Statement by Dr. Bimal Jalan, Governor, Reserve Bank of India on Monetary and Credit Policy for the year 2002-03

The Statement consists of three parts: (I) Review of Macroeconomic and Monetary Developments during 2001-02, (II) Stance of Monetary Policy for 2002-03, and (III) Financial Sector Reforms and Monetary Policy Measures.

2. Like last year, a technical and analytical review of macroeconomic and monetary developments is being issued as a separate document. This document provides the necessary macroeconomic and other information in somewhat greater detail with the help of simple charts and tables.

I. Review of Macroeconomic and Monetary Developments: 2001-02

Domestic Developments

3. Recently, the Central Statistical Organisation (CSO) released revised figures for national income growth for the year 2000-01. According to the latest estimates, the growth rate of GDP was substantially lower than earlier estimated, mainly due to downward revision in the growth rate of the services sector. While the growth rate of the services sector was revised downwards from 7.5 per cent to 5.0 per cent, that of agriculture and allied activities was revised from 0.2 per cent to (-) 0.2 per cent. On the other hand, industrial sector growth was revised upwards from 5.3 per cent to 6.2 per cent. As a result, overall GDP growth during 2000-01 was placed at 4.0 per cent on a revised basis as against 5.2 per cent estimated earlier.

4. During 2001-02, according to preliminary estimates by the CSO the growth in agricultural sector is expected to be buoyant at about 5.7 per cent as against a negative growth of 0.2 per cent in the previous year. However, the overall growth performance of the industrial sector at 3.3 per cent is estimated to be lower than that of 6.2 per cent in the previous year. Combined with a reasonable performance of the services sector, estimated

to grow by 6.2 per cent mainly on account of trade and transport, finance and business services, the CSO in its latest estimates has projected real **GDP growth in 2001-02** at 5.4 per cent as compared with 4.0 per cent in 2000-01. This is consistent with the rate of growth between 5.0 and 6.0 per cent indicated by RBI in the Mid-term Review of October 2001.

5. The **domestic inflationary situation** during 2001-02 was highly favourable. The annual rate of inflation, on a point-to-point basis, as measured by variations in the wholesale price index (WPI) (base: 1993-94 = 100) declined from 4.9 per cent in end-March 2001 to 1.4 per cent by end-March 2002. Inflation on account of manufactured products (weight: 63.7) registered a decline of 0.4 per cent as compared with an increase of 3.8 per cent in the previous year reflecting sluggish conditions in industrial sector. Primary articles (weight: 22.0) showed an increase of 3.8 per cent as against a decline of 0.4 per cent last year. The moderation in inflation rate has been largely on account of much lower increase of 3.8 per cent in 'fuel, power, light and lubricants' group (weight: 14.2) in contrast to 15.0 per cent increase a year ago. The base effect of higher oil prices last year is apparent, as annual inflation measured by increase in WPI on an average basis, worked out to 3.6 per cent as against 7.2 per cent a year ago. Inflation, as reflected by the consumer price index (CPI) was higher on a point-to-point basis (5.2 per cent) as well as on an average basis (4.1 per cent) up to February 2002. Comparative figures for the previous year were 3.0 per cent and 4.0 per cent, respectively.

6. During 2001-02, the annual growth in **money supply (M_3)** was in line with the projected trajectory at 14.0 per cent (Rs.1,83,912 crore) as against 16.8 per cent (Rs.1,89,046 crore) a year ago. Among the components, the growth in aggregate deposits of scheduled commercial banks at 14.3 per cent was lower than that of 18.4 per cent in the previous year during which deposits were augmented by India Millennium Deposit inflows. The expansion in currency with the public was higher at 15.2 per cent (Rs.31,890 crore) as against 10.8 per cent (Rs.20,468 crore) in the previous year. This could partly be attributed to higher agricultural activity and larger procurement of foodgrains.

7. The increase in **reserve money** during 2001-02 at 11.4 per cent (Rs. 34,514 crore) was higher than that of 8.1 per cent (Rs.22,757 crore) in the previous year. It is interesting to note that the expansion in reserve money was entirely on account of the increase in net foreign exchange assets of RBI which rose by 33.9 per cent (Rs. 66,794 crore) as compared with 18.9 per cent (Rs.31,295 crore) in 2000-01. On the other hand, unlike in the past, net domestic assets of RBI declined on account of both net RBI credit to the Central Government as well as credit to the commercial sector. Notwithstanding RBI's subscription to fresh government dated securities of Rs.28,892 crore, net RBI credit to the Central Government declined by 0.3 per cent (- Rs.506 crore) due to open market sales of government securities of Rs.30,335 crore. RBI's claims on banks and commercial sector also showed a decline of Rs.9,575 crore reflecting comfortable liquidity available with them.

8. During 2001-02, **non-food credit** registered a lower growth of 12.8 per cent (Rs.60,411 crore) as against an increase of 14.9 per cent (Rs.61,176 crore) in the previous year reflecting deceleration in industrial production. The increase in total flow of funds from scheduled commercial banks to the commercial sector during 2001-02 including banks' investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper, etc. was also lower at 12.0 per cent (Rs.65,862 crore) as against 16.1 per cent (Rs.75,791 crore) in the previous year. Total flow of resources to the commercial sector, including capital issues, global depository receipts (GDRs) and borrowing from financial institutions was Rs.1,37,429 crore as compared with Rs.1,71,928 crore in the previous year.

9. The increase in **food credit** at Rs.13,987 crore during 2001-02 was similar compared with Rs.14,300 crore in the previous year reflecting large scale procurement operations. The buffer stock of foodgrains rose to 54.5 million tonnes by end-February 2002 from 46.8 million tonnes in end-February 2001. The carrying costs of holding large buffer stocks beyond an optimal level need to be carefully considered, keeping in view the fact that the outstanding food procurement credit of scheduled commercial banks was as high as Rs.53,978 crore by March 2002.

10. As per the revised estimates in the Budget 2002-03, the **fiscal deficit** of the Central Government for 2001-02 was placed at Rs.1,31,721 crore as against the budget estimate of Rs.1,16,314 crore. During the financial year 2001-02, net market borrowings of the Central Government at Rs. 92,302 crore (gross Rs. 1,33,801 crore), exceeded the budget estimates by Rs. 14,949 crore and was higher by Rs.822 crore over the revised estimate. The State Governments' net market borrowings have also increased by Rs. 4,404 crore from the earlier budgeted level of Rs. 12,857 crore. Although the combined slippage in the borrowings of the Centre and States by as much as Rs. 19,353 crore did not exert undue pressure on interest rates because of availability of ample liquidity and depressed credit demand, as emphasised in the Budget speech for 2002-03, there is an urgent need to contain fiscal deficit to improve the task of monetary and debt management from a medium-term perspective.

11. As emphasised in various policy Statements, the overall monetary management becomes difficult when a large and growing borrowing programme of the Government, year after year, puts pressure on the absorptive capacity of the market. Already, the banking system holds government securities of more than 36.5 per cent of its net demand and time liabilities as against the statutory minimum requirement of 25.0 per cent. In terms of volume, such holdings above the statutory liquidity ratio (SLR) amounted to more than Rs.1,40,300 crore, which is higher than the gross borrowings of the Government. Such a large exposure to government securities may inhibit the ability of banks to meet the credit requirements of the productive sectors of the economy, if there is a significant pick-up in demand during the current year. Further, the sustainability of public debt is now a matter of concern, given the increasing interest payments. The reduction in fiscal deficit would impart flexibility to the interest rate regime and, in turn, release government resources for the much needed investment in physical and social infrastructure. Further, fiscal consolidation will also have a favourable effect on inflationary expectations in the economy.

12. It was indicated in the annual policy Statement of April 2001, and reiterated in the Mid-term Review of October 2001 that RBI is committed to maintain adequate liquidity in the market with preference for softening of interest rates to the extent the evolving situation warrants. To this end, despite the high level of government borrowing programme during 2001-02, it was possible to maintain adequate liquidity and a softer interest rate environment without engendering inflationary conditions in the economy. This is evidenced from the fact that the **primary market yields** on 91-day and 364-day Treasury Bills came down by as much as 262 basis points and 280 basis points, respectively. Simultaneously, the call money rate and weighted average discount rate of CP declined by 156 basis points and 153 basis points, respectively, during the course of the year.

13. There was also a perceptible downward shift in **secondary market yields** on government securities across the maturity spectrum during the year. The yield on government securities with 1-year residual maturity moderated from 9.05 per cent in March 2001 to 6.10 per cent by March 2002 indicating a reduction in yield by as much as 295 basis points. Similarly, the yield on government securities with 10-year residual maturity had declined by 287 basis points to 7.36 per cent by March 2002 from 10.23 per cent in March 2001. These are among the sharpest reductions in interest rates during the course of a year in the last three decades. However, it needs to be recognised that it may not be possible to reduce the cost of borrowing in the face of higher market borrowings, year after year, particularly when credit demand picks up.

14. In this context, it may be mentioned that while the yields on government securities have declined sharply, those on non-government bonds have witnessed a lower reduction resulting in widening of the spread between these two categories of fixed income securities. Illustratively, the spread between the prime-rated CP and 91-day Treasury Bills widened from 82 basis points in end-March 2001 to 202 basis points by end-March 2002. This could be attributed to greater preference of investors, particularly the banking sector, to seek high quality securities in the face of sluggish growth of industrial sector. The "flight to quality" has been so strong that the yield rate on 10-year

government securities had fallen by 287 basis points to reach 7.36 per cent as at end-March 2002. On the other hand, the reduction in deposit rates has been less pronounced with the term deposit rates of public sector banks moving down from a range of 4.0-10.5 per cent for various maturities in March 2001 to 4.25-8.75 per cent by March 2002.

15. The **term structure of interest rates** reveals that the long-term interest rates have declined more sharply than the short-term rates. For example, in the government securities market, the spread between the yields on 10-year government securities and 91-day Treasury Bills narrowed down from 237 basis points at end-April 2001 to 123 basis points by end-March 2002. While the tenor spread in the government securities market has narrowed reflecting, *inter alia*, moderation of inflationary expectations, the term spread between highly rated corporate paper and government securities has widened. For example, the spread between AAA rated 5-year corporate bonds and the yield on government securities of equal residual maturity widened from about 65 basis points in end-April 2001 to about 177 basis points by end-March 2002 reflecting, *inter alia*, an increase in investor preference for sovereign paper.

16. It is necessary to impart greater flexibility to interest rate structure in India consistent with the underlying macroeconomic conditions. Further progress in this direction could be made if banks move over to a variable interest rate structure on longer term deposits as early as possible. Since interest rates could vary in both directions, depending on the phase of business cycle and inflationary outlook, a variable interest rate regime on long-term deposits does not necessarily imply lowering of the average interest rate earned by depositors over a period of time (compared with a fixed rate regime, which favours old deposits over new deposits when interest rates are coming down, and *vice versa* when rates are moving in the opposite direction). In addition, banks need to reduce their operating costs over time by improving productivity and increasing their volume of lending. This should be possible with proper upgradation of technology in areas which, at present, are contributing to higher costs.

17. In view of the easy liquidity conditions and softer interest rate environment, the overall monetary conditions are at present reasonably comfortable. However, experience

of recent years once again confirms that monetary management has now become much more complex than was the case even a few years ago. This is because of several factors, such as the on-going integration of financial markets across the world, the phenomenal increase in financial turnover, liberalisation of the economy, and the rapidity with which unanticipated domestic and international tremors get transmitted to financial markets across the world because of the new technology.

18. It may be recalled that at the beginning of 2001-02, the Reserve Bank had taken steps to ease monetary policy. However, adverse external developments post-September 11 and their effect on financial markets in India necessitated a quick response to provide assurance and stabilise domestic financial markets without tightening monetary conditions. Fortunately, these measures succeeded in stabilising financial conditions without calling for a reversal in the monetary stance. The need for proactive countercyclical policy in the light of emerging situation has also been the experience of other monetary authorities, including the US and European central banks.

19. It is important to emphasise this since, in case the present economic circumstances change, it may again become necessary to take appropriate monetary measures, which may not be in consonance with the present easy liquidity conditions. Keeping these realities in view, it is particularly important for banks and financial institutions to make adequate provisions for unforeseen contingencies in their business plans, and fully take into account the implications of changes in the monetary and external environment on their operations. In this context, in January 2002, RBI proposed that banks should build up **investment fluctuation reserve (IFR)** to a minimum of 5.0 per cent of their investment portfolio by transferring the gains realised on sale of investments within a period of five years. Banks are, however, free to build up higher percentage of IFR of up to 10.0 per cent of their portfolio depending on the size and composition of their portfolio, with the concurrence of their Board of Directors. Now that the government security prices are high, it may be the opportune time for banks to build up IFR.

External Developments

20. While the **world economy** had slowed down considerably during the first half of the year 2001, the expectation of revival was modest for the second half. The recessionary trends were compounded by the adverse impact of September 11 events on services and trade. In addition, all segments of the financial market, particularly the equity markets, were badly affected. The impact was also felt in the financial markets of the emerging market economies, as there was a shift away from risky assets. These uncertainties prompted the IMF to sharply scale down its growth projection for the global economy to 2.4 per cent, which is almost half of the level of growth recorded in 2000. Fortunately, in recent weeks, the outlook for a recovery in the world economy, particularly in the US, has become much better. This has now prompted the IMF to upgrade its growth projection for the global economy for 2002 to 2.8 per cent from the earlier projection of 2.4 per cent in December 2001. The volume growth in world trade is also likely to be better in 2002 than that in 2001. Coupled with the positive effects of decline in global inflation and interest rates, the prospects for turnaround in world economic growth now appear distinctly more favourable than was the case a couple of months ago. With easing of uncertainties, stabilisation of confidence and improvements in financing conditions, the risks to global economic outlook is now more balanced barring the recent volatility in international oil prices which continues to be a matter of concern.

21. International developments, consequent to the events of September 11, had their destabilising impact on Indian financial markets with a sharp decline in the equity prices and net capital outflows of foreign institutional investors. Foreign exchange market also became volatile with the rupee depreciating *vis-à-vis* US dollar and consequent uncertainties also affected the government securities market. However, RBI promptly announced its intention to provide appropriate liquidity and initiated several measures so as to stabilise domestic financial markets. These actions by RBI restored stability and confidence in financial markets, which were reflected in the quick return of these markets to normal conditions.

22. Despite adverse external developments, **India's foreign exchange reserves** continued to record a healthy growth during 2001-02 due to moderation in trade deficit and strong capital and other inflows. Foreign exchange reserves increased by as much as US $ 11.8 billion from US $ 42.3 billion in end-March 2001 to US $ 54.1 billion by end-March 2002. Of these, foreign currency assets increased by US $ 11.5 billion. This is the highest increase recorded in a single year and is an evidence of strong domestic and international confidence in India's management of its balance of payments in the post-1991 period. Reflecting this confidence, in the last four years since the East Asian crisis of 1997-98, India's foreign exchange reserves have more than doubled despite substantial increase in oil imports during the period and several other unfavourable developments affecting the prospects of developing countries.

23. India's sustained efforts to build an adequate level of foreign exchange reserves have been vindicated by global uncertainties. 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. The overall approach to the management of India's foreign exchange reserves in recent years has, therefore, reflected the changing composition of balance of payments. In addition to the likely developments in the current account, the reserve management has also 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 of 1997-98 or increase in oil prices during 1999-2001); and movements in the repatriable foreign currency deposits of non-resident Indians. A sufficiently high level of reserves is necessary to ensure that even if there is prolonged uncertainty, reserves can cover the

"liquidity at risk" on all accounts over a fairly long period. Taking these considerations into account, India's foreign exchange reserves are now very comfortable.

24. The prevalent national security environment further underscores the need for strong reserves. We must continue to ensure that, leaving aside short-term variations in reserves level, the quantum of reserves in the long-run is in line with the growth of the economy, the size of risk-adjusted capital flows and national security requirements. This will provide us with greater security against unfavourable or unanticipated developments, which can occur quite suddenly.

25. India's **exports** have not done well last year largely on account of global slowdown exacerbated by the September 11 events which affected export of services. The growth rate of exports in US dollar terms decelerated to 0.05 per cent during 2001-02 (April-February) as compared with 20.6 per cent in the corresponding period of the previous year. In view of enlargement in domestic refining capacity, increase in oil exports (by 12.7 per cent) have emerged as a significant item of export growth. Non-oil exports, on the other hand, declined by 0.5 per cent as against an increase of 15.7 per cent in the previous year. The growth of imports showed an increase of 2.1 per cent as compared with 1.6 per cent in the corresponding period of the previous year reflecting lower oil imports emanating from moderation in international oil prices. While oil imports registered a decline of 11.9 per cent as against an increase of 55.0 per cent in the previous year, non-oil imports increased by 8.7 per cent as compared with a decline of 12.6 per cent in the corresponding period of the previous year. At a further disaggregated level, non-oil imports excluding gold and silver increased by 6.3 per cent during 2001-02 (April-December) in contrast to a decline of 6.4 per cent in the corresponding period of the previous year. As a result of deceleration in exports, the trade deficit widened to US $ 6.7 billion during 2001-02 (April-February) from US $ 5.8 billion in the corresponding period of the previous year.

26. It was announced in the annual policy Statement of April 2001 that a survey would be conducted through an independent outside agency in order to have a feedback

on simplification of procedures by RBI for export credit delivery as also the level of exporters' satisfaction with bank services. Accordingly, the work of the survey was entrusted to National Council of Applied Economic Research (NCAER), New Delhi. NCAER has since submitted its report. The results of the survey reflect positive responses to RBI's initiatives in improving the credit delivery system to exporters. More than three-fourths of exporters were satisfied with overall bank services relating to export credit delivery. Nearly one-fourth of exporters perceived them as "excellent" and more than half as "good". The only exception is the eastern region where only 12 per cent perceived them as "excellent" and less than half as "good". The report also made some suggestions for improving the credit delivery to exporters which are being examined by RBI. Summary of the report will be sent to banks for consideration and necessary action. It is also proposed to release the report for public information. The results of this survey will be useful for bringing about further improvements in bank services to exporters.

27. Reflecting comfortable supply position, the foreign exchange market generally exhibited stable conditions during 2001-02 barring some instances of volatility arising out of occasional uncertainties in market sentiments. The foreign exchange market witnessed brief periods of uncertainty in May 2001 on account of pressure on oil prices and downgrading of sovereign outlook; deceleration in capital inflows following September 11 events; and again in December 2001 due to terrorist attack on Indian Parliament and border tension. While the rupee depreciated against the US dollar during the year, it showed a mixed trend against other major currencies such as, Japanese Yen, Euro and Pound Sterling.

28. In the European Monetary Union, **Euro**, as a single currency, came into being with effect from January 1, 1999. As a preparatory measure, RBI, on November 20, 1998 had notified Euro as a permissible transaction currency under FERA and advised banks to accept FCNR (B) deposits in euro and convert existing deposits to euro freely besides balances in Exchange Earners' Foreign Currency (EEFC) and Resident Foreign Currency accounts. Banks were given freedom to use Euribor and Eurolibor as benchmarks for pricing their foreign exchange transactions. At the instance of RBI, FEDAI conducted a

training programme for bankers to familiarise them with the procedure of handling euro notes/coins. In the wake of smooth transition to euro notes and coins from January 1, 2002, RBI instructed Authorised Dealers (ADs) and full-fledged money changers to make arrangements to display euro exchange rates for travellers' cheques and currency notes and extend facilities to residents for conversion of legacy currencies to euro till January 31, 2002 and even after this date by banks and money changers having the necessary arrangements in place for realising the value of legacy currencies. RBI also provided necessary information on euro on its website and started announcing reference rate for euro in addition to US dollar.

29. Another major development in this area is that the Government of India has since given the option to RBI to use **euro as intervention currency** in addition to US dollar. Furthermore, Hyderabad and Nagpur have been included as new centres for sale and purchase of US dollar and euro.

30. It may be recalled that in the annual policy Statement of April 1998, soon after the Asian crisis, RBI had highlighted the need for caution in the **management of the exchange rate** in emerging economies. It was observed that: "all countries, and developing countries in particular, have to be constantly watchful of developments that may adversely affect exchange markets. There can be no room for complacency in this regard". It was further reiterated in the Mid-term Review of October 1998 that: "RBI will continue to closely monitor developments in the financial markets at home and abroad, and take such monetary and administrative actions as may be considered necessary from time to time. RBI will not hesitate to use its reserves, when warranted, to meet sharp day-to-day supply-demand imbalances in the market. As before, it will ensure that lumpy and uneven demand, particularly for oil imports and debt servicing obligations of the Government, does not cause any disturbance in the orderly functioning of foreign exchange market".

31. Subsequent international developments have further underscored the need for careful management of the exchange rate in order to maintain orderly conditions in the

markets (without, however, targeting a specific level). An important reason for this conclusion was highlighted in the Mid-term Review of October 2000 which observed that: " in the very short-run, "expectations" about the likely behaviour of a currency next day or over a week or fortnight can play a major role in determining its movement against foreign currencies, particularly the US dollar. Given the "bandwagon" effect of any adverse movements, and the herd behaviour of market participants, expectations can often become self-fulfilling. This is particularly true of thin developing country markets, where net volumes are relatively small. The day-to-day movement in currency markets is further complicated by volatility in private capital flows, which are highly sensitive to short-term domestic and international developments as well as future expectations".

32. Another important reason for a vigil on exchange rate is the likely effect of adverse developments in forex market on the real economy, as has been seen in several East Asian and Latin American countries a couple of years ago, and in Turkey and Argentina recently. The "contagion" effect is quick, and a sharp change in the currency value can affect the real economy more than proportionately. Exporters may suffer if there is unanticipated sharp appreciation and debtors or other corporates may be affected badly if there is a sharp depreciation, which can also lead to bank failures and bankruptcies.

33. Against the above background, India's exchange rate policy of focusing on managing volatility with no fixed rate target, while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way, has stood the test of time. Despite several unexpected external and domestic developments, India's external situation continues to remain highly satisfactory. RBI will continue to follow the same approach of watchfulness, caution and flexibility while dealing with the forex market. It is a matter of satisfaction that the recent international research on viable exchange rate strategies in emerging markets has lent considerable support to the exchange rate policy followed by India. A number of countries (including those in East Asia) are now following similar policies.

34. In the past two years, a number of changes have been introduced in various schemes for remittances, investment and maintenance of bank accounts by non-resident Indians (NRIs). Continuing with the policy of **liberalisation of the capital account,** following the announcement made in the Budget 2002-03, the Reserve Bank has implemented the following measures:

? With a view to providing full convertibility on non-resident deposit schemes, non-resident non-repatriable (NRNR) account and non-resident special rupee (NRSR) account schemes were discontinued with effect from April 1, 2002. Banks would not accept any deposit, whether by way of renewal of existing deposits or otherwise under these two schemes with effect from April 1, 2002. Existing accounts under NRNR scheme, however, may be continued up to the date of maturity. On maturity of the existing deposits under the NRNR scheme, the maturity proceeds shall be credited to the account holder's non-resident (external) account (NRE account), after giving notice to the account holder. Similarly, the existing accounts in the form of term deposits under NRSR scheme may be continued till the date of maturity. On maturity, the maturity proceeds shall be credited to the account holder's non-resident (ordinary) account (NRO account). Existing NRSR accounts, other than term deposits, would not be continued after September 30, 2002 and may, at the option of the account holders, be closed or the balance therein credited to their NRO accounts on or before that date.

? Existing limits for Indian direct investment outside India under automatic route has been raised from US $ 50 million in a financial year to US $ 100 million. Such Indian investors could now purchase foreign exchange up to 50 per cent of their net worth as on the date of last audited balance sheet as against the existing limit of 25 per cent.

? Corporate borrowers are allowed to prepay ECBs to the extent of the balances in their EEFC accounts, with the approval of RBI. Corporates which are export-oriented units and others can credit up to 70 per cent and 50 per cent, respectively, of their foreign exchange earnings to their EEFC accounts. RBI has since decided to allow the corporates to credit higher than the above percentage of export

proceeds to their EEFC accounts on a case-by-case basis to enable them to take advantage of lower interest rates and prepay their ECBs.

? It has been decided to allow Indian corporates with proven track record to contribute funds from their foreign exchange earnings for setting up Chairs in educational institutions abroad, and for similar such purposes. Such cases will be considered by RBI on a case-by-case basis.

? RBI had issued a notification in September 2001 permitting Indian companies to raise the 24 per cent limit on Foreign Institutional Investors' (FIIs) investment to the sectoral cap/statutory ceiling as applicable. As announced by the Finance Minister in his Budget speech for 2002-03, FII portfolio investments will not be subject to sectoral limits for foreign direct investment except in specified sectors. The details of sectors and the limits applicable will be specified by the Government in due course.

? NRIs will be able to repatriate their current income in India such as rent, dividend, pension, interest, etc. by submitting a certificate from their chartered accountant certifying that the amount proposed to be remitted is eligible for remittance and that applicable taxes have been paid/provided for.

? Indian mutual funds will be allowed to invest in rated securities in countries with fully convertible currencies, within the existing limits. Earlier such investment was only permitted in ADRs/GDRs issued by Indian companies in overseas markets.

? With a view to further liberalise capital account transactions, it has been decided to put the limit for Foreign Currency Convertible Bond (FCCB) scheme under the automatic route up to US $ 50 million.

35. The Reserve Bank, as a part of the consultative process, constituted various working groups on relevant policy subjects with the participation of bankers, market participants and experts. Working groups were also set up for suggesting road maps for implementation of international best systems and practices in the financial system in general and banking sector in particular. The reports of the working groups were examined internally and, as necessary, these were also put on the RBI website for wider

dissemination and comments. The details of the progress made in respect of certain working groups constituted recently are given in the Annexure to this Statement.

II. Stance of Monetary Policy for 2002-03

36. The overall stance of monetary policy in 2001-02, as outlined in last year's annual policy Statement, was as follows:

- ? Provision of adequate liquidity to meet credit growth and support revival of investment demand while continuing a vigil on movements in the price level.
- ? Within the overall framework of imparting greater flexibility to the interest rate regime in the medium-term, to continue the present stable interest rate environment with a preference for softening to the extent the evolving situation warrants.

The monetary management in 2001-02 was largely in conformity with the monetary policy stance announced in annual policy Statement of April 2001 and reiterated in the Mid-term Review of October 2001. However, the monetary management in 2001-02 was fraught with several challenges like overhang of liquidity, global slowdown, external developments after September 11 and the tense situation on the borders.

37. As spelt out in the Mid-term Review of October 2001, RBI has been able to maintain stable interest rate regime throughout the year with a bias towards further softening of the interest rates. The yields on government securities in the secondary market ruled much lower than the yields at the beginning of the financial year. The large market borrowing programme of the Government could be completed at a lower cost without unduly affecting the general interest rates.

38. Though there have been substantial lendable resources with banks due to reduction in the Cash Reserve Ratio (CRR) and prevalence of soft interest rate regime, as mentioned earlier, non-food credit off-take has not picked up to a desirable extent due to low level of economic activity in general, which is evident from the decelerated growth in industrial production.

39. During the last quarter of 2001-02, a pick-up in the non-food credit has been observed which is expected to continue. Further, benign inflation, good agricultural prospects, and signs of recovery, though incipient, in the US and euro-zone should help the process of recovery in our economy. Agricultural recovery should increase rural demand for both durable and non-durable goods. The global recovery should also help our exports, specifically in software and knowledge-based industries. As such, it is anticipated that the demand for credit is likely to increase in the current year.

40. During 2001-02, forex market showed considerable stability without any undue pressure on exchange rate. As pointed out in the previous Section, India's exchange rate policy of focusing on managing volatility with no fixed rate target, while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way, has stood the test of time. Despite several unexpected external and domestic developments, India's external situation has remained highly satisfactory. RBI will continue to follow the same approach of watchfulness, caution and flexibility in regard to the forex market. Barring major unforeseen global development, RBI will also continue to ensure that, leaving aside short-term variations in reserve levels, the quantum of reserves in the long-run is in line with the growth rate in the economy, the share of external sector in the economy, and the size of the risk-adjusted capital flows. It is heartening to note that our system of exchange rate and reserve management now commands increasing international acceptance.

41. The fiscal deficit of the Central Government which was budgeted at 4.7 per cent of GDP for 2001-02 was revised upward to 5.7 per cent. For the year 2002-03, the fiscal deficit was placed at 5.3 per cent of GDP and the market borrowing programme of the Centre at Rs.1,42,867 crore (gross) and Rs.95,859 crore (net). While the market borrowing programme in respect of some States has come under stress, RBI expects to conduct debt management without serious pressure on overall liquidity and interest rates.

42. The projection of overall growth rate for the year 2002-03 basically depends on the speed of recovery in the industrial sector and the expected growth in agriculture. The present indications show that agriculture is likely to grow at a higher rate than last year and there are positive indications of a quicker recovery in the industrial sector with good prospects for export sector. For the purpose of monetary policy formulation, for the year as a whole, growth rate of real GDP in 2002-03 is placed at 6.0 – 6.5 per cent. The rate of inflation is assumed to be slightly lower than 4.0 per cent. The projected expansion in broad money (M_3) for 2002-03 is 14.0 per cent. Consistent with this order of growth in M_3, an increase in aggregate deposits of scheduled commercial banks is set at Rs. 1,54,000 crore. Non-food bank credit adjusted for investments in commercial paper, shares/debentures/bonds of PSUs and private corporate sector is projected to increase by 15.0 – 15.5 per cent. This magnitude of credit expansion is expected to adequately meet the credit needs of all the productive sectors of the economy.

43. Against this background, RBI proposes to continue to ensure that all legitimate requirements for credit are met, consistent with price stability. Towards this end, RBI will continue its policy of active demand management of liquidity through OMO, including two-way sales/purchase of Treasury Bills and using the policy instruments at its disposal, whenever required. Unless circumstances change unexpectedly, RBI will continue to maintain current interest rate environment with a bias towards softer interest rate regime in the medium-term. Further, the long-term objective would be towards realignment of interest rates of all types of debt instruments, both the government and private sector, within a narrow band.

44. The monetary policy framework has also substantially changed during the past few years in moving from direct to indirect instruments and improved the transmission mechanism of monetary policy. This process is likely to accelerate with the operationalisation of the Real Time Gross Settlement (RTGS) system. The precursors for RTGS such as operationalisation of Negotiated Dealing System (NDS) and Clearing Corporation of India Ltd. (CCIL) have been put in place. There have been substantial improvements in the systems of regulation and supervision of banks and the proposal to

set up a Credit Information Bureau (CIB) to collect, process and share credit information on the borrowers among banks and FIs within the existing legal framework attains importance in this regard.

45. The Bank Rate changes combined with CRR and repo rate changes have emerged as signalling devices for interest rate changes and important tools of liquidity and monetary management. The liquidity adjustment facility (LAF) has evolved as an effective mechanism for absorbing and/or injecting liquidity on a day-to-day basis in a more flexible manner and, in the process, providing a corridor for the call money market. With most of the procedural and technological constraints removed, RBI's endeavour to make LAF much more efficient will continue. RBI will also continue its efforts to bring about development and smooth functioning of the financial market and pursue further financial sector reforms towards achieving a greater degree of financial stability.

46. In sum, under normal conditions and barring emergence of any adverse and unexpected developments in the various sectors of the economy, the **overall stance of monetary policy** for 2002-03 will be:

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

? In line with the above, to continue the present stance on interest rates including preference for soft interest rates.

? To impart greater flexibility to the interest rate structure in the medium-term.

III. Financial Sector Reforms and Monetary Policy Measures

47. The annual policy Statements as well as Mid-term Reviews have been focussing on the structural and regulatory measures to strengthen the financial system and improve the functioning of various segments of the financial market. These measures, introduced after extensive consultations with experts and market participants, have been directed towards increasing operational effectiveness of monetary policy, redefining the regulatory role of the Reserve Bank, strengthening the prudential and supervisory norms,

improving the credit delivery system, and developing technological and institutional infrastructure of the financial sector.

48. Recent policy measures have endeavoured to take into account the technological developments which have a major impact on the financial sector. Information technology allows sophisticated product development, better market infrastructure, implementation of reliable techniques for control of risks and also help the financial intermediaries to reach distant and diversified markets. In view of this, technology has changed the contours of three major functions performed by banks, i.e., access to liquidity, transformation of assets and monitoring of risks. The interaction of technology with deregulation is also contributing to the emergence of a more open, competitive and globalised financial market which should improve efficiency in the economy, while at the same time calling for greater vigilance and prudence in asset-liability management. In this regard, banks have positively responded to the Reserve Bank's directions to adopt the necessary technology in their operations.

49. Keeping in view the progress made in the implementation of measures taken so far, and their impact on the soundness of the Indian banking system, it is proposed to speed up the process further to enable the Indian financial sector to be better equipped to meet the global competition.

Monetary Measures

(a) Rationalisation and Reduction in Cash Reserve Ratio

50. The Reserve Bank has been pursuing its medium-term objective of reducing CRR to the statutory minimum level of 3.0 per cent. In this direction, RBI gradually reduced the CRR from 11.0 per cent in August 1998 to 7.5 per cent by May 2001. In the Mid-term Review of October 2001, CRR of scheduled commercial banks [excluding Regional Rural Banks (RRBs)] was reduced by 200 basis points to the present level of 5.5 per cent of their net demand and time liabilities (NDTL). Rationalisation of CRR was also

initiated by withdrawing various exemptions given to banks on certain specific categories of liabilities for the CRR requirement. Subsequently, all categories of banks, including co-operative banks, were also made subject to the CRR prescription as applicable to the scheduled commercial banks. These measures were designed to facilitate development of short-term yield curve, develop money market, enhance availability of lendable resources with banks and improve the efficacy of indirect instruments in the conduct of monetary policy. Further, RBI announced its intention to move away from sector-specific refinance. As a further step in the direction of moving towards the medium-term objective of reducing the CRR while strengthening the LAF and introducing better prudential standard, it is proposed to:

? Reduce CRR further from 5.5 per cent to 5.0 per cent effective fortnight beginning June 15, 2002.

The proposed reduction in CRR is being made effective from fortnight beginning June 15, 2002 in view of the prevailing excess liquidity with the banking system as can be seen by larger turnover in the call money market and the higher average recourse to RBI repos. However, in case there is an unexpected change in the liquidity conditions in the market, RBI may advance the effective date of reduction before the above announced date.

(b) Bank Rate

51. At present, there is substantial excess liquidity in the system which is reflected in the repo amounts received by the Reserve Bank during the past six weeks. On April 4, 2002, the total amount tendered by way of repo was as high as Rs.30,055 crore. On an average, amounts tendered by banks in one or three-day repos have ranged from Rs.1,565 crore to Rs.16,024 crore in the past six weeks. The repo rate is currently 6.0 per cent, which is below the Bank Rate of 6.5 per cent, and call money rates on several days have also been lower than the Bank Rate. In response to the easy liquidity situation, some banks have also recently reduced their deposit rates as well as lending rates. Further, yields on fixed income securities have also come down substantially. Under these

circumstances, on balance, it is considered desirable to leave the Bank Rate unchanged. The matter, however, will be kept under constant review. In case the overall liquidity and credit situation warrants, and inflation rate continues to remain low, a reduction in the Bank Rate by up to half a percentage point (50 basis points) will be considered by RBI as and when necessary.

(c) Statutory Liquidity Ratio of Regional Rural Banks

52. RRBs are required to maintain SLR at 25 per cent of their NDTL in cash or gold or in unencumbered government and other approved securities. Unlike in the case of scheduled commercial banks, balances maintained in call or fixed deposits by RRBs with their sponsor banks are treated as "cash" and hence, reckoned towards their maintenance of SLR. As a prudential measure, it is desirable on the part of all RRBs to maintain their entire SLR portfolio in government and other approved securities, which many of them are already doing. Accordingly:

? All RRBs may maintain their entire SLR holdings in government and other approved securities. In order to allow sufficient time to RRBs to convert existing deposits with sponsor banks into government securities, this provision may be complied with by March 31, 2003.

Interest Rate Policy

(a) Interest Rate Flexibility

53. As pointed out in the earlier Section, the year 2001-02 witnessed one of the steepest declines in interest rates on long-term government securities. The yield on 10-year government securities declined by as much as 287 basis points. The secondary market yield on 10-year paper is currently 7.27 per cent. The Bank Rate, the repo rate and the overnight call money rates have also been very low in recent months ranging between 6.0 and 7.0 per cent. In relation to the average rate of inflation of 3.6 per cent during 2001-02, it is evident that the real interest rates on long-term paper, the Bank Rate and short-term rates are now fairly reasonable.

54. However, the sharp reduction in nominal and real interest rates is not yet fully reflected in the interest rates generally charged by banks on advances. There is also some evidence that the spread between the interest rates charged by banks to different borrowers has also tended to widen. The relatively lesser reduction in the rates of interest that most borrowers have to pay is despite the action taken by the Government in the last three years to lower administered interest rates on Relief Bonds and small savings, etc. as well as the sharp reduction by RBI in the CRR of banks (along with an increase in the interest rate paid by RBI on eligible cash balances maintained by banks with RBI). The reasons for the relative downward inflexibility in the commercial interest rate structure seems to be primarily due to the following factors:

? The average cost of deposits for major banks continues to be relatively high (6.25 to 7.25 per cent). Further, a substantial portion of deposits is in the form of long-term deposits at fixed interest rates. Thus, flexibility available to banks to reduce interest rates in the short-run, without adversely affecting their return on assets, is limited. The relatively high overhang of non-performing assets (NPAs) further pushes up the average cost of funds for banks, particularly public sector banks.

? The non-interest operating expenses of banks work out to 2.5 to 3.0 per cent of total assets, putting pressure on the required spread over the cost of funds.

? In view of legal constraints and procedural bottlenecks in recovery of dues by banks, the risk-premium tends to be higher resulting in wider spread between deposit rates and lending rates.

? The large borrowing programme of the Government, over and above SLR requirements, provides significant prospects for deployment of funds by banks in sovereign paper.

55. From the medium-term perspective, it is necessary to initiate measures to make the interest rate structure in India more flexible and reflective of the underlying inflationary situation. So far as reduction in spreads is concerned, it is no doubt necessary to improve man-power productivity (for example, through increase in volumes), and also

reduce establishment costs. Some progress in this area has been made in the last two years, but there is still a long way to go. However, it has to be recognised that, given various constraints (including public ownership in the banking sector and legislative provisions), especially poor debt-recovery systems, actual progress in reducing average spreads is likely to be slow.

56. Without prejudice to further progress in reduction in spreads, and other measures to reduce delays in recovery, in order to impart flexibility to interest rate structure, following measures need to be considered as early as possible:

? Encourage introduction of flexible interest rate system for all new deposits with reset at six-monthly intervals. At the same time, the fixed rate option should also be made available to depositors. Illustratively, banks may offer longer term deposits with six-monthly reset conditions and at the same time offer a fixed rate for similar maturity, the interest rate on which may be higher or lower depending on the period of deposit and banks' perception regarding inflation as well as interest rate outlook over the longer period. All banks are advised to put such a flexible rate system (with a fixed rate option also for depositors) in practice as early as possible.

? Banks are also urged to devise schemes for encouraging depositors to convert their existing long-term fixed rate past deposits into variable rate deposits. Commercial banks may consider paying the depositors at the contracted rate for the period of deposit already run and waive the penalty for premature withdrawal if the same deposit is renewed at the variable rate.

(b) Prime Lending Rate and Spreads

57. In the Mid-term Review of October 1996, it was stated that "a number of banks are charging lending rates far higher than PLR on a significant portion of bank credit to borrowers with credit limits of over Rs.2 lakh. It has, therefore, been decided that banks, along with the announcement of their PLR, should also announce the maximum spread

over the Prime Lending Rate for all advances other than consumer credit. Banks should obtain the approval of their respective Boards for fixation of maximum spread over the Prime Lending Rate".

58. As per the latest available information, spreads above PLR of some banks are substantial. In the present interest rate environment, it is not reasonable to keep very high spreads over PLR. Banks are, therefore, urged to review the present maximum spreads over PLR and reduce them wherever they are unreasonably high so that credit may be available to the borrowers at reasonable interest rates. Further, banks should also announce the maximum spread over PLR to the public along with the announcement of their PLR. The Reserve Bank will review the matter again in October 2002 after further consultations with select banks with very high spread over PLR.

59. In the interest of customer protection as also meaningful competition, it is necessary to have a greater degree of transparency in regard to actual interest rates for depositors as well as borrowers. In this direction, the following measures are proposed:

? Banks should provide information on deposit rates for various maturities and effective annualised return to the depositors. This information should be made available to RBI also, so that RBI can put a consolidated picture for all banks on its website.

? Banks should provide information on maximum and minimum interest rates charged to their borrowers. RBI will put this information also in public domain.

? Banks are urged to switch over to "all cost" concept for borrowers by explicitly declaring the processing charges, service charges, etc. charged to borrowers. Such bank charges may also be publicly announced.

(c) Interest Rate on Savings Account - No Change

60. In the recent years, banks have been given freedom in fixing interest rates on various deposit liabilities, and flexibility in offering interest rates depending upon tenor and size of deposits with the approval of their Boards. The only interest rate on deposits

side which is regulated by RBI is on “savings account” with cheque facility. This rate is at present 4.0 per cent per annum.

61. However, although the nominal interest rate is 4.0 per cent per annum, the yield on such deposits works out to 3.4 per cent per annum only as interest is payable on the minimum balance between tenth and last day of each month. Nearly four-fifths of such saving deposits are held by households.

62. In view of the present deregulated interest rate environment and the reduction in interest rates on Government’s small savings schemes in the recent period, there is an apparent case for deregulation of interest rates on savings account also. However, considering the fact that bulk of such savings deposits are held by households, including households in rural and semi-urban areas, on balance, it is not considered as opportune time to deregulate the interest rate on savings account for the present. In any case, the present effective yield of 3.4 per cent is quite reasonable in relation to other prevailing interest rates on even short-term instruments.

(d) Interest Rate on Export Credit

63. Exporters have the option to avail of pre-shipment and post-shipment credit in foreign currency from banks in India. Such credit is currently available at LIBOR plus a maximum spread of 1.0 percentage point making this rate internationally competitive for Indian exporters. In order to make the interest rate even more competitive in the present low interest rate environment, it is desirable to further lower the ceiling rate on foreign currency loans for Indian exporters by banks. Accordingly:

? The ceiling rate on export credit in foreign currency is being reduced to LIBOR plus 0.75 percentage point from the present LIBOR plus 1.0 percentage point.

64. Considering this competitive interest rate on foreign currency loans and to mitigate any possible exchange risk, exporters are encouraged to make maximum use of foreign currency loans in one or more currencies of their choice depending on the currency of their export receipts (e.g., US dollar, euro, Pound Sterling, etc.). Indian

banks, located in areas with concentration of exporters, are being advised to give this important facility due publicity and make it easily accessible to all exporters, including small exporters.

65. In the annual policy Statement of April 2001, interest rates on export credit in rupee terms were rationalised and ceilings were prescribed for both pre-shipment and post-shipment credit linked to PLR. This prescription of ceilings of 1.5 percentage points below PLR has facilitated exporters to avail of credit at substantially lower rates than the PLR of the banks. Considering the unusual international developments, effective September 26, 2001, the ceilings on export credit interest rates were further reduced to 2.5 percentage points below PLR for a period of six months (i.e., up to March 31, 2002). From April 1, 2002, the ceiling rates were to revert to 1.5 percentage points below PLR. However, keeping in view the continued international uncertainties, the period during which interest rate of 2.5 percentage points below PLR will be applicable has been extended up to September 30, 2002. With this concession, the ceiling rate on pre-shipment rupee export credit up to 180 days works out to 7.5 to 8.5 per cent for most public sector banks. As exporters are eligible to sell their export earnings in the forward market, taking into account the forward premia, the effective interest cost to exporters becomes only 2.0 to 3.0 per cent, which is internationally highly competitive.

66. In view of the need to ensure transparency and also encourage banks to continue to provide finance at competitive rates, there is a need for putting in place a reporting system by which commercial banks provide information on interest rates charged on pre-shipment and post-shipment credit. This will facilitate exporters in choosing the most competitive rate. Accordingly:

? With effect from fortnight beginning June 15, 2002, banks will report to RBI, the minimum and maximum lending rates to exporters. This information will be placed in public domain.

67. In view of the above proposals (i.e., a reduction in interest rates for foreign currency loans to exporters and compulsory reporting of minimum and maximum lending

rates charged by banks to exporters), a further proposal which requires consideration is to deregulate the interest rate on export credit in domestic currency. Linking of domestic interest rates on export credit to PLR has become redundant in the present circumstances, when the effective interest rates are in any case substantially lower than the PLR for exporters. Deregulation of the present ceiling on interest rate for domestic currency, may in fact encourage greater competition among banks and may have the effect of further lowering interest rates for exporters with a good credit record. This proposal will be considered by RBI after further consultations as necessary.

(e) Deemed Exports

68. As per the extant guidelines, banks are permitted to extend rupee pre-shipment and post-supply rupee credit at concessional rate of interest to parties against orders for supplies in respect of deemed exports. Such rupee export credits, both at pre-shipment and post-supply stages, are eligible for refinance from RBI. However, it has been represented that some exporters still do not get the advantage of the concessional rate of interest in the case of deemed exports. Banks are, therefore, urged to widely publicise the concessionality in the interest rates for deemed exports and make these available to all eligible exporters.

(f) Abolition of Minimum Lending Rate for Co-operative Banks

69. State and Central Co-operative Banks were given freedom to determine their lending rates subject to the prescription of minimum lending rate (MLR) of 12.0 per cent per annum by the Reserve Bank since October 18, 1994. Similarly, the Urban Co-operative Banks (UCBs) were subject to the prescription of MLR at 13.0 per cent per annum effective June 21, 1995, which was reduced to 12.0 per cent effective March 2, 2002. Since August 26, 1996, RRBs were given freedom to determine their lending rate. At present, commercial banks other than RRBs have the freedom in deciding their PLRs with the approval of their Boards. In the annual policy Statement of April 2001, PLR was made a reference/benchmark rate, so that commercial banks are free to lend at sub-PLR

rates to creditworthy borrowers. In order to provide greater flexibility to co-operative banks in a competitive environment, it is proposed:

- ? To withdraw the stipulation of MLR for all co-operative banks with immediate effect. Co-operative banks will now be free to determine their lending rates taking into account their cost of funds, transaction cost, etc. with the approval of their managing committee. This will help the co-operative banks in attracting good/prime borrowers.
- ? It should be ensured that the interest rates charged by co-operative banks are transparent and known to all their customers. Banks are, therefore, requested to publish the minimum and maximum interest rates charged by them, and display this information in every branch.

(g) Liberalisation of Investment Norms of Funds Mobilised under FCNR(B) Deposits

70. At present, banks are allowed to accept FCNR(B) deposits for a period of 1-3 years. However, on the assets side, there are certain restrictions on deploying these funds. Presently, banks can lend funds to Indian residents for their foreign exchange requirements or for financing of Joint Ventures or Wholly Owned Subsidiaries set up by resident corporates. Besides, banks can also invest such funds in certain money market instruments which satisfy prescribed rating. In view of restrictions on the deployment of funds, the assets side could be shorter in tenor than the liabilities side resulting in asset-liability mismatches. Further, there exists interest rate risk in view of changes in LIBOR rates, if matching investment opportunities are not available to banks. In this regard, RBI had received a number of representations from banks for reviewing the investment norms.

71. In order to avoid asset-liability mismatches, and also consistent with the risk management guidelines put in place by RBI, banks are now permitted:

- ? To invest their FCNR(B) deposits in longer term fixed income instruments, subject to the condition that these instruments should have an appropriate rating prescribed for the money market instruments. Moreover, banks have to obtain

prior approval from their Boards with regard to type/tenor of instruments along with relevant rating and likely cap on such investments within the asset-liability management (ALM) guidelines in force.

(h) Interest Rate on FCNR(B) Deposits

72. Currently, banks are free to accept FCNR(B) deposits for a maturity period of 1-3 years and to offer fixed and floating rates, subject to the ceiling of LIBOR/SWAP rates. In view of the prevailing international environment of low interest rates, and to reduce the cost of FCNR(B) deposits, it is decided:

? To revise the above ceiling rate downward to LIBOR/SWAP rates for the corresponding maturities minus 25 basis points.

(i) Relaxation on Borrowing from and Investment in Overseas Market by Banks

73. At present, banks in India are allowed to borrow from and invest in the overseas market up to 15 per cent of their unimpaired Tier I capital or US $ 10 million, whichever is higher. In order to enable banks to have greater operational flexibility and also to align the domestic interest rate with overseas market, it is decided:

? To allow banks to borrow up to 25 per cent of their unimpaired Tier I capital from overseas market. The borrowings should be within the banks' Open Position Limit and maturity mismatch limits (Gap Limits) for which detailed guidelines will be issued.

? On the same lines, the existing limit of 15 per cent of unimpaired Tier I capital for investment in overseas market is being raised to 25 per cent of unimpaired Tier I capital. The investments in money market instruments will be within the existing Open Position Limit and maturity mismatch limits (Gap Limits). This will ensure uniformity in overseas borrowing and investment portfolio of banks.

The increased borrowing limit would enable banks to get cheaper funds and help them to have adequate rupee resources and thus reduce the cost of funds for the banks. While it

will enhance the process of integration of Indian financial market with the global market, different segments of the domestic market will also get further integrated.

(j) Crystallisation of External Commercial Borrowings

74. It is customary for the overseas branches of the ADs in foreign exchange to extend external commercial borrowings (ECBs) to Indian corporates against guarantees/letters of comfort issued by their branches in India. A suggestion was made by banks that they should have the freedom to crystallise the foreign exchange liability in rupees in select cases where circumstances warrant, keeping in view the status of account of the corporates and their impact on liabilities of overseas branches. In order to provide greater freedom and flexibility to banks in their fund management, it is proposed to:

? Grant permission with appropriate safeguards for crystallisation of ECBs into rupee loans where it is considered necessary by banks to do so.

Credit Delivery Mechanism

(a) Priority Sector Lending

75. In order to improve credit delivery mechanism for the priority sector, the Reserve Bank has taken various measures to reduce procedural delays and provide greater flexibility to banks. In order to further improve credit delivery to the priority sector, and in particular to agriculture, the following measures are proposed:

? The limits for financing of distribution of inputs for allied activities such as cattle feed, poultry feed, etc. under priority sector is being increased to Rs.25 lakh from the present limit of Rs.15 lakh.

? In order to help the farmers in marketing their products, credit limits for marketing of crops (pledge financing) is being increased from Rs.1 lakh to Rs.5 lakh. Further, the repayment schedules of such credit has been enhanced to 12

months from 6 months at present. With this liberalisation, farmers can have maximum benefit in marketing their agricultural products.

? To avoid any double counting, sponsor banks, while meeting the priority sector targets, should exclude funds provided to RRBs for on-lending to priority sector.

(b) Credit Facilities for Small-Scale Industries

76. Recognising the requirement of providing collateral securities as a bottleneck in the flow of bank credit to very small units, RBI in annual policy Statement of April 2000, announced dispensation of collateral requirement for loans up to Rs.5 lakh for tiny sector. This dispensation was extended subsequently to all small-scale industrial (SSI) units. In order to further improve the flow of credit to SSIs:

? Banks may, on the basis of good track record of the units and the financial position of units, increase the limit of dispensation of collateral requirement for loans from the existing Rs.5 lakh to Rs.15 lakh.

77. Banks are also advised to take a pro-active stance in providing timely assistance for rehabilitation of small-scale units which are affected by the industrial downturn, and delays in payments against supplies made by them to large-scale and other units. In January 2002, following the report of a High Level Working Group, RBI issued detailed guidelines to scheduled commercial banks for providing timely assistance to potentially viable small-scale units. These guidelines, *inter alia*, provide for waiving of penal rate of interest to such units, and for extension of working capital at 1.5 percentage points below the prevailing fixed/prime lending rates. Provision has also been made in these guidelines for extension of term loans at reduced rate of interest. Banks are requested to implement these guidelines fully and to submit a report to their Boards by the end of the current calendar year on the progress made in assisting small-scale units under the new guidelines.

(c) Securitisation and Risk Weights for Housing Finance

78. Banks have been playing an important role in providing credit to the housing sector in consonance with the goals of National Housing and Habitat Policy. Recognising the growing importance of the construction sector including its forward and backward linkages with other sectors of the economy, RBI has encouraged banks to increase the flow of credit to this sector and has advised banks to allocate a minimum of 3.0 per cent of incremental deposits for housing for the year 2001-02. In order to increase the flow of credit, term loans extended by banks to intermediary agencies against the loans sanctioned by them were allowed to be reckoned as part of housing finance. Also, investment in bonds issued by HUDCO and NHB exclusively for financing of housing is being reckoned for priority sector targets.

79. At present, banks' loans and advances secured by mortgage on residential property and also commercial property are assigned a risk weight of 100 per cent for capital adequacy purposes. So far no explicit risk weights have been prescribed for banks' investment in securitised papers. The Basel Capital Accord of 1988 and also the New Capital Adequacy Framework, which is at the consultative stage, envisage risk weight of 50 per cent and 100 per cent for claims secured by residential property and commercial real estate, respectively.

80. With a view to further improving the flow of credit to the housing sector, it is proposed to liberalise the prudential requirements for housing finance by banks and encourage investment by banks in securitised debt instruments of Housing Finance Companies (HFCs). Accordingly:

? Banks extending loans against residential housing properties would be required to assign risk weight of 50 per cent, instead of present 100 per cent. Loans against the security of commercial real estate would continue to attract 100 per cent risk weight as hitherto.

? Investments made by banks in Mortgage Backed Securities (MBS) of residential assets by HFCs which are recognised and supervised by NHB would also be assigned a risk weight of 50 per cent for the purpose of capital

adequacy. However, investment by banks in MBS of housing assets which include commercial properties would attract 100 per cent risk weight.

? Investments by banks in MBS issued by HFCs supervised by NHB will be reckoned for inclusion in the prescribed housing finance allocation of 3.0 per cent.

? A Working Group would be set up to suggest modalities for widening the investor base, improving the quality of assets, creating liquidity for trading in such assets and other related issues.

(d) Kisan Credit Cards

81. Kisan Credit Cards (KCC) Scheme formulated in 1998 has helped the farmers considerably and has been very successful. The Reserve Bank had advised all banks pursuant to the Budget 2002-03 announcement, to make concerted efforts to reach the annual target of 33 lakh KCCs by March 2002. Further, banks were advised to ensure that all existing and prospective KCC holders are covered under the Personal Accident Insurance Policy. In addition, banks are urged to make suitable plans for covering all eligible borrowers in agricultural sector under the KCCs by March 2004. It is proposed that a survey may be conducted for assessing the impact of the scheme on the beneficiaries. This survey may be entrusted to an outside agency.

(e) Rural Infrastructure Development Fund

82. Pursuant to the announcement made in the Budget 2002-03, funds for RIDF VIII will be enhanced to Rs.5,500 crore and the rate of interest on loans to the State Governments will be reduced from 10.5 per cent to 8.5 per cent, i.e., Bank Rate plus 2.0 percentage points. Henceforth, interest rate on loans to States from RIDF are linked to the Bank Rate.

(f) Micro-credit

83. Micro-credit institutions and Self Help Groups (SHGs) are important vehicles for generation of income and delivery of credit to self-employed persons. Special emphasis was also placed on promotion of micro enterprises in rural areas set up by vulnerable sectors including women, SC/ST and other backward classes. Banks were also advised to provide maximum support to SHGs in this regard. As the scheme of micro-credit through SHGs is progressing well, the target for the same has been raised to 1.25 lakh for 2002-03. Accordingly, scheduled commercial banks and NABARD may take immediate steps in forming such linkages across the country so as to achieve the aforesaid target.

Money Market

(a) Moving further towards Pure Inter-bank Call Money Market

84. It may be recalled that in the annual policy Statement of April 2001, the intention to move towards a pure inter-bank call/notice money market, by gradually phasing out non-bank participation, was highlighted. Accordingly, a time-frame was outlined in four stages for implementation. In stage I, non-bank participants are allowed to lend, on average, up to 85 per cent of their average lending during 2000-01 in a reporting fortnight. These limits are strictly monitored by RBI. However, in case a particular financial institution has excess liquidity at some point of time but could not explore proper avenues for investment, RBI permits the institution to lend more than the prescribed limit for a specific period with suitable limits. A review of progress revealed that phasing out non-banks has not caused any strain on the market: the volatility in the call money rate has reduced and average daily turnover in the call money market has gone up. Simultaneously, net lending through repo transactions by non-banking financial institutions and mutual funds have also increased. In view of these encouraging developments, and with the operationalisation of NDS and CCIL, it is felt necessary to accelerate the progress of moving towards a pure inter-bank call/notice money market and facilitate further deepening of the repo market. Accordingly, it has been decided:

? To move towards stage II, wherein non-bank participants would be allowed to lend, on average, in a reporting fortnight up to 75 per cent of their average

lending in call market during 2000-01 with effect from a date to be announced later. RBI will announce the date of effectiveness of stage II depending on the date when NDS/CCIL becomes fully operational, and widely accessed.

(b) Reliance on Call/Notice Money Market

85. Narasimham Committee II had recommended that there must be clearly defined prudent limits beyond which banks should not be allowed to rely on call/notice money market, and that access to this market should essentially be for meeting unforeseen mismatches and not as a regular means of financing banks' lending operations. This was also recognised in the guidelines on Asset-Liability Management System issued by RBI in February 1999 which required, *inter alia*, that mismatches during the first two time buckets, viz., 1-14 days and 15-28 days should not, in any case, exceed 20 per cent of the cash outflows in each time bucket. Further, in order to reduce excessive reliance on short-term funding, banks were also advised to set a cap on inter-bank borrowings, especially call borrowings.

86. Some banks, however, continue to depend overwhelmingly on call money market for carrying out their banking operations. It needs to be appreciated that call money borrowings, being uncollateralised in nature, have the potential to create serious instability in the financial market because of unethical or imprudent behaviour of some participants. In view of such an observed phenomenon in early part of last year, a ceiling on access to call money market was imposed in respect of a select segment. At present, except for UCBs, which are subject to a ceiling on borrowing of 2.0 per cent of their aggregate deposits of previous financial year, other entities are not under any explicit limit.

87. An internal Working Group has examined the need to place prudential limits on exposure to call/notice money market in a symmetric way so as to preserve the integrity of the financial system. The Group felt that building up of substantial exposure relative to balance-sheet size by some participants on a continuous basis has the potential not only for default and the consequent systemic instability, but also impedes the development of

other segments of money market, particularly, the term money market. The Technical Advisory Committee on Money and Government Securities Markets (TAC) also suggested linking of borrowing and lending in call/notice money market to the size of the balance sheet. Accordingly:

? Lendings of scheduled commercial banks in the call/notice money market, on a daily basis, should not exceed 25 per cent of their owned funds (paid-up capital plus reserves) as at the end of March of the previous financial year.

? Borrowings by scheduled commercial banks in the call/notice money market, on a daily basis should not exceed 100 per cent of their owned funds or 2.0 per cent of aggregate deposits as at the end of March of the previous financial year, whichever is higher.

? In order to ensure that scheduled commercial banks do not face any disruption in their ALM in adjusting to this stipulation, the existing borrowers and lenders should unwind their positions in excess of the prudential limits by the end of August 2002.

? The borrowings of State Co-operative Banks (SCBs) and District Central Co-operative Banks (DCCBs) in the call/notice money market on a daily basis should not exceed 2.0 per cent of their aggregate deposits as at the end of March of the previous financial year.

? In case any bank has, for a temporary period, some mismatches in their liquidity positions, RBI, on request, may consider allowing them further access to call/notice market. Similarly, if any bank has put in place a fully functional ALM system to the satisfaction of RBI, an increased access over the stipulated norm may be permitted by RBI for a longer period.

? A Working Group is being constituted with representatives from eligible entities to recommend by June 30, 2002, the criteria for fixing the limits for Primary Dealers (PDs) in call/notice money market and suggest a road map for phasing them out from the call money market. In the meanwhile, all PDs are urged to keep their call money lending/borrowing within a prudent limit in relation to their net owned funds.

88. The limits so prescribed for call/notice money market are prudential in nature, and are sufficiently high for most of the participants in the market, and it is expected that all legitimate liquidity needs of banks would be met.

(c) Collateralised Lending Facility

89. At present, RBI is providing standing liquidity facilities comprising (i) Export Credit Refinance (ECR) and Collateralised Lending Facility (CLF) to banks, and (ii) liquidity support to PDs. These are in addition to facilities operated through LAF as also outright sales/purchases of government securities as part of open market operations (OMO). With the inherent superiority of the LAF in moderating liquidity in the financial system, both banks and PDs have tended to rely to a predominant extent on LAF.

90. Scheduled commercial banks are provided CLF against the collateral of excess holdings of Government of India dated securities/Treasury Bills over their SLR requirement. The extent of liquidity support available to each bank has been stipulated at equivalent to 0.125 per cent of its fortnightly average outstanding aggregate deposits in 1997-98. Accordingly, the overall limit for the system stands at Rs.656.61 crore as of now; however, the average utilisation of this facility in 2001-02 up to the fortnight ended March 22, 2002 was Rs.124 crore. With the development of inter-bank repo market and operationalisation of CCIL, the standing facilities could be phased out. Accordingly:

? CLF may be phased out with effect from the fortnight beginning October 5, 2002. RBI, however, will have the option to reintroduce CLF for a temporary period in future, should it be considered necessary to do so in the light of changes in monetary conditions.

? The apportionment of liquidity facilities to PDs between normal and back-stop will be reviewed by the Working Group set up vide paragraph 87.

(d) Certificates of Deposit

91. Several developments in financial market have so far been undertaken by RBI, which include issuing of guidelines for Commercial Paper (CP) in consultation with the market players. Subsequently, Fixed Income Money Market and Derivatives Association

(FIMMDA) was requested to prepare the necessary standard procedures and documentation to be followed by the participants in the CP market. Such guidelines were issued by FIMMDA in June 2001. Further, as announced in the annual policy Statement of April 2001, instructions were issued to banks and FIs that they should make investments and hold CPs only in the dematerialised form and convert existing outstandings also into demat form by October 31, 2001. It was felt that on similar lines standard procedures and guidelines for issuing Certificates of Deposit (CDs) may also be prepared for the benefit of issuers of CDs. Accordingly, FIMMDA has prepared the guidelines and documentation procedures in consultation with market participants, depositories and RBI. Pending release of final guidelines and as a further step towards transparency, it has been decided that:

? With effect from June 30, 2002, banks and FIs should issue CDs only in the dematerialised form. The existing outstandings of CDs shall be converted into the demat form by October 2002.

Government Securities - Review of Recent Developments

92. The Reserve Bank has been continuously making attempts in deepening and widening the government securities market both in primary and secondary segments. Some significant steps which RBI has taken include: elongation of the maturity profile of outstanding issuance including issuances of bonds of 25 years maturity, development of new benchmark government securities by consolidating new issuances in key maturities, enhancing fungibility and liquidity through consolidation by reissuances of existing loans, promoting retailing of government securities and introduction of floating rate bonds.

93. Important developments in infrastructure facilitating trading and settlement in money and government securities markets are the operationalisation of the NDS and CCIL. The market has also become more diversified with the entry of new participants such as high networth individuals, co-operative banks, large corporates, mutual funds and insurance companies. The uniform valuation basis, as announced by FIMMDA, provides transparency to the market and facilitates active management of portfolios. The

regulatory and supervisory framework for the PDs has been strengthened in accordance with the risks perceived in the market, in line with international practices.

(a) Uniform Price Auction

94. With the experience of uniform price auction in the issuance of 91-day Treasury Bills (since November 6, 1998), the annual policy Statement of April 2001 proposed to extend uniform price auction format to the auctions of Government of India dated securities on selective and experimental basis. In line with this policy, the uniform price auction format was extended to the auctions of Floating Rate Bonds (FRBs) on November 21 and December 5, 2001. The government securities auction held on April 4, 2002 was also based on uniform price auction, on an experimental basis. RBI will continue to take recourse to uniform price auctions on an experimental and selective basis during this calendar year also as considered necessary.

(b) Negotiated Dealing System

95. The Negotiated Dealing System (Phase I) has been operationalised effective February 15, 2002. The NDS provides on-line electronic bidding facility in the primary auctions of Central/State Government securities, OMO/LAF auctions, screen-based electronic dealing and reporting of transactions in money market instruments including repo, secondary market transactions in government securities and dissemination of information on trades with the least time lag. In addition, the NDS facilitates “paperless” settlement of transactions in government securities with connectivity to CCIL and the DVP settlement system at the Public Debt Office. So far, 80 market participants including 31 non-bank participants are members of NDS. All entities having SGL Accounts with RBI have been advised to become members of NDS by May 31, 2002.

(c) Government Securities Act

96. The Reserve Bank made a proposal to replace the existing Public Debt Act, 1944 by Government Securities Act to simplify the procedures for transactions in government

securities, allow lien-marking/pledging of securities as also electronic transfer in dematerialised form. This proposal was approved by the Government of India. The State Governments have completed the process of passing the requisite resolutions under Article 252 of the Constitution of India empowering the Parliament to enact the Government Securities Bill. With the concurrence of all State Legislatures also having been obtained, the Finance Minister in his Budget speech for 2002-03 proposed to introduce the Bill in the present Parliament Session.

(d) Retailing of Government Securities through Non-competitive Bidding

97. In the Mid-term Review of October 2001, RBI had announced finalisation of a scheme to encourage retail participation, in particular by mid-segment investors like UCBs, non-banking financial companies (NBFCs), Trusts, etc., in the primary market of government dated securities. Accordingly, the scheme of non-competitive bidding facility with a provision for allocation up to 5.0 per cent of the notified amount to retail investors at the weighted rate that evolves in the case of competitive bidding was announced on December 7, 2001.

98. The scheme was operationalised on January 14, 2002, when auction of 15-year Government stock was held. In this auction, 36 non-competitive bids from 273 applicants were received through PDs and banks amounting to Rs.148.3 crore against the allocation of Rs.250 crore. In the twin auctions held on April 4, 2002 for 7-year and 10-year Government stocks, 46 non-competitive bids from 304 applicants amounting to Rs.238.5 crore were received as against the reserved amount of Rs.350 crore. While 2.97 per cent of the notified amount was allotted in January 14, 2002 auction, on April 4, 2002, it was 3.41 per cent. The scheme was continued in the auction of a new 15-year Government stock for Rs.6,000 crore held on April 15, 2002, wherein 19 bids from 137 applicants for an amount of Rs.95.49 crore (1.59 per cent of notified amount) have been received and fully allotted.

99. It is advisable for banks to promote schemes for sale/purchase of government securities over their counters to retail investors through demat accounts with depositories or with CSGL account holders. A few banks and PDs have taken useful initiatives to promote retail investment in government securities by offering these securities for sale at retail outlets coupled with facility of holding investments and servicing thereof through existing demat account with depositories or in CSGL accounts. The proposed Government Securities Act specifically recognises the rights of ownership of such investors. In formulating such schemes, PDs and banks may also provide both sale and purchase facility to ensure that the retail investors are assured of liquidity of such investments. Banks could also promote retail sale of government securities along with schemes for availing of automatic finance against such investment at attractive rates, thereby providing ready liquidity.

(e) Treasury Bills

100. The auctions of 14-day and 182-day Treasury Bills were discontinued since May 14, 2001. The notified amount of 91-day Treasury Bills was increased to Rs.250 crore from May 16, 2001. The notified amount of 364-day Treasury Bills was enhanced from Rs.750 crore to Rs.1,000 crore with effect from April 3, 2002.

(f) Consolidation of the Government Stocks

101. The consolidation of the Government stocks by improving fungibility imparts liquidity to the existing stocks, limits the number of floating stocks and helps in building benchmark securities. However, flexibility in active consolidation is limited because of large market borrowing programme of the Government year after year. Since April 1999, RBI has been attempting “passive consolidation” by reissuing the existing stocks through price-based auctions which resulted in limiting the number of outstanding stocks. As at the end of March 2002, there were 111 government securities with outstanding amount of Rs.5,36,325 crore, of which 23 securities, each with minimum outstanding amount of Rs.10,000 crore, accounted for more than 50 per cent.

(g) Floating Rate Bonds

102. In order to cater to the diverse needs of investors in government securities, several innovative instruments, like Zero Coupon Bonds, Floating Rate Bonds (FRBs), Index Linked Bonds, etc. were issued in the past. Currently, except for one Capital Indexed Bond, which will mature this year, all outstanding government market loans are in the form of plain vanilla fixed rate bonds. In view of ALM and risk weight needs of the major investors such as banks, two FRBs of 5-year and 8-year maturity were issued for a total amount of Rs.5,000 crore in November/December 2001 which were fully subscribed. FRBs serve as a diversifying instrument in debt management as it takes advantage of the term premium while minimising refinancing risk. However, FRBs are vulnerable to interest rate risks. Considering both the advantages and the risks, issue of further FRBs in the current year would be examined.

(h) Calendar for Dated Securities

103. In order to enable both institutional and retail investors to plan their investments better, the Government announced issuance of calendar for dated securities for 2002-03. Such an advance calendar imparts transparency to the Government's borrowing programme and is expected to bring stability in the government securities market. Out of the total expected borrowing for first six months, a calendar for an amount of Rs.68,000 crore was announced. The remaining market borrowing programme for the first half of the year, as in the past, will be announced from time to time depending upon the emerging requirement of the Government and market conditions.

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

104. A road map for developing STRIPS was prepared and put on RBI website for comments and suggestions from the market participants. The Government was requested

to issue necessary clarification on tax treatment of Zero Coupon Bonds. In order to operationalise the scheme of STRIPS, it has been decided:

? To constitute a Working Group comprising banks and market participants to suggest operational and prudential guidelines in respect of STRIPS.

(j) Satellite Dealer System

105. In the Mid-term Review of October 2001, RBI announced its decision to undertake a review of the Satellite Dealer (SD) system in consultation with market participants. After obtaining the views of the Primary Dealers Association of India (PDAI) and after further discussions in TAC and considering their role in the present conditions, it has been decided to discontinue the system. Accordingly:

? No new SDs will be licensed.

? Existing SDs will be required to make action plans, satisfactory to RBI for termination of their operations as SDs by May 31, 2002.

(k) Issue of Long-term Bonds for Insurance Companies and Others

106. RBI has been consciously elongating the maturity profile of government debt having regard to its implications for the Government's annual borrowing requirements and debt redemption pattern, need for establishing benchmark for long-term financing for infrastructure and catering to the needs of long-term investors such as insurance companies, provident funds and pension funds. During 2001-02, a 25-year bond was issued for Rs. 8,000 crore after a span of 17 years. RBI proposes to continue its policy of issuing long-term bonds to meet the requirements of such investors.

(l) Automatic Debit Mechanism

107. In some cases, State Governments have given instructions to RBI to debit their accounts on specified dates either as a matter of course to meet certain obligations or in case of specified events. Such automatic debits carry an overriding priority over other

payments. After examining the past experience with automatic debits, a Technical Committee of State Finance Secretaries on State Government Guarantees had observed that pre-emption through automatic debit mechanism runs the risk of resulting in insufficient funds for financing critical minimum obligatory payments such as, salaries, pensions, amortisation and interest payments. In view of the recommendation of the Committee, and keeping in view the need to maintain integrity of the public debt segment of debt markets, it is proposed that:

? In future, as a general policy, with prospective effect, to dispense with such automatic debits where there are no legal or other compulsions.

? Where there is a legal compulsion for creation of such mechanism, to suggest amendments to such provisions.

? To review all the existing automatic debits in consultation with State Governments and others concerned, with a view to dispensing with such mechanisms wherever feasible.

Urban Co-operative Banks

(a) New Apex Supervisory Body

108. The annual policy Statement of April 2001 had announced a proposal to set up a new Apex Supervisory Body to take over the entire inspection/ supervisory functions relating to scheduled and non-scheduled UCBs in consultation with the Central Government. In the Mid-term Review of October 2001, it was mentioned that RBI has submitted a draft Bill on setting up of a separate Supervisory Authority. The matter is under consideration of the Government.

109. The events of the last two years have made it abundantly clear that the present system of dual/triple regulatory and supervisory control (involving Centre, States and RBI) is not conducive to efficient functioning of the co-operative banks in the interest of their depositors. Several committees in the past have also recommended elimination of multiple layers of supervision and regulation of this sector. In view of the local interest involved, it is also clear that there is no consensus at present in favour of removing

supervisory and regulatory responsibilities at Central/State Government levels, and for entrusting it exclusively to RBI. As a result, the managements and boards of several co-operative institutions continue to reflect political interests rather than genuine co-operative spirit, and are not always amenable to normal banking discipline in their operations. In view of this, it would be best, in the interest of the public depositors, if the situation is faced squarely and a separate supervisory authority is set up, with representatives of Centre, State and other interested elements. Such a body can then be exclusively made responsible for efficient functioning of the co-operative institutions, and also take responsibility for ensuring the safety of public deposits.

(b) Working Group on Asset-Liability Management

110. It was indicated in the Mid-term Review of October 2001 that RBI has circulated the report of the Working Group on ALM guidelines for UCBs to select UCBs for their comments. Only six banks responded; however, their responses were positive. It was felt that the guidelines need simplification and towards smooth implementation, a few workshops may be held to explain these guidelines for obtaining feedback from the officials/CEOs of UCBs in their implementation. The first workshop held on January 14-15, 2002 at College of Agricultural Banking, Pune was attended by 37 executives from 17 UCBs. The second workshop was conducted at Bankers Training College, Mumbai. After taking into account the suggestions received from the participating banks in the two workshops, the guidelines have since been issued.

(c) Supervisory Rating System for UCBs

111. The Reserve Bank, based on its on-site inspection, had put in place a supervisory rating "CAMELS" model for Indian commercial banks and "CACS" model for foreign banks so as to assess their performance. In 1999, on-site inspection based on "CAMELS" model was extended to UCBs as an additional tool for supervision. Since UCBs are members of the payment system and also beneficiaries of deposit insurance scheme, in the light of recent experience, it is felt that there is a need to further strengthen the supervisory regime for UCBs. Towards this end, RBI constituted a Working Group in October 2001 to evolve a suitable rating model for UCBs taking into account their

operational characteristics. The Working Group in consultation with CEOs of large UCBs, submitted its report on March 23, 2002. The recommendations of the Group are being examined and necessary guidelines would be issued in due course.

Supervision and Monitoring

112. Progress made in respect of certain announcements made in the annual policy Statement of April 2001 is reviewed below:

(a) Off-site Monitoring and Surveillance

113. The Reserve Bank had rationalised off-site returns to monitor liquidity and interest rate risks on quarterly basis in 1999. With the intention to finally move over to a fortnightly reporting system, in consultation with the banks, a revised system was put in place in June 2000. The reporting schedule for the reports on (i) interest rate sensitivity, (ii) structural liquidity, both for rupee and forex transactions, (iii) assets, liabilities and exposures, (iv) exposure to sensitive sectors, and (v) Indian subsidiaries, was made monthly with effect from October 2001.

(b) Risk Based Supervision

114. The Project Implementation Group formed for the smooth switch over to Risk Based Supervision (RBS) process by 2003, has initiated certain management processes which include preparation of discussion paper, risk profiling, manual writing, training and legal requirements. The responses from banks on the discussion paper were analysed and in order to assess their progress and needs in this regard, a consultation process has started. The Group has prepared a draft risk assessment template for risk profiling of banks under the RBS approach. The template is being tested with a few banks for further customisation and refinement. An internal group was constituted for drafting of Manuals.

(c) Prompt Corrective Action

115. As indicated in the Mid-term Review of October 2001, the scheme of prompt corrective action (PCA) with various trigger points for prompt responses by the

supervisors was developed and sent to the Government for their views before implementation. The Government has since cleared the scheme which will be put in place shortly.

(d) Macro-Prudential Indicators

116. It was indicated in the annual policy Statement of April 2001 that pilot reviews using macro-prudential indicators (MPIs) for the half-year ended March 2000 and September 2000 were prepared for internal circulation. Subsequently, the reviews for the half-year ended March 2001 and September 2001 were also prepared. While the earlier reviews were largely compilation of MPIs, scope and coverage of the subsequent reviews are enhanced by including data on capital market, forex market and other segments of the financial system.

(e) Consolidated Accounting and Supervision

117. As mentioned in the annual policy Statement of April 2001, the Board for Financial Supervision (BFS) has evolved an approach for consolidated supervision as appropriate in the Indian context. A multi-disciplinary Working Group was set up to look into the introduction of consolidated accounting and quantitative techniques for consolidated supervision, in line with international best practices. The Group's report was placed before BFS on January 29, 2002. The report was also put in public domain for comments/suggestions. Based on the comments, necessary guidelines would be issued by RBI.

Present Status of Prudential Measures

118. Increasing globalisation and blurring of distinction among different segments of financial intermediaries have posed a special challenge for banking sector. Being the mainstay of financial intermediation, developing a sound and healthy banking system through promotion of prudent financial practices has become essential to sustain financial stability. It has been recognised that Indian banking system should be in tune with well laid down international standards of capital adequacy and prudential norms.

119. RBI initiated the banking sector reforms as per the recommendations of Committee on the Financial System to improve the financial health and enhance the efficiency, productivity and profitability of the Indian banking system over time.

Keeping in view the changes in pace and pattern of developments in the financial sector and with the objective of achieving convergence between Indian standards and international best practices, a number of measures were announced in earlier policy Statements. The progress made in the implementation of these measures along with further measures considered necessary are indicated below.

(a) Adoption of 90 days Norm for Recognition of Loan Impairment

120. As indicated in the annual policy Statement of April 2001, banks were advised to adopt 90 days norm to classify their assets from the year ending March 31, 2004. They were asked to chalk out an appropriate transition path for smoothly moving over to the 90 days norm and submit their action plans with the approval of their Boards to RBI. As a facilitating measure, they were advised to move over to charging of interest at monthly rests by April 1, 2002. In this connection, some banks sought clarifications on application of interest on agricultural advances, options available for applying interest for longer rests, etc. In consultation with IBA, detailed guidelines were issued clarifying that with effect from April 1, 2002, banks may move over to charging of interest on loans/advances at monthly rests except for agricultural advances.

(b) New Basel Capital Accord

121. In the Mid-term Review of October 2001, it was mentioned that RBI had forwarded its comments on the second consultative paper on the New Capital Accord issued by the Basel Committee on Banking Supervision (BCBS). The Committee received over 200 responses from national supervisors, banks, international institutions and others which can be accessed at www.bis.org. Such wide variety of comments indicate the fact that achieving global consensus on the methodology of capital regulation is not an easy task. Many respondents have expressed their concerns at the difficulties

that would be experienced in implementing the proposals on account of their complexity and costs. Several respondents have also pointed out that capital requirements could increase across the board in most jurisdictions on account of the new proposals.

122. In view of these, the consultation process has been extended and some modifications to the proposals are currently being discussed by BCBS which could mitigate the more than anticipated upward impact on capital requirements. Another Quantitative Impact Study (QIS) will be conducted in the coming months with wider participation and the Reserve Bank will also be participating in this impact assessment. At the same time, an internal group in RBI is also engaged in developing a suitably modified approach within the philosophical framework of the Basel proposals which could be adapted to the Indian situation and simpler to implement and supervise. For this purpose, the internal group will invite representatives from select banks to provide inputs into the development of the modified approach as well as the upcoming QIS. Further, assigning risk weights for bank assets should largely be a matter for the banks or their supervisors. Banks are expected to constitute an expert internal team to study the methodology of the new proposals and its likely impact.

(c) Counterparty and Country Risks

123. The Reserve Bank is committed to the implementation of the “Core Principles for Effective Banking Supervision” drawn up by BCBS. It is a matter of satisfaction that the banking system in India is largely compliant with most of the Core Principles.

124. In October 1999, RBI had issued risk management guidelines which, *inter alia,* advised banks to use the country ratings of international rating agencies and classify the countries into low risk, moderate risk and high risk categories and endeavour to develop an internal matrix that reckons the counterparty and country risks. With a view to moving further in complying with the Core Principles, RBI would be shortly issuing draft guidelines on country risk management and provisioning therefor in consultation with banks, IBA and other market participants.

(d) Capital for Market Risk

125. It was announced in the Mid-term Review of October 1998, that government and other approved securities would have to be provided for a risk weight of 2.5 per cent towards market risk by March 31, 2000. Guidelines on categorisation and valuation of banks' investments, in consonance with international practices, were also announced in the Mid-term Review of October 2000 and were effective from the half-year ended September 30, 2000. Accordingly, banks were required to provide for 2.5 per cent risk weight on SLR and non-SLR securities, with effect from March 31, 2000 and 2001, respectively, as an interim arrangement, till such time as banks move over to the framework suggested by the Basel Committee.

126. The Basel norms provide for assigning capital for market risk on a standardised or on internally developed Value at Risk (VaR) methods. As the valuation norms on banks' investment portfolio have already been put in place and aligned with the international best practices, it is appropriate to adopt the Basel norms on capital for market risk. In view of this, banks are advised to study the Basel framework on capital for market risk as envisaged in Amendment to the Capital Accord to incorporate market risks published in January 1996 by BCBS and prepare themselves to follow the international practices in this regard at a suitable date to be announced by RBI.

(e) Prevention of Money Laundering

127. India has been sharing the increasing international concern on the use of the financial system for money laundering and financing of terrorism. The challenges faced by the international community in combating financial crimes require sustained and co-ordinated action among the various agencies concerned with regulation and enforcement responsibilities, both in India and abroad. RBI and the Government have initiated various steps from time to time to check any misuse of the financial system for laundering proceeds of criminal activities.

128. As part of these initiatives, RBI is in the process of issuing a Master Circular setting out the policy, procedures and controls required to be introduced by banks. These include strict adherence to “Know Your Customer” (KYC) procedures for prevention of misuse of banking system for money laundering and financing of terrorist activity. The recommendations of the Working Group on Anti-Money Laundering set up by IBA would also be taken into account while framing the guidelines.

(f) Reduction in Transition Period of a Sub-standard Asset to Doubtful Category

129. Narsimham Committee II had recommended that an asset should be classified as doubtful, if it is in the sub-standard category for 18 months in the first instance and for 12 months subsequently. Accordingly, RBI had announced in the Mid-term Review of October 1998 that with effect from March 31, 2001, an asset should be classified as doubtful, if it has remained in the sub-standard category for 18 months.

130. Consistent with the recommendations of Narsimham Committee II and with a view to moving closer to international best practices, it is proposed that:

? With effect from March 31, 2005, an asset would be classified as doubtful if it remained in the sub-standard category for 12 months. Banks are permitted to phase the consequent additional provisioning over a four-year period, with a minimum of 20 per cent each year.

(g) Recovery of Non-Performing Assets

131. It was indicated in the Mid-term Review of October 2001, that the broad framework provided for compromise settlements of NPAs issued by RBI in 1995 will continue to be in place and banks are free to design and implement their own policies for recovery and write off incorporating compromise and negotiated settlements with the approval of their Boards. The Finance Minister in his meeting with the CMDs of banks held on November 12, 2001 at New Delhi had indicated that a suitable scheme be evolved for small borrowers by banks for recovery of dues up to Rs.25,000. Accordingly, banks have been advised to formulate a policy for recovery of dues, principal amount

(excluding the interest element) in all sectors irrespective of the nature of business or purpose, which have become NPAs as on March 31, 1998. As announced in the Budget 2002-03, a special one time settlement (OTS) scheme for small and marginal farmers to cover loans up to Rs.50,000 has been issued. At the request of Government of India, RBI also conducted a review of the functioning of the Debt Recovery Tribunals (DRTs) subsequent to various amendments carried out in the Recovery of Debts Due to Banks and FIs (Amendment) Act, 2000, with reference to their position as on March 31, 2001.

(h) Corporate Debt Restructuring

132. It may be recalled that in August 2001, RBI had issued guidelines on Corporate Debt Restructuring (CDR) for implementation by banks and FIs to put in place a framework outside the purview of BIFR, DRT and other legal procedures to ensure timely and transparent mechanism for restructuring debts of viable corporate entities facing financial problems. As proposed in the Budget 2002-03, RBI constituted a High Level Group (Chairman: Shri Vepa Kamesam, Deputy Governor) to review the operations of the CDR scheme to identify the operational difficulties, if any, in smooth implementation of the scheme and to suggest measures to make the scheme even more effective. As an interim measure, it has been decided that permission for debt restructuring will be made available by RBI on the basis of specific recommendations of CDR "Core-Group", if a minimum of 75 per cent (by value) of the lenders constituting banks and FIs consent for CDR, irrespective of differences in classification of the assets by banks/financial institutions.

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

133. A mention was made in the Mid-term Review of October 2001 that further prudence should be observed by banks and FIs in order to contain the risk arising out of non-SLR investment portfolio of banks and FIs, in particular through the private placement route. The draft prudential guidelines on management of non-SLR investment portfolio were issued to banks for their comments/views. On the basis of feedback, guidelines are being finalised and would be issued in due course.

(j) Investment Fluctuation Reserve

134. The Reserve Bank, with a view to building up of adequate reserves to guard against any possible reversal of interest rate environment in future due to unexpected developments, advised banks in January 2002, to build up an IFR of a minimum 5.0 per cent of the investment portfolio within a period of 5 years. However, banks have been given the freedom to build up IFR to a maximum of 10.0 per cent of the portfolio depending on the size and composition of their portfolio, with the approval of their Board. On the basis of feedback received from banks on the above proposals, it has been decided that IFR should be computed with reference to investments in two categories, viz., "Held for Trading" and "Available for Sale". Thus, it will not be necessary to include the investment under "Held to Maturity" category, which is not meant to be traded, for purposes of computation of IFR.

Technology Upgradation

135. The Reserve Bank has been playing a pivotal role in upgrading the payment and settlement system in the country. The progress achieved so far 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 real-time environment has been substantial.

136. The Mid-term Review of October 2000 mentioned the preparation of a "Payments System Vision Document". After examining the comments/feedback, the final version of the Vision Document was published in December 2001. It provides a road map of important developments in the payment system projects. This would facilitate banks in getting fully prepared to participate effectively in the new products aimed at better payment and settlement services.

(a) Networking of Branches of Banks for Information Dissemination

137. The process of reforms in payment and settlement systems has gained momentum with the implementation of projects such as NDS, Centralised Funds Management System (CFMS) for better funds management by banks and Structured Financial Messaging Solution (SFMS) for secure message transfer. This would result in funds transfers and funds-related message transfer to be routed electronically across banks using the medium of the Indian Financial Network (INFINET). To reap the full benefits of such electronic message transfers, it is necessary that banks bestow sufficient attention on the computerisation and networking of the branches situated at commercially important centres on a time-bound basis. Intra-city and intra-bank networking would facilitate in addressing the "last mile" problem which would in turn result in quick and efficient funds transfers across the country.

(b) Extension of Electronic Funds Transfer Facilities

138. Recognising that the key to quick, safe and efficient funds transfers lies in the use of electronic modes of funds transfers, the Reserve Bank has improved the existing facilities under Electronic Funds Transfer (EFT). EFT is now available for transfer of funds across banks and 13 different centres with one settlement a day and an enhanced per transaction limit of Rs. 2.0 crore which would make EFT attractive even for corporate funds movement. In the case of four metropolitan cities, the settlement is being effected at three time slots every day which will shortly be extended to all the other centers so as to enable transfers on a T+0 basis. Adequate security features are also being incorporated in the EFT scheme, apart from providing for integration of the RBI's EFT scheme with various schemes already in vogue within some banks. Once all banks start using the EFT on a large scale, the dependence on conventional funds transfer modes would diminish thus bringing about greater efficiency in the movement of funds, better funds management capabilities for constituents of banks and reduction in risks associated with funds transfers which take time.

(c) Real Time Gross Settlement System – Status

139. In earlier policy Statements, RBI had announced its intention of putting in place a RTGS system, which will enable real time movement of funds. The preparatory work for RTGS system has been completed and a suitable vendor for designing and development of the system has been selected. The work on design specifications is in progress. These specifications would take into account the international best practices as suitable to requirements of Indian banking. The system is scheduled to be ready for testing in about a year.

Ownership Functions of Reserve Bank of India

140. It was indicated in the annual policy Statement of April 2001 that RBI should not own the institutions it regulates. Towards this end, in the case of Discount and Finance House of India (DFHI) and Securities Trading Corporation of India (STCI), the process of disinvestment has already been completed.

141. The Finance Minister in his Budget speech for 2002-03 announced that the Deposit Insurance and Credit Guarantee Corporation (DICGC) will be converted into the Bank Deposits Insurance Corporation (BDIC) to make it an effective instrument for dealing with depositors' risks and distressed banks. Appropriate legislative changes will be proposed for this purpose. In the case of transfer of ownership of RBI in State Bank of India, National Bank for Agriculture and Rural Development and National Housing Bank, an internal Working Group was constituted to recommend the modalities, viz., valuation, payment adjustments, etc. and the legislative measures required consequent to transfer of shareholding. The Working Group has submitted its report in November 2001 which was forwarded to the Government for their comments.

Non-Banking Financial Companies

142. The Reserve Bank has received applications for Certification of Registration (CoR) from 36,414 Non-Banking Financial Companies (NBFCs), of which, 14,079 applications were approved and 19,058 were rejected as at the end of March 2002. Out of

14,079 companies, only 780 NBFCs have been allowed to accept/hold deposits from the public. Applications of 3,277 companies are still pending for various legal/procedural reasons. Out of these, 2,916 applications are held in abeyance pending enactment of the Financial Companies Regulation Bill, 2002.

143. Certain NBFCs were granting demand/call loans with an open period or without any stipulation regarding the rate of interest and servicing. Difficulty was experienced in ensuring compliance with prudential norms on income recognition, asset classification and provisioning in respect of such loans. In order to obviate these difficulties and to ensure that all such loans are appropriately classified and the position of NPAs is truly reflected in the financial statements of NBFCs, it was decided that all NBFCs granting/intending to grant demand/call loans should lay down a policy duly approved by their Board. The policy should cover aspects such as stipulation of cut-off date within which the repayment of the loan will be demanded/called up, stipulation of the rate of interest and the periodic rests for payment of interest, stipulation of cut-off date not exceeding 6 months for review of the performance of loan, criteria for renewal. Directions covering NPA classification and provisioning requirements have also been issued.

144. With a view to further strengthening the regulatory/supervisory framework for NBFCs, the following measures are proposed.

(a) Formation of SRO for NBFC Sector

145. The Reserve Bank has taken a number of steps to speed up the reform process in the functioning of NBFC sector along prudent lines. For further development of this sector, emphasis has been placed on formation of a Self Regulatory Organisation (SRO), particularly for the benefit of smaller NBFCs. Towards this end, as mentioned in the Mid-term Review of October 2001, RBI has been on an on-going basis discussing with the Informal Advisory Group of NBFCs and also with various NBFC Associations. In the meeting of the Informal Advisory Group held on March 11, 2002, the matter was

discussed and the representatives of NBFC Associations have informed that SRO would be constituted at the earliest.

(b) Submission of Returns by NBFCs

146. NBFCs are required to submit periodic control returns to RBI. However, as laxity has been observed in this regard, in order to inculcate a sense of discipline in this sector, it has been decided to take action against NBFCs for non-submission of returns. Accordingly, in the first instance:

? RBI would impose penalties as provided for in the Reserve Bank of India Act, 1934 as also launch court proceedings, besides considering rejection/cancellation of the CoR of NBFCs having public deposits of Rs.50 crore and above, in case of default in the submission of returns.

147. The above stipulation in respect of the size of NBFCs (i.e., Rs.50 crore and above) will be progressively reduced over time to ensure that as far as possible, all NBFCs submit periodic returns on a timely basis.

Rationalisation of Current Account Facility with the Reserve Bank

148. As indicated in the Mid-term Review of October 2001, an internal Group was set up to rationalise the present policy of access to current account facility provided by RBI in view of phasing out of non-banks from call/notice money market, upgradation of payment system infrastructure such as operationalisation of CCIL and NDS and operations of OMO/LAF only through banks and PDs. These would obviate the need of non-bank entities to have access to current account with RBI. In this context, a Group of Senior Executives of RBI was constituted to examine the recommendations of the report, suggest modifications and take such other follow-up actions as necessary. In order to ensure that current account facility with the Reserve Bank serves its core objectives, it has been decided that current account facility may be extended only to scheduled commercial banks, scheduled co-operative banks, and PDs. Current account facility for

entities other than those indicated above would be phased out in due course. A programme for phasing out current account facility in respect of all India financial institutions will be chalked out concurrently. At a later stage, depositories like NSDL, CDSL and other custodians like SHCIL will also be phased out and they can then operate through banks.

International Financial Standards and Codes

149. The Mid-term Review of October 2001 mentioned the progress made by the Advisory Groups on International Financial Standards and Codes. All the ten Advisory Groups constituted by the Standing Committee have submitted their reports to the Chairman of the Standing Committee and these reports were placed on RBI website for wider dissemination. It was also mentioned that the Standing Committee will prepare its own report indicating the course of follow-up/reforms required and the regulatory agencies involved in such follow-up actions. The Standing Committee is synthesising the views and comments of all the Advisory Groups and the final report will be placed shortly in the public domain for wider dissemination and appropriate follow-up action.

Short-Term Liquidity Assessment Model

150. Considering the importance of guiding monetary policy operations on a sound basis, the annual policy Statement of April 1999 mentioned the need for developing a short-term operational model which takes into account the behavioural relationships among different segments of the financial system. Under the guidance of a Group of eminent academic experts, an operational model was developed and is being tested. The draft model will also be put on RBI's website for wider public debate. Once the model is made operational, it may be feasible to constitute a technical committee in order to assist in monetary policy strategy. It is felt that in future, a technical monetary policy committee would act as a back office projecting various alternate policy strategies as is the practice in some other central banks.

Mid-term Review

151. A review of credit and monetary developments in the first half of the current year will be undertaken in October 2002. 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 29, 2002

Annexure

RBI Working Groups – Progress Report

Expert Committee on Bank Frauds

The Expert Committee on Bank Frauds (Chairman: Dr. N. L. Mitra) submitted its Report to RBI in September 2001. The report was examined as per the directions of the BFS and the report along with comments of RBI was forwarded to the High Level Group on frauds in banking sector constituted by Central Vigilance Commission (CVC) for its examination and comments.

Consultative Group for Strengthening the Internal Supervisory Role of Boards of Banks

A consultative Group of Directors of Banks and FIs was constituted under the Chairmanship of Dr. A.S. Ganguly, Director, Central Board, RBI to suggest, for consideration of the Government/RBI, measures that could be taken in respect of strengthening the internal supervisory role of Boards of banks/FIs in view of the on-going financial sector reforms which has entrusted greater autonomy and powers to the banks' Boards. The Group submitted its report recently which is under examination.

Transparency and Accounting Standards

A Working Group was constituted under the Chairmanship of Shri N.D. Gupta, President, ICAI along with representatives from RBI and commercial banks to put in place appropriate arrangements to identify the compliance and also gaps in compliance with the accounting standards issued by ICAI and to recommend steps to eliminate/reduce such gaps. The Working Group will, *inter alia*, analyse the difficulties faced by the banks in adoption of the accounting standards and evolve suitable guidelines in this regard. Report is awaited.

Defaulters' List – Widening the Coverage

A Working Group was constituted under the Chairmanship of Shri S. R. Iyer, Chairman, Credit Information Bureau (India) Ltd. (CIBIL), with representatives from RBI, commercial banks and FIs, to examine the possibility of the CIBIL performing the role of collecting and disseminating information on the list of suit filed accounts and the list of defaulters, including wilful defaulters, which is presently handled by RBI. The Group submitted its report which is under examination.

Credit Information Bureau

A Working Group under the Chairmanship of Shri S.R. Iyer, Chairman, CIBIL with representatives from banks, FIs and RBI was constituted to evolve a framework for collecting and sharing of information on private placement of debt. The Report submitted by the Group is being examined.