Statement by Dr. Bimal Jalan, Governor,
Reserve Bank of India on Monetary and Credit
Policy for the year 2000-2001

The Statement consists of three parts: (I) Review of Macro-economic and Monetary Developments during 1999-2000*, (II) Stance of Monetary Policy for 2000-2001, and (III) Financial Sector Reforms and Monetary Policy Measures.

I. Review of Macro-economic and Monetary Developments: 1999-2000

Domestic Developments

2. According to the estimates of the Central Statistical Organisation (CSO), the GDP growth in 1999-2000 is likely to be 5.9 per cent as compared with 6.8 per cent in 1998-99 and 5.0 per cent in 1997-98. (It may be noted that the CSO figures for 1998-99 have been substantially revised upwards because of increase in the growth rate of agriculture and allied activities to 7.2 per cent during that year.) A welcome feature of macro-economic developments last year was a substantial acceleration in the growth of industrial output, particularly manufacturing output. Recovery in industrial production, witnessed during the first six months of the year was further consolidated during the second half of the year. During April 1999-February 2000, industrial growth was 7.9 per cent, with manufacturing output showing a growth of 8.8 per cent.

3. The annual rate of inflation as reflected in the movements in the wholesale price index (1981-82=100) during the year was 3.74 per cent (on a point-to-point basis) and was 2.97 per cent (on an average basis). The inflation rates were significantly lower than in the preceding year+. The reduction in the rate of inflation was also reflected in the Consumer Price Index (CPI). The CPI for the month of February 2000 showed an increase of 3.61 per cent over the previous year (as compared with 8.64 per cent in February 1999). A relatively high growth of output, fuelled by sustained industrial recovery, combined with low inflation and high reserves, provided a positive environment for monetary management in 1999-2000.

4. During 1999-2000, the annual growth in M_3, on a point to point basis, was 13.6 per cent (provisional) as against 19.2 per cent in 1998-99. The aggregate deposits of the scheduled commercial banks increased by 13.5 per cent as against 19.3 per cent in the previous year. It may be mentioned that a substantial part of the increase in the aggregate deposits was due to increase in time deposits (of over Rs.87,187 crore). This is a continuation of the pattern observed in 1998-99 when almost the entire increase in the aggregate deposits was accounted for by increase in time deposits.

5. Non-food credit showed an expansion of 16.0 per cent as against an increase of 13.0 per cent in the previous year. The total flow of funds from scheduled commercial banks to the commercial sector, including banks' investments in bonds/debentures/shares issued by public sector undertakings (PSUs) and private corporate sector and commercial paper, etc., is estimated at Rs.69,380 crore as against Rs.56,558 crore in the corresponding period of the previous year. Total resource flow to the commercial sector, including capital issues, Global Depository Receipts (GDRs) and borrowings from financial institutions, is placed at Rs.1,34,013 crore as compared with Rs.1,13,488 crore in the previous year. The faster

growth in bank credit to the commercial sector despite a lower growth in deposits was facilitated by substantial reduction in cash reserve ratio (CRR) and increase in non-deposit sources of funds, such as bills payable, operating surplus, etc.

6. Partly as a result of tax concessions extended to mutual funds in the last year's Budget, there was a substantial increase in resources flowing to such funds during 1999-2000. Preliminary figures indicate that mutual funds have mobilised net resources of Rs.17,966 crore during the year as compared with a net outflow of Rs.1,204 crore in the previous year. Further growth and development of mutual funds, provided they are able to compete for household and corporate savings without special concessions, could contribute to the development and stability of the financial system in the long run. A developed financial infrastructure, with multiple intermediaries operating in different asset markets with varying risk profiles, is likely to be less vulnerable to unanticipated developments, including external shocks.

7. Food credit expansion during the year was of the order of Rs.8,875 crore as against Rs.4,331 crore in the previous year. Investment by scheduled commercial banks in government securities increased by Rs.54,612 crore during the year as against Rs.36,261 crore in the previous year. The share of lending to government in the overall deployment of resources by the scheduled commercial banks during the year was substantially larger than in the previous year.

8. As per the Revised Estimates in the Union Budget, the fiscal deficit of the Central Government (excluding small savings) for 1999-2000 was higher at 5.6 per cent of GDP as against budgeted figure of 4.0 per cent. As a result, gross market borrowings exceeded the budgeted level by Rs. 15,616 crore. In addition, State Governments' gross market borrowings amounted to Rs. 13,706 crore as against Rs.12,114 crore in the previous year

9. Due to favourable macro-economic environment, the Reserve Bank was able to meet the large market borrowing requirements of government without too much stress and without causing upward pressure on interest rates. In fact, secondary market yields on government securities of 7-year and 10-year maturity were nearly 110-120 basis points lower at end-March 2000 than those prevailing a year ago. Since 1998-99, a conscious attempt has been made to elongate the maturity structure of marketable debt of the Government to avoid bunching of redemption with consequent pressure on sustainability of the gross market borrowing programme. During 1999-2000, there was no issue of dated securities up to 5 years. Furthermore, about 65 per cent (Rs.56,630 crore) of the total dated securities (Rs.86,630 crore) issued during the year was above 10-year maturity.

10. An important monetary development during the year has been the negative growth in the monetised deficit of the Government (i.e., net Reserve Bank credit to Government), and low growth of reserve money, despite large borrowing requirements. As on April 24, 2000, i.e., a day before the final closing of government accounts, the monetised deficit of the Government was negative by as much as Rs.5,584 crore, reflecting the success achieved by Reserve Bank in activating its Open Market Operations (OMO). This compares with an increase in the monetised deficit by Rs.11,800 crore in 1998-99 and by Rs.12,915 crore in 1997-98. So far as reserve money is concerned, the increase during the year was only 8.1 per cent as compared with 14.6 per cent in the previous year.

11. The relatively low growth of M_3 of 13.6 per cent (as compared with 19.2 per cent last year) was possible because of a lower expansion in reserve money. Particularly significant was the decline in the monetised deficit of the government which contributed to this favourable outcome. It is interesting to note that if the reserve money growth and monetised deficit were of the same order in 1999-2000 as in the previous year, on the basis of the normal relationship among these variables, M_3 expansion could have actually been even higher than last year, which would have had an unfavourable effect on the inflationary outlook for the current year.

12. While some comfort can be drawn from the fact that we have been able to manage a large government borrowing programme without undue strain on interest rates or the overall liquidity environment, it is also clear that such high levels of fiscal deficits are not sustainable over the medium term. The continuing large fiscal deficits year after year have already led to sharp increase in repayment obligations on outstanding public debt in the nineties. In 1990-91, the gross and net borrowing of the Central Government stood respectively at Rs.8,988 crore and Rs.8,001 crore in a ratio of 1:0.89. Thus, for every rupee of fresh borrowing, the government received 89 paise in net terms. In 2000-01, the gross and net borrowings of the government are projected at Rs.1,17,704 crore and Rs.76,383 crore respectively. Thus, in the current year, the net receipt for every rupee of borrowing will be only 65 paise. Yet another consequence of larger borrowings is the substantial increase in interest payments which will touch Rs.1,01,266 crore in 2000-01. Interest payments in 1990-91 were only Rs.21,498 crore.

13. The large borrowing programmes of Government year after year have also put pressure on the absorptive capacity of the market. The banking system now holds government securities of around 34.3 per cent of its net demand and time liabilities as against a minimum statutory requirement of 25 per cent. In terms of volume, the holdings above the Statutory Liquidity Ratio (SLR) amounted to about Rs.85,000 crore, which is higher than the last year's net borrowings.

14. The overall monetary management has also become much more complex now than was the case a few years ago. The last year's positive outcome was partly due to the fact that the economy was in a phase of business cycle when there was no problem of excess demand or emerging inflationary pressures. If the economy were characterised by excess demand and liquidity pressures, it would have been difficult to meet the large borrowing requirements of government without a sharp increase in interest rates and some crowding out of private investments. Under those circumstances, the economy could have slipped into a vicious circle of tight liquidity and high interest rates. It is of utmost importance that such an eventuality is avoided by taking credible fiscal action urgently. A national consensus on an effective and time bound programme of fiscal correction is, therefore, essential so that efforts made in this direction in the Union Budget for 2000-01 can be further intensified.

External Developments

15. A notable development affecting India's balance of payments during the year was the sharp increase in prices of crude oil and petroleum products. In the last 16 months, crude oil prices increased by around 150 per cent from US $ 10-11 per barrel during January 1999 to about US $ 25 per barrel during most part of March 2000. Following the recent decision of OPEC to increase production, oil prices have declined to around US $ 20-21 per barrel in April 2000.

16. The impact on oil import bill, due to increase in the prices of oil, is estimated to be US $ 12 billion during the year 1999-2000. Fortunately, the increase in oil import bill was absorbed without an undue pressure in the overall current account deficit. The current account deficit is likely to be around 1.0 per cent of the GDP in 1999-2000, i.e., the same level as in the previous year. The relatively low current account deficit was made possible by a turnaround in exports, lower growth of non-oil imports and continued buoyancy in invisible receipts. After taking into account the recent changes in oil prices as well as changes in EXIM policy, the current account deficit in the year 2000-2001 is still expected to be well below 2 per cent of GDP.

17. Developments in respect of both the exchange rate of the rupee as well as movements in foreign exchange reserves were also satisfactory. At the end of March 2000, the foreign currency assets of the country were higher by US $5.54 billion compared with a year ago, and reached the highest level of US $ 35.06 billion. Foreign exchange reserves, including gold and SDRs, were also at their highest (US $ 38.04 billion), and showed an increase of US $ 5.55 billion during the course of the year. Net reserves, after taking into account forward liabilities, increased by US $ 5.67 billion over the year.

18. Following the East-Asian crisis and subsequent developments in certain other countries, an appropriate policy for management of foreign exchange reserves in emerging economies has figured prominently on the international agenda. India is a member of various international groups where discussions on the international financial architecture and related issues are currently in progress (e.g., the International Monetary and Financial Committee at the IMF, the Bank for International Settlements, the Group of 20, and Working Groups set up by the Financial Stability Forum, etc.). It is now widely agreed that in judging the adequacy of reserves in emerging economies, it is not enough to relate the size of reserves to the quantum of merchandise imports or the size of the current account deficit. In view of the importance of capital flows, and associated volatility of such flows, it has become increasingly important to take into account the composition of capital flows, particularly short-term external liabilities, in judging the adequacy or otherwise of foreign exchange reserves. An additional factor which has to be built into this assessment is the need to take into account certain contingencies, such as, unanticipated increase in commodity/asset prices.

19. The recent international experience, particularly during the period of the East Asian crisis, also highlighted the fact that the emerging economies have to largely rely on their own resources during external exigencies as there is no "lender of the last resort" to provide additional liquidity at short notice. While the International Monetary Fund and the World Bank did their best to arrange rescue packages and provided financial assistance to the affected economies, the agreement on conditionality packages necessarily took some time and their implementation posed further difficult challenges for the policy makers. The content, size and the speed with which these programmes could be approved also varied from country to country depending on the strength of political support by industrialised countries, which are the major shareholders of the international financial institutions.

20. The overall approach to the management of India's foreign exchange reserves has reflected the changing composition of balance of payments, and has endeavoured to reflect the "liquidity risks" associated with different types of flows and other requirements. The policy for reserve management is thus judiciously built upon a host of identifiable factors and other contingencies. Such factors *inter alia* include: the size of the current account deficit;

the size of short-term liabilities (including current repayment obligations on long-term loans); the possible variability in portfolio investments and other types of capital flows; the unanticipated pressures on the balance of payments arising out of external shocks (such as, the impact of the East Asian crisis in 1997-98 or increase in oil prices in 1999-2000); and movements in the repatriable foreign currency deposits of Non-Resident Indians.

21. The movements in India's foreign exchange reserves in recent years has kept pace with our requirements on trade as well as capital account. The strength of the foreign exchange reserves has also been a positive factor in facilitating flow of portfolio investments by FIIs and in reducing the 'risk' premium on foreign borrowings and Global Depository Receipts (GDR)/American Depository Receipts (ADR) issued by Indian corporates. However, there can be no room for complacency. Unanticipated domestic or external developments, including undue volatility in asset prices in equity/bond markets, can create disproportionate pressures in the foreign exchange market in emerging economies. It is, therefore, essential to continue with the pursuit of realistic and credible exchange rate policies, in addition to vigorous implementation of domestic and external sector reforms to further strengthen the balance of payments position over the medium term. It is also necessary to ensure that, leaving aside short term variations in levels, the quantum of reserves in the long run is in line with the growth in the economy and the size of risk-adjusted capital flows. This will provide us with necessary security against unfavourable or unanticipated developments.

22. The day-to-day movements in exchange rates are market determined. The primary objective of the Reserve Bank in regard to the management of the exchange rate continues to be the maintenance of orderly conditions in the foreign exchange market, meeting temporary supply-demand gaps which may arise due to uncertainties or other reasons, and curbing destabilising and self-fulfilling speculative activities. To this end, as in the past, the Reserve Bank will continue to monitor closely the developments in the financial markets at home and abroad, and take such measures as it considers necessary from time to time.

23. Exports, particularly software exports (which technically form part of the invisible receipts in the balance of payments statistics) have done well during the year. In the interest of balance of payments viability, this momentum must be kept up. In the past 18 months, several measures were introduced to ensure timely delivery of credit to exporters and remove procedural hassles. These measures included provision of 'On Line credit' to exporters, extension of 'Line of Credit' for longer duration for exporters with good track record, peak/non-peak credit facilities to exporters, permission for interchangeability of pre-shipment and post-shipment credit and meeting the term loan requirements of exporters for expansion of capacity and modernisation of machinery and upgradation of technology. Improvements were also made in the procedure for handling of export documents and fast track clearance of export credit at specialised branches of banks. Similarly, new simplified guidelines were issued for sanction of credit facilities for software services, project services and software products and packages.

24. In order to ensure that the above procedural and other improvements in the credit delivery system are actually reaching the exporters, the Reserve Bank had also set up a Bankers' Group at the operational level (comprising senior officials from commercial banks and the Reserve Bank). The Group has held a number of inter-active sessions with exporters as also base-level officials of the commercial banks at 21 major export centres in the country in addition to discussions with industry associations. So far, the feedback received from this

exercise is highly positive. In order to further improve the credit delivery system, the Reserve Bank would now like to invite exporters, particularly those who are located in non-metropolitan centres, to send their reactions on whether the new systems are working satisfactorily. They may also send their suggestions for improvement in procedures, particularly those which are designed to reduce paper work without diluting accountability. Exporters' responses can be sent directly to the RBI by post or by e-mail at ***exportsreview@rbi.org.in*** by end of June 2000. On the basis of responses received, the Bankers' Group will be advised to formulate a programme of action to further improve the credit delivery system.

25. Over the past two years, the Reserve Bank has also introduced several new facilities for Non-resident Indians (NRIs). The overall objective is to make financial transactions in and out of India by NRIs as flexible and easy as possible, and to reduce the need for seeking individual or specific permission from the Reserve Bank. Thus, general permission has already been issued for opening of different types of bank accounts, transactions in shares, securities and debentures, and portfolio and direct investments, etc. As in the case of exporters, NRIs are also requested to send in their responses on whether the facilities and procedures are working satisfactorily. They may also send their further suggestions for improvement in these facilities. Their views/suggestions may also be sent by e-mail at **nrireview@rbi.org.in** by the end of June 2000. Further action to improve the facilities will be taken by the Reserve Bank, in consultation with the Government, wherever necessary.

26. Recently, the Government has substantially expanded the automatic route for Foreign Direct Investment (FDI). RBI has already granted general permission to the Indian companies to receive funds and issue shares to their foreign collaborators. No specific approval of Reserve Bank is required for such investments. The same benefit has also been extended to all cases of foreign investment approved by the Foreign Investment Promotion Board (FIPB). The above facilities are subject to filing a post-facto report by the recipient company with the Regional Offices of the RBI within 30 days of the issue of shares to foreign collaborators. All companies are requested to comply with this requirement.

27. In January, 2000 general permission was granted to Indian companies for issue of ADRs and GDRs without any value limits. Accordingly, Indian corporates can now freely utilise up to 50 per cent of such ADRs/GDRs for overseas investments subject only to post facto reporting to the Reserve Bank. In addition, companies in IT & entertainment software and certain other knowledge-based sectors have been granted further facilities for overseas acquisition without requiring prior permission of the Government or the Reserve Bank. These facilities provide for acquisitions allowed by issue of ADRs/GDRs on stock swap basis up to a value limit of 10 times the export earnings of the Indian company in the previous year, or up to U.S. $ 100 million (without reference to the level of actual exports). It is also open to Indian companies to apply to the Reserve Bank for approval of any overseas investment or acquisition proposals which do not fall within the above parameters. It is hoped that these facilities would provide sufficient scope for expansion of internationally competitive Indian enterprises at the global level.

II. Stance of Monetary Policy for 2000-2001

28. Against the background of the developments in the economy last year and economic prospects during 2000-2001 an important objective of monetary policy in the current year is to provide sufficient credit for growth while ensuring that there is no emergence of inflationary pressures on this account. On current assessment, the prospects for achieving these objectives look reasonably promising. Notwithstanding the sharp increase in oil prices, the international inflationary environment continues to be reasonably benign. A freer trade regime, combined with a high level of food stocks and a high level of foreign exchange reserves, should provide sufficient scope for effective supply management during the year. On the demand side, the budget stance of reining in the overall fiscal deficit is welcome. Some allowance, however, has to be made for the fact that there has been considerable delay in the adjustment of important administered prices, including prices of petroleum products. However, such adjustments cannot be avoided if fiscal deficit has to be kept under reasonable control in order to keep potential inflationary pressures under check and future expectations favourable.

29. Keeping the above considerations in view, the Reserve Bank proposes to continue the current stance of monetary policy and ensure that all legitimate requirements for bank credit are met while guarding against any emergence of inflationary pressures due to excess demand. Towards this objective, the Reserve Bank will continue its policy of active management of liquidity through OMO, including two-way sale/purchase of treasury bills, and reduction in cash reserve ratio as and when required.

30. In line with the continuing overall stance of policy, at the beginning of the new financial year on April 1, 2000, the RBI announced a number of measures to enhance liquidity and reduce the cost of funds to banks. These measures were :

(i) A reduction in the Bank Rate by 1.0 percentage point;
(ii) A reduction in CRR by 1.0 percentage point in two stages;
(iii) A reduction in Repo Rate by 1.0 percentage point; and
(iv) A reduction in savings deposit rate of scheduled commercial banks from 4.5 per cent to 4.0 per cent.

Following the above measures most public sector banks have also announced a reduction in their lending and deposit rates. For major banks, deposit rates have been reduced by 0.50 to 1.00 percentage point depending on maturity and prime lending rates have been reduced by 0.50 to 0.75 percentage point. In March 1999 also, banks had effected similar reductions in the PLR. Taking these changes in the PLR into account, the prime lending rate of the largest bank (i.e., the State Bank of India) was lower by 1.75 percentage point on April 3, 2000 compared with end-February, 1999.

31. For purposes of monetary policy formulation on the basis of current trends, growth in real GDP may be placed at 6.5 to 7.0 per cent in 2000-2001, assuming a normal agricultural crop and continued improvement in industrial performance. Assuming the rate of inflation to be around 4.5 per cent (i.e., close to the average of last two years), the projected expansion in M_3 for 2000-2001 is about 15.0 per cent. This order of growth in M_3 should lead to an increase in aggregate deposits of scheduled commercial banks by about 15.5 per cent (or Rs.1,25,000 crore). Non-food bank credit adjusted for investments in commercial paper, shares/debentures/bonds to PSUs and private corporate sector is projected to increase by

around 16.0 per cent. This is expected to be adequate to meet the credit needs of the productive sectors of the economy.

32. However, it cannot be over-emphasised that the above outlook can change dramatically within a relatively short period of time in the event of unanticipated domestic or international events. Several unfavourable events that affected the outlook for the economy during the years 1997 through 1999 point to the need to respond quickly and to change course, if and when required. In the past 3 weeks, even after eliminating the effect of the change in the base year of the Wholesale Price Index, the inflation rate has been somewhat rising. Some States have also been affected by severe droughts. On the inflation front, therefore, there is need for continuous vigilance and caution. The Reserve Bank will continue to monitor domestic monetary and external developments, and tighten monetary policy through the use of instruments at its disposal, when necessary and unavoidable. Banks and other financial institutions should make adequate allowances for unforeseen contingencies in their business operational plans, and take into account the implications of changes in the monetary and external environment on their operations.

33. Based on the experience of some industrialised countries, there is a view that, in India also, monetary policy, to be transparent and credible, should have an explicit narrowly defined objective like an inflation mandate or target. While technically this appears to be a sound proposition, there are several constraints in the Indian context in pursuing a single objective. First, there is still fiscal dominance and the debt management function gets inextricably linked with the monetary management function while steering the interest rates. If the two functions, (i.e., monetary management and debt management) were to be separated as has also been suggested by some experts, it is almost certain that the prevailing interest rates in the market would be substantially higher than considered desirable from monetary stability and/or growth points of view. The last year's experience in our ability to maintain a softer interest rate environment, during a period of low inflation, while at the same time meeting large government borrowing requirements, confirms this view. Secondly, in the absence of fully integrated financial markets, which remain still imperfect and segmented, the transmission channel of policy is rather weak and yet to evolve fully. Thirdly, the high frequency data requirements including those on a fully dependable inflation rate for targeting purposes are yet to be met. Under these circumstances, it is necessary to carefully measure and balance between possible outcomes, after taking into account movements in a variety of monetary and other indicators.

34. It may be recalled that during the last 2 ½ years, the Bank Rate, Repo Rate and CRR have been used in conjunction with OMO and other operations bearing on liquidity to meet short-term monetary policy objectives in the light of emerging domestic and external situations. The Bank Rate and short-term repo rate announced by the RBI have been perceived by the markets as signals for direction in market rates of interest, in particular the call money rates. The active debt management, combining private placements and distribution of securities through open market sales at convenient intervals and activating the OMO window for Treasury bills, has helped in keeping the short-term liquidity situation reasonably comfortable during the year without causing undue pressure on security prices.

35. While there has been a significant softening of interest rates in the last 13 months, the decline in nominal interest rates has not kept pace with the decline in the rate of inflation. Under the circumstances, there has been some debate in the country on the need to bring nominal interest rates down sharply so that real interest rates would move down

correspondingly. If this happens, it is argued, industrial growth could be accelerated further and India's competitiveness abroad would improve. At the same time, it has to be recognised that there are several structural factors which constrain downward flexibility in the interest rate structure in India. The mid-term review of the Monetary and Credit Policy in October 1999 had dealt with some of these structural rigidities. In view of the interest in the subject, and also significant decisions taken recently to reduce some of the administered interest rates and abolish the interest tax, it may be useful to revisit this matter again.

36. It needs to be reiterated that the prime lending rates of banks for commercial credit are entirely within the purview of the banks and are not set by the Reserve Bank. The domestic interest rates which are subject to regulation are only the rate of interest on savings accounts and rates of interest on export credit and credit for small and tiny sectors, including DRI schemes, up to an amount of Rs.2 lakh. It is interesting to note that several key rates fixed by RBI, i.e., the Bank Rate, Repo Rate and the rate on savings account have already come down substantially (to 7.0 per cent, 5.0 per cent and 4.0 per cent, respectively). At the present levels, these rates are not too out of line with ruling international rates.

37. Decisions in regard to interest rates on bank credit have to be taken by banks themselves in the light of various factors, including their own cost of funds, their transaction costs, and interest rates ruling in the non-banking sector. It is interesting to note that, even after reduction in several administered rates, the post tax return on deposits being provided by banks is considerably lower than the prevailing rates on contractual savings like Provident Fund, as well as National Savings Scheme. The interest rate, subject to tax, on 3-yearly deposits is currently 9.5 per cent as compared with 11 per cent for National Savings Scheme and Provident Fund (which, of course, have longer maturity and are also less liquid).

38. Banks have been given freedom to offer variable interest rates on longer-term deposits. However, partly due to historical reasons and partly due to strong preference of depositors (for example, fixed-income groups and retirees), banks have continued to offer fixed interest rates on relatively long-term deposits. The effect of this practice is to reduce the flexibility that banks have in lowering their lending rates since the rates on the existing stock of deposits cannot be lowered. (For example, in respect of one of the large public sector banks, it is estimated that 80 per cent of time deposits are longer than 1 year. Even though the rates of interest for maturities of one year and above are currently in the range of 8.00 to 9.50 per cent, the effective rate of interest for the outstanding deposits of maturities above one year is as high as 11 per cent.)

39. Another factor affecting the interest rate structure in India is the high level of non-interest operating expenses of public sector banks. These work out to 2.5 to 3 per cent of total assets. The high transaction costs which generally reflect high staff costs, combined with relatively high levels of Non-Performing Assets (NPAs), further constrain the manoeuvrability in respect of lending rates.

40. Against the above background, it is clear that, while much greater flexibility in the structure of interest rates in tune with changes in the inflationary environment is desirable, there is no "quick fix" solution to engineer a sharp fall in nominal deposit and lending rates of banks. Vigorous action has to be taken by banks to reduce their transaction costs and the volume of NPAs, and improve risk management. This requires action in a number of areas, including legal reforms for recovery of dues and restructuring of weak banks. Concerted action is also required to move forward with financial reforms in a competitive environment

coupled with a reduction in Government's fiscal deficit and wider public acceptance of the need for flexibility in administered interest rates.

III. Financial Sector Reforms and Monetary Policy Measures

41. The recent annual Monetary and Credit Policy Statements in April, as well as mid-term reviews in October, have focused on 'structural measures' to strengthen the financial system and to improve the functioning of the various segments of financial markets. The main objectives of these measures have been five-fold: (a) to increase operational effectiveness of monetary policy by broadening and deepening money market and bond market, especially the government securities market; (b) to redefine the regulatory role of the Reserve Bank; an attempt has been made to reduce RBI's direct role in fixing interest rates, margins and credit allocations, while simultaneously strengthening its role in the development of financial markets and the management of overall liquidity in the system; (c) to strengthen prudential and supervisory norms, while at the same time providing banks and financial institutions maximum autonomy in operational matters; (d) to improve the credit delivery system, particularly for agriculture, exports, services, small-scale industries, self-help groups and micro-credit institutions; and (e) to develop the technological and institutional infrastructure for an efficient financial sector.

42. While there has been substantial progress in achieving some of these objectives, the pace of progress has been relatively slow in certain areas. Thus, for example, considerable success has been achieved in redefining the role of the Reserve Bank in financial markets and in actively associating financial experts and intermediaries in policy formulation and its implementation. Substantial progress has also been made in the area of deregulation and providing much greater autonomy to banks in operational matters. Money market is functioning reasonably satisfactorily with substantial volume of transactions, although it still continues to be dominated by a few operators. The secondary market for government securities has been strengthened with the emergence of a large number of Primary Dealers (PDs) as active participants. Technological infrastructure in the form of Indian Financial Network (INFINET) has been put in place, and preparatory work for Real Time Gross Settlement System (RTGS) and Centralised Data Base Management has been completed. However, so far, very little progress has been made in making the secondary market for securities and bonds sufficiently liquid and accessible to individuals and small investors. Prudential and supervisory norms have been strengthened, but there is considerable scope for further improvement in risk management and internal control procedures of banks and other institutions. The NPA levels remain unduly high, and there is still a long way to go in making the loan recovery/settlement procedures timely and efficient. A large number of measures have been introduced to make the credit delivery system less cumbersome and hassle free, but progress on the ground is slow.

43. In this year's policy also, it is proposed to review the present position and carry forward the direction of financial reforms initiated in recent years, keeping in view the actual experience in implementation and other relevant developments.

Introduction of Liquidity Adjustment Facility (LAF) replacing Interim Liquidity Adjustment Facility (ILAF)

44. Pursuant to the recommendations of the Narasimham Committee Report on Banking Reforms (Narasimham Committee II), it was decided in principle, to introduce a Liquidity Adjustment Facility (LAF) operated through repo and reverse repos in order to set a corridor

for money market interest rates. To begin with, in April 1999, an Interim Liquidity Adjustment Facility (ILAF) was introduced pending further upgradation in technology and legal/procedural changes to facilitate electronic transfer and settlement.

45. The ILAF was operated through a combination of repo, export credit refinance, collateralised lending facilities and OMO. ILAF provided a mechanism for injection and absorption of liquidity available to banks and PDs to overcome mismatches in supply and demand from time to time. The fortnightly average utilisation of CLF/ACLF and export credit refinance facilities by banks ranged between Rs.3,180 crore and Rs.10,122 crore during the year 1999-2000. Liquidity support availed of by PDs was in the range of Rs.814 crore and Rs.7,406 crore during the above period.

46. The ILAF has served its purpose as a transitional measure for providing reasonable access to liquid funds at set rates of interest. In view of the experience gained in operating the interim scheme last year, an Internal Group was set up by RBI to consider further steps to be taken. Following the recommendation of the Internal Group, it has now been decided to proceed with the implementation of a full-fledged LAF. The new scheme will be introduced progressively in convenient stages in order to ensure smooth transition.

- In the first stage, with effect from June 5, 2000, the Additional CLF and level II support to PDs will be replaced by variable rate repo auctions with same day settlement.

- In the second stage, the effective date for which will be decided in consultation with banks and PDs, CLF and level I liquidity support will also be replaced by variable rate repo auctions. Some minimum liquidity support to PDs will be continued but at interest rate linked to variable rate in the daily repos auctions as determined by RBI from time to time.

- With full computerisation of Public Debt Office (PDO) and introduction of RTGS expected to be in place by the end of the current year, in the third stage, repo operations through electronic transfers will be introduced. In the final stage, it will be possible to operate LAF at different timings of the same day.

47. In the proposed LAF, the quantum of adjustment as also the rates would be flexible, responding immediately to the needs of the system. At the same time, funds made available by the RBI through this facility would meet primarily the day-to-day liquidity mismatches in the system and not the normal financing requirements of eligible institutions. It is expected that the LAF would also help the short-term money market interest rates to move within a corridor and impart greater stability, facilitating emergence of a short-term rupee yield curve. Both the time-table and the scope of proposed changes are, however, subject to review in the light of actual experience.

48. There will be no change in the export credit refinance scheme. This will continue as before and as such banks will be entitled to automatic access for export refinance as per present policy. Ideally, it would also be desirable for export credit refinance to be subsumed in the LAF for effectiveness of monetary policy. However, under the present circumstances, given certain domestic rigidities in the interest rate structure and the desirability of giving maximum support to exporters, there is a case for the scheme of export credit refinance to continue for some more time. It would be possible to do away with sector-specific refinance,

like export credit refinance facility, when domestic interest rates in nominal and real terms converge with international rates on a sustainable basis.

Development of Financial Markets

49. In an effort to carry forward the reforms towards widening and deepening of the financial markets, the following measures are being introduced for further development of the markets :

(a) Money Market

- Forward Rate Agreements and Interest Rate Swaps were formally introduced in 1999. The guidelines had indicated that the rate on any domestic money or debt market instrument can be used as the benchmark. In order to provide more flexibility for pricing of rupee interest rate derivatives and to facilitate some integration between money and foreign exchange markets, the use of 'interest rates implied in the foreign exchange forward market' as a benchmark would be permitted in addition to the existing domestic money and debt market rates.

- At present, the minimum maturity for Certificates of Deposit (CDs) is 3 months. To bring it on par with other instruments such as CP and term deposits, the minimum maturity of CDs is being reduced to 15 days. Incidentally, the minimum period of transferability for CDs has already been reduced to 15 days.

- It was indicated in the 'Mid-Term Review' of October 1999 that permission given to non-bank entities for routing their transactions in call/notice money market through PDs will be withdrawn by end-June 2000. It has been decided that the facility to non-bank entities for routing transactions through PDs would be further extended up to end-December 2000 and simultaneously steps will be initiated to extend repo facility to such entities through Subsidiary General Ledger (SGL) II Accounts.

- It was indicated in the 'Mid-Term Review' of October 1998 that, in line with the suggestion of the Narasimham Committee II, the Reserve Bank ultimately aims to move towards a pure inter-bank (including PDs) call/notice money market. Subsequent to the amendment of the Securities Contracts (Regulation) Act (SCRA) 1956, the repo market has been widened to cover all such non-bank entities holding both current and SGL Accounts with RBI, Mumbai, including mutual funds. These entities can now borrow as well as lend in the repo market. Hence, it is proposed to review and evolve a time bound programme of withdrawing permission to these entities for lending in the call/notice money market, coinciding with development of repo market.

- To keep pace with several developments in financial markets, the current guidelines for issue of CPs were reviewed by an Internal Group. It has been decided to modify the guidelines in the light of Group's recommendations. The modified draft guidelines would cover aspects such as, greater flexibility to the issuers to raise CP through introduction of an automatic route for CP issuance, broadening the investor-base, simplification of procedures for issuing CP, permission to issue CP in dematerialised form and standardisation of documentation procedures. These

measures are expected to provide more liquidity and depth to the product. A draft of the revised guidelines would be circulated separately and final guidelines would be issued after consultation with market participants.

- As per the RBI Act 1934, CRR is to be maintained on an average daily basis during a reporting fortnight by all scheduled banks. This system provides manoeuvrability to banks to adjust their cash reserves on a daily basis depending upon intra-fortnight variations in cash flows. For the computation of CRR to be maintained during the fortnight, a lagged reserve system has been introduced effective fortnight beginning November 6,1999 whereby banks have to maintain CRR on the net demand and time liabilities (NDTL) of the second preceding fortnight. With this, banks are able to assess their exact liability positions and the corresponding reserve requirements. With a view to providing further flexibility to banks and enabling them to choose an optimum strategy of holding reserves depending upon their intra-period cash flows, it has been decided to reduce the requirement of a minimum of 85 per cent of the CRR balances to be maintained to 65 per cent with effect from the fortnight beginning May 6, 2000. This is expected to result in smoother adjustment of liquidity between surplus and deficit units and enable better cash management by banks.

(b) Government Securities Market

(i) Amendments to Securities Contracts (Regulation) Act, 1956

50. In terms of notification issued under Section 16 of the Securities Contracts (Regulation) Act, 1956 and under the amended Section 29A of the Act, Government of India has delegated regulatory powers to RBI to regulate dealings in Government securities, money market securities, gold related securities and securities derived from these securities as also ready forward contracts in debt securities, vide notification dated March 1, 2000. Consequent upon the delegation of powers by the Government and as part of development of the repo market, State Government securities have been made eligible for undertaking repos. RBI has also widened the scope of participation in the repo market to all the entities having SGL and Current Account with RBI, Mumbai, thus increasing the number of eligible non-bank participants to 64 from the earlier 35. These measures are expected to give a fillip to the repo market besides enabling better cash and asset-liability management by non-bank institutions.

(ii) Special Facility for Securities Settlement

51. RBI operates the government securities settlement system for those having SGL Accounts in the Public Debt Office through Delivery versus Payment. Under this system, trades are settled on a gross “trade by trade” basis with irrevocable final settlement taking place simultaneously for securities and funds after ensuring that there is sufficient funds in buyer’s account and sufficient securities in seller’s account. In view of increased volumes in transactions, it is proposed to introduce a scheme for automatic invocation by the SGL Account holder of undrawn refinance/liquidity support from RBI for facilitating smooth securities settlement. The facility will be available only to banks and PDs, subject to adequate safeguards. Detailed guidelines will be issued separately.

(iii) Sale of Securities Allotted in Primary Issues on the same day

52. In terms of the guidelines issued by RBI, no sale deal should be entered into without actually having the securities in the investment portfolio at the time of sale. This procedure is inhibiting entities which get allotments in primary issues from selling securities allotted, on the same day. Hence, it has been decided to remove such restriction and allow such entities to sell the securities after they have been allotted to them, thus enabling sale, settlement and transfer on the same day.

(iv) Payments for Treasury Bills

53. At present auctions in respect of 14 and 91 day Treasury Bills are normally held on Fridays and payments in respect of allotments made on Saturdays. Considering the request from the market participants, the day of payment has been changed from Saturday to the next working day in respect of both 14 and 91 day Treasury Bills. This will be reviewed after six months.

(v) Operations of Primary Dealers

54. Under the existing scheme, the liquidity support to PDs is linked to their bidding commitments and secondary market operations and are provided at level I at the Bank Rate and at level II at 2 per cent above the Bank Rate. As level II will be discontinued with the introduction of LAF, a detailed review of liquidity support to PDs will be made and modifications will be introduced in consultation with PDs.

55. The minimum bidding commitment by PDs cover more than 100 per cent of the auction issue of Treasury Bills and the PDs are not required to take devolvement. OMO window for Treasury Bills with exclusive access to PDs has also been opened. In view of these developments, the commission payment to PDs for auction Treasury Bills is being withdrawn.

56. Currently, the capital adequacy requirements for PDs for credit risk are based on the same norms as applicable to NBFCs. For market risk, separate requirements have been given in the "Guidelines for the PDs in the Government Securities Market". As these do not still adequately address the risks being faced by the PDs in the market, comprehensive capital charges on the portfolio risks are considered essential. Taking into account the principles for capital adequacy for market risk evolved by regulatory bodies such as the International Organisation of Securities Commissions (IOSCO) and the Bank for International Settlements (BIS), fresh guidelines for capital adequacy standards for PDs are being evolved, which will be finalised in consultation with PDs.

(c) Debt Securities Clearing Corporation

57. A mention was made in the Mid Term Review of October 1999 about the setting up of a clearing corporation for money and debt securities. This is expected, *inter alia,* to pave the way for further opening up of the repo market to PSU bonds and bonds of Financial Institutions held in demat form in depositories. A preliminary proposal to set up such a corporation has already been received from the PDs and action to establish such a corporation is being initiated.

Banks' entry into Insurance Business

58. With the passage of the Insurance Regulatory and Development Authority (IRDA) Act, 1999, banks can enter into insurance business. The insurance business does not break-even during the initial years of operation. Banks do not also have adequate actuarial and technical expertise in undertaking insurance business. It is, therefore, necessary to restrict entry only to strong banks in insurance sector on risk participation basis. Consequently, banks having minimum net worth of Rs.500 crore, and satisfying other criteria in regard to capital adequacy, profitability, etc., will be allowed to undertake insurance business through joint venture on risk participation basis. RBI will consider bank's equity contribution in the joint venture up to 50 per cent. However, higher equity contribution by a promoter bank may be allowed initially, on a highly selective basis, pending divestment of the equity in excess of 50 per cent within the period prescribed under the amended insurance statutes. Banks which do not satisfy the above criteria will be allowed on a 'without risk participation' basis up to 10 per cent of their net worth or Rs.50 crore, whichever is lower, as strategic investors. There will, however, be no bar on any bank or its subsidiary taking up distribution of insurance products on fee basis as an agent of insurance company. Banks will be required to obtain prior approval of RBI for entering into the insurance area. Detailed guidelines are in Annexure II.

Interest Rate Policy

59**.** With progressive deregulation of interest rates, banks now have considerable flexibility to decide their deposit and lending rate structures and manage their assets and liabilities efficiently. Banks are now free to offer a fixed rate or a floating rate on deposits of any maturity of 15 days and above. On the lending side, banks are free to prescribe their own lending rates including the Prime Lending Rate (PLR). Further, banks have been given the freedom to offer tenor-linked PLRs and fixed rate loans. Certain specified categories of advances have been freed from the norms of PLR. After consultation with banks, with the objective of providing more operational flexibility and eliminating rigidities, the following measures are being introduced:

(a) Review of PLR norms
(i) Tenor-Linked PLR

60. Banks have been provided the freedom to operate different PLRs for different maturities. It is observed that some banks are declaring a stand alone PLR in addition to tenor linked PLRs. Banks which have moved over to declaration of tenor-linked PLRs should always indicate the specific tenor for which the declared PLRs is applicable.

(ii) Fixed Rate Loans

61. Currently, banks are permitted to offer fixed interest rates only when the loan is for project finance purposes. The restriction on fixed rate term loans being extended only for project loan is now being withdrawn. Banks will henceforth have the freedom to offer all loans on fixed or floating rates. However, banks will have to ensure that the PLR stipulations as applicable are complied with. The nature of alignment with PLR will have to be made explicit at the time of sanction of the loan. However, for small loans up to Rs.2 lakh, the stipulation of not exceeding PLR (of relevant maturity) will be applicable.

(b) FCNR (B) Deposits: Greater Flexibility of Operations

62. At present, in the case of FCNR (B) deposits offered by banks, swap rates as on the last working day of the preceding week form the base for fixing the ceiling rates for the interest rates that are effective the following week. In order to make the market more "online", banks at their discretion will have the option to choose the current swap rates while offering FCNR (B) deposits. This will provide banks with the freedom to refer to the swap rates quoted on any online screen based information system.

63. Presently, banks are free to offer fixed/floating rates on NRE/FCNR(B) deposits. It has been decided that banks would be permitted as in the case of domestic term deposits, to offer differential rates of interest on NRE deposits on size group basis. In the case of FCNR(B) deposits where the interest rates offered are subject to a ceiling rate, the differential rates on size group basis would be permitted within the overall ceiling prescribed. This flexibility is expected to help banks to reduce their overall cost of deposits.

(c) Resource Mobilisation by all-India Financial Institutions – Greater Flexibility

64. As per existing stipulations, all-India Financial Institutions (FIs) are allowed to borrow in the term money market, through CDs, term deposits and Inter-corporate Deposits (ICDs) within the umbrella limit equal to their net owned funds. The interest rate on term deposits offered by financial institutions is subject to a ceiling of 'not exceeding 14.0 per cent per annum' and furthermore financial institutions have to ensure that the interest rates offered by them do not exceed the rates offered by SBI for comparable maturities. As financial institutions are free to decide interest rates on all other instruments, it has been decided that they may be given flexibility in the matter of fixing interest rates also on term deposits. This will facilitate FIs using these instruments in a flexible manner for ALM.

65. With progressive deregulation, FIs have been raising resources from the market by issuing bonds as well as through money market instruments subject to RBI regulation. FIs are permitted to issue bonds with maturity of 5 years and above without prior RBI permission but with simple registration with RBI provided the bonds are "plain vanilla" (i.e., without special features like options, etc.) and the interest rate on such bonds is not more than 200 basis points above the yield on Government of India securities of comparable residual maturity at the time of issuing bonds. All other bond issues have to be referred to the RBI for prior approval. Based on a review of regulatory experience, it has been decided to modify the guidelines and provide more freedom and flexibility to FIs in raising resources through bond issues, subject to overall limits fixed in terms of net owned funds. A draft proposal will be circulated among the FIs, and guidelines will be issued after further consultation with FIs.

Liberalisation of Export Credit Refinance Facility

66. The facility of export credit refinance to banks enable them to fund a part of their export credit without any resource constraint, particularly when the level of export credit expands and liquidity conditions are relatively tight. At present, scheduled commercial banks are provided export credit refinance to the extent of 100 per cent of the increase in outstanding export credit eligible for refinance over the level of such credit as on February 16, 1996. Representations have been received from some institutions that the manner in which the export credit refinance limit is fixed under the existing scheme precludes the use

of Export Bill Rediscounting Schemes by banks, which is of benefit to exporters. It is proposed to liberalise the scheme by introducing the following modification:

- For the purpose of fixing refinance limits, the outstanding export credit (including export bills rediscounted with institutions like EXIM Bank and refinance obtained from NABARD/EXIM Bank) will form the basis which will enable banks to use rediscounting of export bills without any reduction in refinance limits.

- Drawal of refinance will be on the basis of export credit eligible for refinance, i.e., after excluding export bills rediscounted with other banks/EXIM Bank and refinance from NABARD/EXIM Bank, Pre-shipment Credit in Foreign Currency (PCFC), scheme of Rediscounting of Export Bills Abroad (EBR) and overdue export credit from outstanding aggregate export credit.

67. The scheme will come into force effective fortnight beginning May 6, 2000. With the revised scheme, banks will have the benefit of rediscounting export bills with institutions like EXIM Bank, without sustaining reduction in refinance limits from RBI. In the proposed scheme, it has also been ensured that the export credit refinance limit already available to a particular bank is maintained. Operating instructions are being issued separately.

Post-award Clearance of Project Proposals for Exports – Enhancement of Limit

68. At present, Authorised Dealers can consider for post-award clearance in respect of supply contract on deferred payment terms, turnkey projects or construction contract if the value of such contract is Rs.25 crore or less. In the case of contract of value exceeding Rs.25 crore (but within Rs.100 crore or where the Authorised Dealer is unable to grant clearance for any reason), Exim Bank may grant post-award clearance. It has now been decided that the above value limits for clearance for post-award proposals for ADs should be raised from Rs.25 crore to Rs.50 crore and that for Exim Bank from Rs.100 crore to Rs.200 crore.

Gold Deposit Scheme - Allowing Banks to Lend Gold to Other Nominated Banks

69. At present, specific deployment avenues have been outlined for the gold mobilised under the Gold Deposit Scheme. In order to provide more deployment avenues within the country and at the same time to exploit the synergy between the lending expertise of a few banks with the vast branch net work of the others, banks are being permitted to deploy the gold mobilised under the Gold Deposit Scheme by lending it to other nominated bank for similar use.

Prudential Measures

(a) Risk Management Systems in Banks

70. The Reserve Bank had issued in October 1999, comprehensive guidelines to banks to enable them to put in place appropriate risk management systems, covering credit risk, market risk, and operational risk. In order to control the magnitude of overall risks faced by banks, they were advised to lay down, in the Loan Policy approved by their Boards, prudential norms among others, on exposure to single borrower, group of borrowers, industry

specific exposure, exposure to sensitive sectors, etc. A review by RBI of the action taken by banks shows that most of the banks are well advanced in setting up a system for an appropriate assessment of risks associated with different types of assets. This process needs to be further accelerated.

71. In this connection, an issue which has received some attention is the appropriate role of banks in providing financial support to individuals as well as to corporates and market intermediaries against the security of shares/debentures/bonds. RBI has already issued some guidelines for advances against shares/units/debentures and PSU bonds, to individuals, stock brokers and corporates. However, some grey areas remain where there is need for removal of any ambiguities so that policy of banks for supporting the development of capital markets is transparent and known to all concerned, including investors. In order to further develop the operating guidelines for bank financing of equities, it is proposed to refer the matter to the Standing Technical Committee on Co-ordination between RBI and SEBI. The Committee will review the status and make suitable recommendations, after appropriate consultations with banks and market participants. The Committee will consider, *inter alia,* the desirability of having an aggregate exposure ceiling for advances against security of shares as well as issues relating to fixing prudent level of margins on all advances (i.e., advances to individuals, corporates, brokers and others) against shares and Initial Public Offers (IPOs). A transparent and stable system of bank financing, which can be sustained during periods of "ups" as well as "downs" in equity prices, would contribute to healthy development of financial markets, while at the same time minimising risks for banks.

(b) Capital Adequacy Norms for Banks' Subsidiaries

72. At present, the balance sheets of subsidiaries of banks are neither consolidated with that of the parent bank nor have any uniform capital adequacy norm been prescribed for subsidiaries. The Basel Committee has proposed that the new capital adequacy framework should be extended to include, on a fully consolidated basis, holding companies that are parents of banking groups. On prudential considerations, in India also, it is necessary to adopt best practices in line with international standards, while duly reflecting local conditions. To achieve this objective, to begin with, banks are advised to voluntarily build-in the risk weighted components of their subsidiaries into their own balance sheet on notional basis. This should be at par with the risk weights applicable to bank's own assets. Banks should also earmark additional capital in their books over a period of time so as to obviate the possibility of impairment to their net worth when switch over to unified balance sheet for the group as a whole is adopted after some time. The additional capital required may be provided in the bank's books in phases beginning from the year ending March 2001.

(c) New Capital Adequacy Framework

73. In June 1999, the Basel Committee on Banking Supervision had released a consultative paper on 'A New Capital Adequacy Framework' for comments by interested parties by March 31, 2000. The new framework aims at further strengthening the soundness and stability of the financial system and is designed to better align regulatory capital with underlying risks faced by banks. The framework also provides for explicit capital charge for other risks, viz., operational risk and interest rate risk in the banking book for banks where interest rate risks are significantly above average. In view of the widespread implications of the new Framework, an internal Working Group was constituted in the RBI to examine its impact and applicability, likely problems in implementation and the time span

within which the Framework could be adapted to suit Indian conditions. RBI has finalised and forwarded its comments on the new Framework to the Basel Committee. These comments are available on the RBI's web-site to generate wider discussion among banks, financial institutions and academia. The adoption of the new Framework, when it comes into force, will have important implications for emerging market economies and will call for structural changes in the current regulatory and supervisory standards. Capital adequacy, in relation to risk profile, calls for adoption of sophisticated tools for management of risks. Banks would, therefore, have to pay even greater attention to Risk Management Systems, and selection and training of personnel. The existing accounting and disclosures standards would also need to be improved further to fall in line with the international best practices.

(d) Monitoring adherence to International Financial Standards and Codes

74. Recent international discussions on building up a sound financial architecture have emphasised the need for evolving codes and standards based on recognised best practices in areas such as monetary and financial policies, fiscal, financial, accounting, corporate governance and payment and settlement systems. In order to monitor developments in this regard and to consider various aspects relevant to India, the Reserve Bank has constituted in association with the Government of India a 'Standing Committee on International Financial Standards and Codes'. The Committee would aim at identifying and monitoring developments in global standards and codes being evolved in the context of the international developments and consider the applicability of these standards and codes to Indian financial system, and chalk out a road map for aligning India's standards and practices with international best practices.

75. The Standing Committee has set up non-official Advisory Groups in ten major subject areas with outside eminent experts in concerned fields. The Groups have undertaken a review of standards and the feasibility of the compliance and the time frame, given the prevailing legal and institutional practices in India. The Standing Committee would undertake a periodic review of the status and progress in this regard and make available its reports alongwith the Reports of the Advisory Groups to all concerned organisations in public and private sector for review and comments.

(e) Move towards Risk Based Supervision of Banks

76. The recent years have witnessed a gradual shift towards deregulation, reinforced by introduction of prudential norms and adoption of international supervisory best practices. Considering the complexities of banking business and emerging product innovations with complex risk profiles, there is a growing acceptance that a Risk Based Supervision (RBS) approach would be more efficient than the traditional transaction-based approach. The risk based supervision approach entails the monitoring of banks by allocating supervisory resources and focusing supervisory attention according to the risk profile of each institution. The instruments of risk based supervision will be by way of enhancements of the supervisory tools traditionally used, viz., off-site monitoring and on-site examination supplemented by a market intelligence mechanism. In this regard, the Reserve Bank would be engaging services of reputed international consultants to draw on other countries' experiences and to develop an overall plan for moving towards RBS, which would incorporate international best supervisory practices suited for Indian conditions.

(f) Non-Performing Advances (NPAs) of Banks

77. The level of NPAs of public sector banks has been a cause for concern. The Government of India and Reserve Bank of India have initiated a number of measures for expeditious recovery of the accumulated stock of NPAs but the progress of recovery has been slow. The measures include setting up of more Debt Recovery Tribunals (DRTs), strengthening the infrastructure of DRTs, amendment to the Recovery of Debts Due to Banks & Financial Institutions Act as well as setting up of Settlement Advisory Committees (SACs) for compromise settlement of chronic NPAs of small sector. The guidelines on Settlement Advisory Committees were aimed at reducing the stock of NPAs by encouraging the banks to go in for compromise settlement in a transparent manner. Banks will have to more aggressively pursue the recourse to DRTs as well as compromise settlement through the SACs since the operation of SACs is scheduled to lapse on September 30, 2000.

(g) Banks' non-SLR Investments

78. A study undertaken by RBI on the non-SLR investment portfolio of banks has caused some concern, as substantial portion of such investments composed of privately placed unquoted securities. With a view to ensuring that such non-SLR investments are made on sound prudential considerations, with more transparency and guarding against potential risks, draft guidelines for banks' non-SLR investments have been evolved in consultation with banks and financial institutions. These guidelines were circulated among banks and financial institutions on April 4, 2000. The draft guidelines was also put on the RBI website for comments from the general public. Guidelines would be revised duly taking into account the comments and suggestions from banks, financial institutions and others. The revised guidelines will be recirculated before they are finalised.

Credit Delivery Mechanisms

79. Banks and financial institutions have been entrusted with providing credit on reasonable terms to certain sectors, viz., agriculture, micro-credit institutions, small scale industries and housing. In order to enhance the flow of credit to these sectors various steps have been undertaken by the RBI.

(a) Micro-credit

80. The Micro-credit Special Cell which was set up in the RBI pursuant to the Monetary and Credit Policy announcement in April 1999 submitted its report in January 2000. Meanwhile, the Task Force on Supportive Policy and Regulatory Framework for Micro finance, set up by NABARD, had also submitted its report. A circular letter was issued to banks on February 18, 2000 for main-streaming micro-credit. Banks have been advised that micro- credit extended by them to individual borrowers either directly or through any intermediary would be reckoned as part of their priority sector lending. Banks have been given freedom to prescribe their own lending norms keeping in view the ground realities and devise appropriate loan and savings products in this regard. Priority should be accorded to this sector in preparation of credit plans by banks. Banks have also been advised that micro-credit should form an integral part of their corporate credit plan and should be reviewed at the highest level every quarter. A revised reporting system for monitoring micro-credit disbursals on a half-yearly basis has been put in place. In view of its potential in alleviation of poverty, banks have to make all out efforts at provision of micro-credit.

(b) Self Help Groups

81. As announced in the Budget Speech for the year 2000-2001, NABARD and SIDBI are expected to cover an additional 1 lakh Self Help Groups (SHGs) during the current year. To give a further boost to this programme, a micro finance Development Fund is proposed to be created at NABARD with a start up contribution of Rs.100 crore from concerned institutions. This fund will provide start up funds to micro finance institutions and infrastructure support for training and systems management and data building. Special emphasis will be placed on promotion of micro enterprises in rural areas set up by vulnerable sections including women, SC/STs and other backward classes. Banks have been advised to continue their efforts at forging linkages with SHGs in their respective service areas either on their own initiative or by enlisting support of NGOs in the field, so that the national goal set out in the Budget announcement is met.

(c) Agriculture

82. Following the Report of the Gupta Committee on Agricultural credit, a number of measures have been taken to improve credit delivery system for agriculture, such as, greater flexibility and discretion to the lending banks in matters of collateral, margin, security, dispensation of "no dues certificates", delegation of sufficient powers to branch managers, introduction of composite cash credit to cover the farmers' production requirements, introduction of new loan procedures, cash disbursement of loans and simplification of procedures for loan agreements. The following further measures are now being taken:

- At present, a ceiling of Rs.5 lakh has been prescribed for classifying advances for financing distribution of inputs for the allied activities, such as cattle-feed, poultry-feed, etc., as indirect advances to agriculture. It has been decided to enhance the ceiling to Rs.15 lakh.

- At present, bank finance to NBFCs for on-lending to Small Road and Water Transport Operators (SRWTOs) and the tiny sector of industry is reckoned under priority sector lending. With a view to providing one more avenue for bank's lending to agriculture and increasing the outreach of banks in rural areas, it has been decided that lending by banks to NBFCs for on-lending to agriculture may be reckoned for the purpose of priority sector lending as indirect finance to agriculture. A circular to this effect has already been issued.

(d) Drought Relief

83. Some parts of the country have been affected by severe drought. These drought affected areas have to be provided maximum support, as per RBI guidelines, for conversion of short-term production loans into medium-term loans, reschedulement/postponement of existing term loan instalments, providing additional need-based crop loans/working capital and consumption loans and relaxation in security and margin norms. RBI has instructed its Regional Offices to remain in close contact with the State Government authorities and local banks so that expeditious action is taken to provide relief. RBI has also advised the convenor banks of State Level Bankers' Committee (SLBC) to convene the meeting of SLBC to take stock of the situation and initiate immediate steps for providing relief.

(e) Budget follow up – the SSI Sector

84. Following the announcements made by the recent Union Budget in respect of the SSI sector, the following action has been taken :

- The requirement of providing collateral security is a major bottleneck in the flow of bank credit to very small units. RBI has recently issued instructions to dispense with the collateral requirement for loans up to Rs. 1 lakh. The limit is being further increased for the tiny sector from Rs.1 lakh to Rs.5 lakh.

- To promote credit flow to small borrowers, the composite loan limit (for providing working capital and term loans through a single window) is being increased from Rs.5 lakh to Rs.10 lakh.

- Public sector banks have been requested to accelerate their programme of SSI branches to ensure that every district and SSI clusters within districts are served by at least one specialised SSI bank branch. Furthermore, to improve the quality of banking services, SSI branches are being asked to obtain ISO certification.

Circular letters have been issued to banks in respect of the above measures.

(f) Setting up of a Credit Information Bureau

85. RBI had set up a Working Group to explore the possibilities for setting up a Credit Information Bureau in India. The Working Group submitted its Report in November, 1999. The Bureau is expected to expedite credit and investment decisions by banks and financial institutions as also curb growth of fresh NPAs through better institutional mechanism. The State Bank of India has entered into an MoU with HDFC to set up a Credit Information Bureau and the modalities for setting up of the Bureau in regard to ownership and equity participation, management structure, security standards, rights and liabilities of the Bureau, etc., are currently being worked out. The banks and financial institutions are advised to make the necessary in-house arrangement for gathering and collection of such information in one place for transmitting it to the Bureau.

Deposit Insurance

86. The Deposit Insurance and Credit Guarantee Corporation (DICGC) is at present engaged in the revamping of the system of deposit insurance in pursuance of the recommendations of the Advisory Group on Reforms in Deposit Insurance in India. The DICGC has, in consultation with the Reserve Bank of India, already examined most of the recommendations. A new law, in supercession of the existing enactment, is required to be enacted to implement the recommendations and the task of preparation of the new draft law has been taken up. The relevant proposals in this respect will be forwarded in due course to the Government for consideration.

Non-Banking Financial Companies (NBFCs)

87. After the passage of the amendment to the RBI Act on March 23, 1997, the RBI received 37,392 applications for grant of certificate of registration. Of these, 26,769 NBFCs had net owned fund (NOF) below Rs.25 lakh till the end of 1999 and, therefore, did not fulfill the primary criteria of having a minimum NOF of Rs.25 lakh, under the RBI Act. These

NBFCs were given three years time to reach the minimum NOF of Rs.25 lakh. As on April 1, 2000, as many as 7,636 NBFCs have reported to have stepped up their NOF to Rs.25 lakh or more thus becoming primarily eligible for Certificate of Registration. In addition, the Bank has received 2,651 applications for extension of time. The remaining NBFCs have neither reported having attained the minimum NOF of Rs.25 lakh, nor sought extension of time. As per the provision in the Act/NBFC Directions, all the remaining NBFCs with NOF of less than Rs.25 lakh are not entitled to accept fresh public deposits. These NBFCs are advised to strictly adhere to the provisions of the Statute, RBI regulations and continue to repay the matured deposits as per the contracted terms.

88. Considering the heterogeneous size and geographical spread of the NBFCs, RBI is keen to promote the concept of self regulatory organisation particularly for smaller NBFCs, and further improve the disclosure requirements in order to instill confidence about their functioning. The Reserve Bank also proposes to extend to the NBFCs the guidelines on Asset Liability Management and Risk Management after getting the views of the industry. The RBI is also considering guidelines for NBFCs for their entry/participation in insurance business. Further, the RBI is reviewing the regulatory structure and procedures for fixing of interest rates on deposits of different types of non-banking companies.

Approach to Universal Banking

89. The Narasimham Committee II suggested that Development Financial Institutions (DFIs) should convert ultimately into either commercial banks or non-bank finance companies. The Khan Working Group held the view that DFIs should be allowed to become banks at the earliest. The RBI released a 'Discussion Paper' (DP) in January 1999 for wider public debate. The feedback on the discussion paper indicated that while universal banking is desirable from the point of view of efficiency of resource use, there is need for caution in moving towards such a system by banks and DFIs. Major areas requiring attention are the status of financial sector reforms, the state of preparedness of concerned institutions, the evolution of regulatory-regime and above all a viable transition path for institutions which are desirous of moving in the direction of universal banking. It is proposed to adopt the following broad approach for considering proposals in this area:

(a) The principle of "Universal Banking" is a desirable goal and some progress has already been made by permitting banks to diversify into investments and long-term financing and the DFIs to lend for working capital, etc. However, banks have certain special characteristics and as such any dilution of RBI's prudential and supervisory norms for conduct of banking business would be inadvisable. Further, any conglomerate, in which a bank is present, should be subject to a consolidated approach to supervision and regulation.

(b) Though the DFIs would continue to have a special role in the Indian financial system, until the debt market demonstrates substantial improvements in terms of liquidity and depth, any DFI, which wishes to do so, should have the option to transform into bank (which it can exercise), provided the prudential norms as applicable to banks are fully satisfied. To this end, a DFI would need to prepare a transition path in order to fully comply with the regulatory requirement of a bank. The DFI concerned may consult RBI for such transition arrangements. Reserve Bank will consider such requests on a case by case basis.

(c) The regulatory framework of RBI in respect of DFIs would need to be strengthened if they are given greater access to short-term resources for meeting their financing requirements, which is necessary.

(d) In due course, and in the light of evolution of the financial system, Narasimham Committee's recommendation that, ultimately there should be only banks and restructured NBFCs can be operationalised.

High Power Committee on Urban Co-operative Banks

90. A High Power Committee (HPC) was constituted in May 1999 under the Chairmanship of Shri K.Madhava Rao, to review the performance of Urban Co-operative Banks (UCBs) and suggest necessary measures to strengthen this sector. The terms of reference included reviewing of existing bank and branch licensing policies, application of capital adequacy norms and bringing in suitable legislative amendments for effective functioning of the UCBs. The HPC submitted its recommendations to RBI on November 30, 1999. The Report of the HPC has been made available for public debate, and the recommendations are presently under consideration of RBI in consultation with Government.

Technology Upgradation

91. The Reserve Bank has been playing a central role in the reform of the payment and settlement system in the country. Much progress has been made in consolidating the existing payment systems, developing new technologically advanced modes of payment and moving towards the ultimate objective of linking various payment and settlement systems into an efficient and integrated system that will function in an on-line real time environment.

92. With the ultimate goal of designing and developing a multiple deferred/discrete net settlement system and RTGS, facilitating efficient funds management, house-keeping and customer service, the Reserve Bank has taken a number of steps to improve the infrastructure. These include :

- The development of the Payment System Generic Architecture Model for both domestic and cross-border payments. The Model conceives networking of computerized bank branches, with their controlling offices, central treasury cells and Head Offices with the proviso for introducing standardisation of operating systems and networking platforms within the bank and a bank-level standardized gateway to INFINET.

- A consultant has been appointed to assist in the implementation of the RTGS. System Requirement Specifications would take into account the international best practices and the specific requirements of Indian banking.

- Progress is being made towards developing standards for newer payment instruments such as SMART Cards. A pilot project on SMART Cards has come out with a set of recommendations for SMART Card standards which have been forwarded to the Bureau of Indian Standards for adoption as National Standards.

The major items in the Action Plan for 2000-2001 are :

- The spread and coverage of the Indian Financial Network – INFINET will be extended to cover all the hundred odd commercially important centres in the country. The development of the Structured Financial Messaging backbone for exchange of financial messages based on international standards will also be implemented.

- Priority will be given for integrating the various segments of the payments and settlement system and on the introduction of the RTGS and the consolidation of the various Deferred Net Clearing Settlements spread across various cities.

- Technology upgradation and increasing the scope of computerisation by bringing in more activities under its ambit within the banking sector.

Regulations Review Authority

93. The experience in the last one year with Regulations Review Authority (RRA) for reviewing Reserve Bank's rules, regulations and reporting systems based on the suggestions received from general public at large, users of services of the Bank and market participants has been satisfactory. After a review of the progress so far, the Reserve Bank has since extended the term of RRA for a further period of one year from April 1, 2000. The RRA has received 200 applications which contained more than 350 suggestions pertaining to the entire gamut of operations of the Bank. Implementation of several suggestions not only paved the way for streamlining several existing procedures and improving customer service, but also helped in reviewing and streamlining Bank's reporting systems. A notable achievement of RRA has been the compilation of Master circulars, subject-wise, in Manual form by merging a large number of circulars issued over many years on specific subjects. Such master circulars cover important operational areas of compliance by banks and institutions. This work is being further pursued.

Mid-Term Review

94. A Review of credit and monetary developments in the first half of the current year will be undertaken in October 2000. The mid-term review will be confined to a review of monetary developments and to such changes as may be necessary in monetary policy and projections for the second half of the year.

Mumbai
April 27, 2000

Annexure I

Features of the Proposed Scheme of Liquidity Adjustment Facility (LAF) (Draft)

The Scheme of Liquidity Adjustment Facility (LAF) will include (i) Repo Auctions and (ii) Reverse Repo auctions. The features of the proposed Scheme are presented below :

Features of Repo Auctions

2. The current Fixed Rate Auction system and ACLF for banks along with Level II support for PDs will be replaced by a variable interest rate auction system on "uniform price" basis to be conducted by Reserve Bank of India. The minimum amount will be Rs.1 crore and in multiples of Rs.1 crore. Only banks and PDs maintaining SGL and Current Accounts with Reserve Bank of India at Mumbai will be eligible to participate in the repo auction. Bids for repos are to be submitted before 10.30 a.m. on all working days, Monday through Friday. Multiple bids can be submitted. There will be no auction on Saturdays. The results of the auctions will be announced by 1.00 p.m. The settlement of transactions in the auctions will take place on the same day. But for intervening holidays, the repo auctions will be for one day except on Fridays; on Fridays, the auction will be for three days or more maturing on the following working day.

3. RBI will maintain a Constituents' Repos SGL Account for purposes of settlement. Securities held by Reserve Bank of India on behalf of banks in the Repo SGL Accounts will be eligible for SLR purposes. The Reserve Bank will issue SGL Balance Certificate indicating the details of total holdings of bank/institution and total loan-wise securities held in the Repo Constituents' SGL Account as on any date. To simplify the provision of liquidity, in case of reverse repo auctions, successful participants who are eligible to draw refinance from RBI will be granted refinance against collateral as per the existing procedures. The other successful banks/institutions not eligible for refinance will be provided liquidity support in the form of reverse repo as per the existing procedures.

4. After further consultations, and modifications as necessary, the above scheme will come into effect on June 5, 2000. It is also proposed to review the scheme after some experience has been gained in implementation.

Annexure II

Guidelines for Entry of Banks into Insurance

1. Any Scheduled Commercial Bank would be permitted to undertake insurance business as agent of insurance companies on fee basis, without any risk participation. The subsidiaries of banks will also be allowed to undertake distribution of insurance product on agency basis.

2. Banks which satisfy the eligibility criteria given below will be permitted to set up a joint venture company for undertaking insurance business with risk participation, subject to safeguards. The maximum equity contribution such a bank can hold in the joint venture company will normally be 50 per cent of the paid-up capital of the insurance company. On a selective basis, the Reserve Bank of India may permit a higher equity contribution by a promoter bank initially, pending divestment of equity within the prescribed period (see Note 1 below).

The eligibility criteria for joint venture participant will be as under, as on March 31, 2000:

(i) The net worth of the bank should not be less than Rs.500 crore,
(ii) The CRAR of the bank should not be less than 10 per cent,
(iii) The level of non-performing assets should be reasonable,
(iv) The bank should have net profit for the last three continuous years,
(v) The track record of the performance of the subsidiaries, if any, of the concerned bank should be satisfactory.

3. In cases where a foreign partner contributes 26 per cent of the equity with the approval of Insurance Regulatory and Development Authority/Foreign Investment Promotion Board, more than one public sector bank or private sector bank may be allowed to participate in the equity of the insurance joint venture. As such participants will also assume insurance risk, only those banks which satisfy the criteria given in paragraph 2 above, would be eligible.

4. A subsidiary of a bank or of another bank will not normally be allowed to join the insurance company on risk participation basis. Subsidiaries would include bank subsidiaries undertaking merchant banking, securities, mutual fund, leasing finance, housing finance business, etc.

5. Banks which are not eligible as joint venture participant, as above, can make investments up to 10 per cent of the net worth of the bank of Rs.50 crore, whichever is lower, in the insurance company for providing infrastructure and services support. Such participation shall be treated as an investment and should be without any contingent liability for the bank.

The eligibility criteria for these banks will be as under:

(i) The CRAR of the bank should not be less than 10 per cent;
(ii) The level of NPA should be reasonable;
(iii) The bank should have net profit for the last three continuous years.

6. All banks entering into insurance business will be required to obtain prior approval of the Reserve Bank. The Reserve Bank will give permission to banks on case to case basis keeping in view all relevant factors including the position in regard to the level of non-performing assets of the applicant banks so as to ensure that non-performing assets do not pose any future threat to the bank in its present or the proposed line of activity, viz., insurance business. It should be ensured that risks involved in insurance business do not get transferred to the bank and that the banking business does not get contaminated by any risks which may arise from insurance business. There should be 'arms length' relationship between the bank and the insurance outfit.

Notes:

1. Holding of equity by a promoter bank in an insurance company or participation in any form in insurance business will be subject to compliance with any rules and regulations laid down by the IRDA/Central Government. This will include compliance with Section 6AA of the Insurance Act as amended by the IRDA Act, 1999, for divestment of equity in excess of 26 per cent of the paid up capital within a prescribed period of time.

2. In case audited balance sheet for the year ending March 31, 2000 is not available, unaudited balance sheet for the year ending March 31, 2000 may be considered for reckoning the eligibility criteria. For subsequent years, the eligibility criteria would be reckoned with reference to the latest available audited balance sheet for the previous year.

3. Banks which make investments under paragraph 5 of the above Guidelines, and later qualify for risk participation in insurance business (as per paragraph 2 of the Guidelines) will be eligible to apply to the Reserve Bank for permission to undertake insurance business on risk participation basis.

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* The macro-economic and monetary developments in 1999-2000 are dealt with in greater detail in a separate document, which is published for the first time, as part of the annual monetary and credit policy.

+With effect from April 1,2000, the Wholesale Price Index had been revised to a new series with 1993-94 as the base year. As per the new series (with base 1993-94=100) the inflation rate last year on a point-to-point basis was 4.16 per cent as compared with 3.74 per cent on the basis of the old series. The increase of 0.42 percentage point, is accounted for by the change in composition and the weighting diagram. However, it may be noted that the inflation rate for 1999-2000 on an average basis, according to the new WPI series was substantially lower (2.9 per cent in 1999-2000 as against 6.0 per cent in the previous year).