDTL effective from the fortnight beginning January 17, 2009.
- In order to address the temporary liquidity constraints of systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI), the Government announced the setting up of a special purpose vehicle (SPV). According to the scheme announced, the SPV was allowed to mobilise resources through issuance of government guaranteed securities for investment in CPs and NCDs of NBFCs-ND-SI. Government guaranteed securities were required to be purchased by the Reserve Bank. The SPV was to ensure that the NBFCs used the money only for addressing liquidity constraints and not for business expansion. The total support from the Reserve Bank was limited to Rs.20,000 crore with an option to raise it by a further Rs.5,000 crore.
- The special term repo facility under LAF for the purpose of meeting the funding requirements of MFs, NBFCs and HFCs was extended up to September 30, 2009.
- The special refinance facility for scheduled commercial banks under Section 17 (3B) of the RBI Act, 1934 was extended up to September 30, 2009.
- The all-in-cost ceiling for ECBs through the approval route has been dispensed with up to June 30, 2009.

*February 2009*

- The Forex Swap facility was extended till March 31, 2010.
- Banks were allowed to apply special regulatory treatment for accounts which were standard on September 1, 2008 and taken up for restructuring up to January 31, 2009 even if these had turned non-performing along this period. Subsequently, the time schedule for taking up restructuring was extended up to March 31, 2009.
- The ceiling rate on export credit in foreign currency was raised from LIBOR + 100 basis points to LIBOR + 350 basis points on February 5, 2009 subject to the condition that the banks would not levy any other charges.
- Correspondingly, the ceiling interest rate on the lines of credit with overseas banks was also increased from 6 months LIBOR/ EURO LIBOR/ EURIBOR + 75 basis points to six months LIBOR/ EURO LIBOR/ EURIBOR + 150 basis points.

*March 2009*

- The repo rate under the LAF was reduced by 50 basis points from 5.5 per cent to 5.0 per cent with effect from March 5, 2009.
- The reverse repo rate under the LAF was reduced by 50 basis points from 4.0 per cent to 3.5 per cent with effect from March 5, 2009.
- The MoU signed by the RBI with the Government on March 25, 2004 on the MSS was amended on February 26, 2009 to enable the transfer of a part of the

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**Policy Measures by the Reserve Bank of India: September 2008 Onwards** *(Concld.)*

amount in the MSS cash account to the normal cash account as part of the Government's market borrowing programme for meeting Government's approved expenditure. An amount of Rs.12,000 crore was transferred from the MSS account to the normal cash account of the Government of India on March 4, 2009 and an equivalent amount of Government securities issued under the MSS formed a part of the normal market borrowing of the Government of India. Based on the emerging fund requirements of the Government, Rs.33,000 crore of MSS would be de-sequestered against the approved market borrowing programme or bought back in the fiscal year 2009-10.

- The Reserve Bank announced OMO purchase of government securities of the order of Rs.80,000 crore in the first half of 2009-10, of which Rs.40,000 crore is envisaged for the first quarter of 2009-10.
- The facility of providing liquidity support to meet the temporary liquidity mismatches for eligible non-banking non-deposit taking systematically important financial companies (NBFCs-ND-SI), which was initially available for any paper issued up to March 31, 2009 was extended for any paper issued up to June 30, 2009. Accordingly, the SPV would cease to make fresh purchases after September 30, 2009 and would recover all dues by December 31, 2009.

## Annex II
## G-20 Working Group on Enhancing Sound Regulation and Strengthening Transparency: Current Status of the Reserve Bank on the Recommendations

Measures for strengthening the regulation of the financial system were considered by the G-20 Working Group on Enhancing Sound Regulation and Strengthening Transparency. The recommendations of the Group and the status with regard to the relevant items for India are set out below.

### *System-wide Approach to Financial Regulation*

#### *Recommendation 1*

*As a supplement to their core mandate, the mandates of all national financial regulators, central banks, and oversight authorities, and of all international financial bodies and standard setters (IASB, BCBS, IAIS and IOSCO) should take account of financial system stability.*

- Over the last few years, financial stability has emerged as a key objective of the Reserve Bank's policy. Accordingly, several measures have been taken in recent years to promote financial stability. As recommended by the Committee on Financial Sector Assessment (CFSA), a Financial Stability Unit is being set up.

#### *Recommendation 2*

*Within each country, there should be an effective mechanism for appropriate domestic financial sector authorities to jointly assess the systemic risks across the financial system and to co-ordinate the domestic policy response to limit the build-up in systemic risk. The structure of this coordinating mechanism should be transparent, with clear assignments of roles, responsibilities and accountability for each authority.*

- In India, the High Level Co-ordination Committee on Financial Markets (HLCCFM) provides a co-ordination mechanism among financial sector regulators, *viz.*, Reserve Bank of India (RBI), Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority (IRDA) and Provident Fund Regulatory and Development Authority (PFRDA). It is supported by other technical committees/ sub-committees, which examine issues relating to entities under various regulators that have cross-sector implications.
- There are separate technical committees for RBI regulated entities, SEBI regulated entities and IRDA regulated entities. These committees review capital market related developments and based on an early warning system attempt to identify any unusual developments that may require co-ordinated action. Exchange-traded currency futures and interest rate futures, financial conglomerate monitoring framework, crisis management group and a corporate bond and securitisation advisory committee have been introduced through co-ordination of inter-regulatory agencies.

#### *Recommendation 3*

*Financial sector authorities should have suitable macroprudential tools to address systemic vulnerabilities.*

- The Reserve Bank has been using various macro-prudential tools to address banking system risks. For instance, during the expansionary phase of 2004-07, the Reserve Bank took various measures to restrict unbridled growth of credit. These

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included increased provisioning for standard advances and increased risk weights in respect of certain asset classes. However, subsequently, during slow credit growth phase beginning November 2008, those counter-cyclical measures were reversed. The Reserve Bank will continue to make efforts to develop and use further macro-prudential tools and would also consider using any tools that may be developed or recommended by international standard setting bodies.

*Recommendation 4*

*The expanded FSF, together with the IMF, should create an effective mechanism for key financial authorities in each country to regularly come together around an international table to jointly assess the systemic risks across the global financial system and to coordinate policy responses.*

- The G-20 has redesignated the Financial Stability Forum (FSF) to Financial Stability Board (FSB) and its membership has, *inter alia,* been enlarged to include, all G-20 member countries, including India. The Reserve Bank, the Government of India and the SEBI look forward to contributing actively and effectively to the work and initiatives of the FSB and the BCBS.

## Scope of Regulation

*Recommendation 5*

*All systemically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight, consistently applied and proportionate to their local and global systemic importance. Non-systemically important financial institutions, markets and instruments could also be subject to some form of registration requirement or oversight, depending on the type and degree of risk posed, for example for the integrity or efficiency of markets.*

*National authorities should have the authority to expand the perimeter of regulation in a timely way, recognizing that it may vary across countries and through time.*

- Banks, which form the largest segment of the Indian financial system, are closely regulated by the Reserve Bank. In recent years, the Reserve Bank has extended its detailed prudential regulation to systemically important non-deposit taking NBFCs (NBFCs-ND-SI) also. The Reserve Bank oversees the payment and settlement systems, regulates money markets, foreign exchange market and government securities market.
- Issues relating to expansion of the perimeter of regulation to those institutions which are not prudentially regulated and are systemically important could be deliberated in the HLCCFM.

*Recommendation 6*

*The systemic importance of financial institutions, markets and instruments depends on a wide range of factors, including their size, leverage, interconnectedness, as well as funding mismatches. The IMF, in consultation with the BIS and the expanded FSF and other bodies, should jointly develop a common*

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*international framework and guidelines to help national authorities assess whether a financial institution, market or an instrument is systemically important as consistently as possible across jurisdictions.*

- The Reserve Bank is committed to follow sound international practices and standards. When a common international framework is available to help national authorities to assess whether a financial institution, market or an instrument is systemically important, the Reserve Bank will use the framework to further sharpen its focus with regard to the supervision of those institutions considered systemically important in consultation with the Government and other regulatory authorities, as necessary, consistent with the legal framework.

*Recommendation 7*

*Large complex financial institutions require particularly robust oversight given their systemic importance, which arises in part from their size and interconnectedness (or correlation) with other institutions, and from their influence on markets.*

- Following the report on financial conglomerates (FCs), a monitoring mechanism for the identified FCs has been in place since 2004 in co-operation with other regulators. Since April 2005, the FC monitoring mechanism has been further strengthened with the introduction of half-yearly discussion with the CEOs of the major group entities within the FC.
- As indicated in the Mid-term Review of October 2008, an 'approach paper' on the supervision of financial conglomerates has since been prepared by an Internal Group. The recommendations of the Group are being examined from the regulatory and supervisory perspectives for initiating appropriate action.
- As part of its endeavour to strengthen the supervision of banking groups, the Reserve Bank extended the major elements of prudential regulations, *viz.*, capital adequacy and exposure norms to all the subsidiaries of commercial banks in 2003.

*Recommendation 8*

*The boundaries of the regulatory framework should be reviewed periodically within national jurisdictions, in light of financial innovation and broader trends in the financial system. International bodies will promote good practice and consistent approaches in this area.*

- The Reserve Bank regularly interacts with other regulators of the financial system within the national jurisdiction, *viz.*, SEBI, the securities regulator, IRDA, the insurance regulator and PFRDA, the regulator of pension funds. The Reserve Bank has also been associated with various international bodies such as G-20 and the BIS, and now also with the FSB and the BCBS.
- The issue of review of the boundaries of the regulatory framework will be kept in focus, both in the interaction with sectoral regulators within the national jurisdiction and with international bodies.

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## *Oversight of Credit Rating Agencies*

### *Recommendation 9*

*All credit rating agencies whose ratings are used for regulatory purposes should be subject to a regulatory oversight regime that includes registration and that requires compliance with the substance of the IOSCO Code of Conduct Fundamentals. National authorities should obtain the authority to enforce compliance and require changes to a rating agency's practices and procedures for managing conflicts of interest and for assuring the transparency and quality of the rating process.*

- In India, all credit rating agencies are registered with the SEBI. The Reserve Bank has accorded accreditation to four credit rating agencies registered with the SEBI for the limited purpose of using their ratings for assigning risk weights within the framework of the Basel II Accord which has been implemented by all banks as at the end of March 2009. Prior to the accreditation, the Reserve Bank had undertaken a review of the rating agencies' practices and procedures to ensure that they comply with the criteria prescribed for accreditation in the Basel II framework.
- Since the Indian banking system has migrated to the Basel II framework, there is a need to review the performance of the credit rating agencies for continuation of the accreditation, especially by looking at the latest data relating to cumulative default rate and transition matrix of the rating agencies. The Reserve Bank will liaise with the SEBI on the issue of rating agencies' adherence to the IOSCO Code of Conduct Fundamentals.

## *Private Pools of Capital*

### *Recommendation 10*

*Private pools of capital, including hedge funds, can be a source of risk owing to their combined size in the market, their use of leverage and maturity mismatches, and their connectedness with other parts of the financial system. They or their managers should therefore be required to register with financial authorities and disclose appropriate information to assess the risks they pose.*

- In India, venture capital funds and mutual funds are registered and regulated by the SEBI. Hedge funds do not operate in India at present. The Reserve Bank proposes to issue a paper on prudential issues in banks' floating and managing private pools of capital to finalise the regulatory guidelines.

## *Transparent Assessment of Regulatory Regimes*

### *Recommendation 11*

*All G-20 members should commit to undertake a Financial Sector Assessment Program (FSAP) report and to publish its conclusions. National authorities may also periodically undertake a self-assessment of their regulatory frameworks based on internationally agreed methodologies and tools.*

- India first participated in an FSAP in 2001 conducted by the IMF and the World Bank and also associated with the independent

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assessment of standards and codes by the Fund/Bank. It also conducted a self-assessment of compliance with international standards and codes in 2002 and its review in 2004 and put these reports in public domain. Since the last FSAP in 2001, India has undertaken a series of ongoing reforms in the financial sector aimed at improving its soundness, resilience and depth. India has completed a comprehensive self-assessment of the financial sector in 2009 under a Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) based on the IMF-WB methodology. The assessment, comprising six volumes, has been published and put in the public domain along with the comments of the internationally acclaimed Peer Reviewers on March 30, 2009. The Reserve Bank will set up a Task Force to take steps for implementation of the recommendations of the two G-20 Working Groups *viz.*, Enhancing Sound Regulations and Strengthening Transparency, and Reinforcing International Co-operation and Promoting Integrity in Financial Markets and will also continuously monitor the implementation. The Task Force will also look into all the issues that have arisen and what follow-up actions relevant to the Reserve Bank need to be taken regarding the recently released report of the Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla). The Task Force would suggest an implementation schedule for every quarter on a rolling basis.

## *Procyclicality*

### *Recommendation 12*

*The FSF and other bodies, particularly the BCBS, should develop and implement supervisory and regulatory approaches to mitigate procyclicality in the financial system by promoting the build-up of capital buffers during the economic expansion and by dampening the adverse interaction between fair valuation, leverage and maturity mismatches in times of stress.*

- As against the Basel norm for minimum CRAR of 8 per cent, in India, banks are required to maintain a minimum CRAR of 9 per cent. The overall CRAR of all scheduled commercial banks continued to be strong and it was at 13 per cent at the end-March 2008 and 13.1 per cent at end-December 2008. The Reserve Bank recognises the need for mitigating the element of procyclicality embedded in the regulatory norms as it may exacerbate cyclical trends. With this objective in view, the Reserve Bank has been employing a menu of macroprudential tools to mitigate the impact of procyclicality.
- FSB and member bodies, BCBS and CGFS have been entrusted with the work of developing regulatory and supervisory approaches to mitigate procyclicality. They are expected to develop a strategic plan by Fall 2009. India will take further action in this regard as per global consensus emerging from the work of international bodies.

### *Recommendation 13*

*Accounting standard setters should strengthen accounting recognition of loan loss provisions by considering alternative approaches*

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*for recognizing and measuring loan losses that incorporate a broader range of available credit information. They should also examine changes to relevant standards to dampen adverse dynamics associated with fair value accounting, including improvements to valuations when data or modelling is weak. Accounting standards setters and prudential supervisors should work together to identify solutions that are consistent with the complementary objectives of promoting the stability of the financial sector and of providing transparency of economic results in financial reports.*

- The Reserve Bank introduced the asset classification and loan provisioning norms in the year 1991-92 which prescribe the minimum provisioning based on classification of assets. Certain areas of difference exist between the requirements of accounting standards in respect of loan loss provisioning (accounting perspective) and the Reserve Bank's present regulatory approach and the Basel II approach of calculating expected loan losses (regulatory perspective). Internationally, there are attempts for a convergence in this regard between the Accounting Task Force (ATF) of the BCBS and the IASB. The Reserve Bank will fine tune its policies in tandem with developments at international level in this regard.
- The Reserve Bank has, over the years, issued guidelines on valuation of various instruments/assets in conformity with the international best practices while keeping India-specific conditions in view. In order to encourage market discipline, the Reserve Bank has developed a set of disclosure requirements which allow the market participants to assess key pieces of information on capital adequacy, risk exposure, risk assessment processes and key business parameters which provide a consistent and understandable disclosure framework that enhances comparability. Banks are also required to comply with the Accounting Standard (AS) on disclosure of accounting policies issued by the Institute of Chartered Accountants of India (ICAI).

## *Capital*

### *Recommendation 14*

*Capital should serve as an effective buffer to absorb losses over the cycle, so as to protect both the solvency of financial institutions in the event of losses, and their ability to lend.*

*In the near term, capital buffers above required minimums should be allowed to decline in response to deteriorating economic conditions and credit quality, and urgent consideration should be given to measures that would facilitate access to additional private sector capital in the downturn.*

*Once conditions in the financial system have recovered, the adequacy of the international standard for the minimum level of capital for banks should be reviewed and the quality and global consistency of capital should be enhanced. In addition, capital buffers above minimum requirements and loan-loss provisions should be built up in good times in order to enhance the ability of regulated financial institutions to withstand large shocks.*

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- Once conditions in the global financial system recover, the Reserve Bank would consider enhancing the minimum capital standards in tandem with the proposals at the international level. The build-up of capital and provisioning buffers in good times will be encouraged by the Reserve Bank so that capital can absorb unexpected losses and be drawn down during difficult times.

*Recommendation 15*

*G-20 leaders should support the progressive adoption of the Basel II capital framework, which will continue to be improved on an ongoing basis, across the G-20.*

- All commercial banks in India were Basel II compliant as on March 31, 2009. Initially the base approach of the Basel II framework have been adopted. The Reserve Bank has placed on its website a draft circular giving an indicative timeframe for implementation of the advanced approach of the Basel II framework. The enhancement to current Basel II framework by the international standard setting bodies will be considered for implementation as appropriate.

## *Liquidity*

*Recommendation 16*

*Prudential supervisors and central banks should deliver a global framework for promoting stronger liquidity buffers at banks, including cross-border institutions, to ensure that they can withstand prolonged periods of market and funding liquidity stress.*

- Indian banks have a significant holding of liquid instruments as they are required to maintain cash reserve ratio and statutory liquidity ratio (5 per cent and 24 per cent of their net demand and time liabilities, as at present). The substantial CRR/SLR holding offers, in effect, a good liquidity buffer. There are prudential norms governing unsecured overnight borrowings by banks and inter-bank liabilities.
- The Reserve Bank has examined the issue of banks establishing a more robust liquidity risk management framework that is well integrated into the bank-wide risk management process by adopting global liquidity planning. In this context, banks will be required to integrate their various foreign currency assets and liabilities positions from their branch operations in India with the rupee asset liability position.

## *Infrastructure for OTC Derivatives*

*Recommendation 17*

*Financial institutions should continue to strengthen the infrastructure supporting OTC derivatives markets. In the case of credit derivatives, this includes standardizing contracts to facilitate their clearing through a central counterparty. National authorities should enhance incentives as needed for the use of central counterparties to clear OTC credit derivatives.*

*Recommendation 18*

*Central counterparties should be subject to transparent and effective oversight by prudential supervisors and other relevant*

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*authorities, including central banks, and meet high standards in terms of risk management, operational arrangements, default procedures, fair access and transparency. The CPSS and IOSCO should review their experiences in applying their recommendations for central counterparties to derivatives.*

- The CCIL provides an institutional structure for the clearing and settlement of transactions undertaken in government securities, money market instruments and foreign exchange products and has adopted the core principles set by the CPSS and IOSCO. In October 2007, CCIL has joined as a member of the CCP 12, an international organisation of central counterparty (CCP) clearing organisations.
- CCIL's role is being gradually extended to the OTC derivatives segment, initially as a reporting platform and thereafter, covering the settlement aspect.
- The Payment and Settlement Systems Act, 2007 has designated the Reserve Bank as the authority to regulate and supervise the payment and settlement systems in the country.
- The netting procedure and settlement finality, earlier governed by contractual agreement/s, have been accorded legal recognition under the Act. The Reserve Bank is empowered to issue directions and guidelines to the system providers, prescribe the duties to be performed by them and audit and inspect their systems/premises.
- The recommendations of the CPSS and the IOSCO when available will be applied as appropriate to CCIL.

## *Compensation Schemes and Risk Management*

### *Recommendation 19*

*Large financial institutions should ensure that their compensation frameworks are consistent with their long-term goals and with prudent risk-taking. As such, the Boards of Directors of financial institutions should set clear lines of responsibility and accountability throughout their organizations to ensure that the design and operation of its remuneration system supports the firm's goals, including its overall risk tolerance. Shareholders may have a role in this process. Boards should also ensure there are appropriate mechanisms for monitoring remuneration schemes.*

### *Recommendation 20*

*In order to promote incentives for prudent risk taking, each financial institution must review its compensation framework to ensure it follows sound practice principles developed by the FSF. These include the need for remuneration systems to provide incentives consistent with the firm's long-term goals, to be adjusted for the risk taken by employees, and for the variable components of compensation to vary symmetrically according to performance.*

### *Recommendation 21*

*Prudential supervisors should enhance their oversight of compensation schemes by taking the design of remuneration systems into account when assessing risk management practices. The BCBS should more explicitly integrate this dimension in its guidance for the*

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*assessment of risk management practices by national prudential supervisors.*

- In terms of Section 35 B of the Banking Regulation Act, 1949 banks in the private sector and foreign banks in India are required to obtain the approval of the Reserve Bank for remuneration payable to their CEOs (the remuneration of public sector bank CEOs is fixed by the Government of India).
- While devising the total remuneration package (including all perquisites and bonus) of CEOs and whole-time directors, Boards of private banks are required to ensure that the total package is reasonable in the light of industry norms including size of the business in India. The Compensation Committee which looks into the remuneration issue is required to have adequate representation of independent directors and directors, if any, representing major institutional shareholders in India. Remuneration of foreign banks' CEOs is mainly driven by the policies of their head offices.
- The Reserve Bank would recommend the implementation of the sound procedures/ principles developed by the FSB for financial institutions regarding the compensation packages.

## *Transparency*

### *Recommendation 22*

*Accounting standard setters should accelerate efforts to reduce the complexity of accounting standards for financial instruments and enhance presentation standards to allow the users of financial statements to better assess the uncertainty surrounding the valuation of financial instruments.*

- International Accounting Standards/ International Financial Reporting Standards (IAS/IFRS) are adopted as a basis for formulation of Indian standards and due consideration is given to local customs, usage, practices, legal and regulatory environment. The Reserve Bank has taken a proactive role in the area of adherence by banks to the Accounting Standards. The Reserve Bank also actually participates in the standard setting process through its nominees in the Accounting Standards Board and the National Advisory Committee on Accounting Standards.
- IASB is in the process of issuing a new globally accepted standard in place of the existing financial instruments standard (IAS 39 *Financial Instruments: Recognition and Measurement)* that would address issues arising from the financial crisis in a comprehensive manner. Implementation of the standard in the Indian context will arise after it is finalised by IASB and adopted by ICAI as a part of its convergence programme.
- The Reserve Bank has, over the years, issued guidelines on valuation of various instruments/assets in conformity with the international best practices while keeping India-specific conditions in view.
- The securitisation framework in India is considered to be reasonably prudent and has been able to minimise the incentives that have led to the problems which surfaced in the current crisis.

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*Recommendation 23*

*The IASB should enhance its efforts to facilitate the global convergence towards a single set of high-quality accounting standards by sharing the experience of countries that have completed this process and by providing technical assistance.*

- The recently published report of the CFSA on India's financial sector assessment has stated that the Indian accounting standards are generally in alignment with international accounting standards, except for some modifications to suit local customs, usages and level of development in the country. There has been significant progress in the area of convergence of accounting standards. The Indian accounting standards are expected to be fully convergent with IFRSs with effect from April 1, 2011 when IFRSs are likely to be adopted in India for listed and other public interest entities.

## Enforcement

*Recommendation 24*

*The effective enforcement of regulation should be a priority of all financial regulators. As such, national financial regulators and oversight authorities should ensure the effectiveness of their enforcement activities and that appropriate resources are available for monitoring the application of regulation and for prosecuting offenders. The enforcement function should be independent from other activities or from external influences.*

- Regulations issued by the Reserve Bank are monitored by its supervisory department. The Banking Regulation Act, 1949 has prescribed extensive penalties for non submission or willful omission of information, for making false statements, and for not following directions issued by the Reserve Bank. Apart from this, the Reserve Bank can impose penalties under specific powers granted to it under the Act. Similar provisions exist in the Credit Information Companies (Regulation) Act, 2005 and the Payment and Settlement Systems Act, 2007. The penalties imposed by the Reserve Bank under the BR Act are placed in public domain.

## Technical Assistance and Capacity Building in Emerging Market Economies

*Recommendation 25*

*Recognizing that the degree of development of financial systems varies considerably across the G20, national authorities should commit to assist each other in enhancing their capacity to strengthen regulatory frameworks. In addition, IOSCO, the IAIS and the BCBS should have the appropriate capacity to provide technical assistance. The needs of emerging market economies deserve particular consideration.*

- India has been striving for adopting the international best practices, tailored to country-specific conditions. Accordingly, the capacity building of all stakeholders has been progressively upgraded. The Reserve Bank has also conducted several international seminars often in collaboration with international bodies, to upgrade the skill levels in various

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developing economies. The Reserve Bank will continue such efforts.

## *G-20 Leaders' Declaration*

The other important elements for strengthening the financial system as contained in the G-20 Leaders' declaration are:

## *International Cooperation*

*To establish the remaining supervisory colleges for significant cross border firms by June 2009 building on 28 already in place.*

- India has been actively participating in supervisory colleges conducted by overseas home regulators of foreign banks operating in India. No Indian bank has significant presence in foreign jurisdictions so as to render them systemically important there. As and when Indian banks attain critical level of operations, the Reserve Bank will consider convening supervisory colleges.

*To implement the FSF principles for cross-border crisis management immediately, and that home authorities of each major international financial institutions should ensure that the group of authorities with a common interest in that financial institution meet at least annually;*

*To support continued efforts by the IMF, FSB, World Bank, and BCBS to develop an international framework for cross-border bank resolution arrangements;*

- An Internal Working Group constituted to lay down the road map for adoption of a suitable framework for cross-border supervision and supervisory co-operation with overseas regulators has submitted its report in January 2009. The recommendations of the Group are being examined for initiating further action.
- Further, an Inter-departmental Group is examining additional areas/issues which need to be brought under supervisory focus, including modalities for on-site supervision of overseas branches and subsidiaries of Indian banks. The group is expected to submit its report by end May, 2009.
- As and when international framework is developed by international agencies/ standard setters, India will adopt the same in line with country specific needs.

## *Tax havens and non-cooperative jurisdictions*

*Increased disclosure requirements on the part of taxpayers and financial institutions to report transactions involving non-cooperative jurisdictions.*

- In India, banks have been advised to be extremely cautious while continuing relationships with respondent banks located in countries with poor know-your-customer (KYC) standards and countries identified as 'non-co-operative' in the fight against money laundering and terrorist financing.
- The AML/CFT guidelines issued by the Reserve Bank are in consonance with the FATF recommendations and the Reserve Bank would continue to incorporate in its regulations latest international best practices.