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

The Statement on Mid-term Review of Monetary and Credit Policy consists of three parts: **I.** Mid-term Review of Macroeconomic and Monetary Developments in 2002-03; **II.** Stance of Monetary Policy for the Second Half of 2002-03; and **III.** Financial Sector Reforms and Monetary Policy Measures.

I. Mid-term Review of Macroeconomic and Monetary Developments in 2002-03

Domestic Developments

2. The annual Statement on monetary and credit policy released on April 29, 2002 had projected a GDP growth of 6.0 to 6.5 per cent for the year 2002-03, based on the assumption of a normal monsoon. The latest estimate, released by the Central Statistical Organisation (CSO) for the first quarter (April-June) of 2002-03 is 6.0 per cent (as against 3.5 per cent in the corresponding period of the previous year). While the CSO estimate for the first quarter of the current year is in line with the projected rate of growth of 6.0 to 6.5 per cent, it is likely that for the year as a whole, the rate of growth in GDP will be lower in view of the poor rainfall in some parts of the country.

3. Taking into account the performance of the South-West monsoon, it is expected that production of foodgrains this year will be lower than last year by about 5.0 per cent. Production of non-foodgrains is, however, likely to show a positive growth. On balance, the present indications are that agricultural GDP for the year 2002-03 will decline by around 1.5 per cent. On the other hand, there are indications of a recovery in industrial production during the first half of the current year. The composite index of six infrastructure industries, viz., electricity, coal, steel, cement, crude petroleum and refinery products registered a growth of 6.0 per cent during April-September 2002, substantially higher than 1.5 per cent in the corresponding period of the previous year. During this period, all infrastructure industries recorded higher growth as compared to the corresponding period of the previous year. There are also indications of recovery in the production of basic goods, capital goods and consumer goods.

4. Export performance has also been impressive. According to the latest information available, **exports** in US dollar terms during April-August 2002 increased by 13.4 per cent as against a decline of 0.6 per cent in the corresponding period of last year.

5. On the whole, taking these developments into account, it appears that overall **GDP growth** for the year 2002-03 is likely to be in the range of 5.0 to 5.5 per cent as against the earlier projection of 6.0 to 6.5 per cent.

6. Scheduled commercial banks' credit showed a sharp increase of 14.1 per cent (Rs.83,400 crore) upto October 4, 2002 largely reflecting the impact of mergers in the banking sector during the year.* Excluding the impact of mergers, scheduled commercial banks' credit increased by 6.6 per cent (Rs.38,800 crore) upto October 4, 2002 as against 6.8 per cent (Rs.34,700 crore) in the corresponding period of the previous year. Food credit declined by Rs.800 crore in contrast to an increase of Rs.10,200 crore in the previous year on account of lower procurement and higher off-take of foodgrains. In the same period, on the other hand, there has been improvement in the growth of **non-food bank credit** by 7.4 per cent (Rs.39,600 crore), net of mergers, compared with 5.2 per cent (Rs.24,500 crore) in the corresponding period of the previous year reflecting better outlook for industrial growth. Apart from credit growth, various business expectation surveys point to a positive industrial outlook for the current year. However, while taking a view on the industrial outlook, the impact of deficient South-West monsoon may have to be considered in view of the linkages among the various sectors of the economy.

7. The feedback on industry-wise credit flows received from banks for April-August 2002 reveals that, at a disaggregated level, there was discernible increase in credit to coal, iron & steel, cotton & other textiles, tea, tobacco & tobacco products, paper & paper products, fertiliser, drugs & pharmaceuticals, cement, construction, gems & jewellery, petroleum, computer software,

automobiles, power and residual industries. On the other hand, decline in credit was observed in mining, other metal & metal products, all engineering, electricity, sugar, vegetable oils & vanaspati, food processing, petrochemicals, rubber & rubber products, leather & leather products and telecommunications.

8. The increase in scheduled commercial banks' investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP) etc., was much higher at 7.6 per cent (Rs.6,200 crore) upto September 20, 2002 as compared with an increase of 4.5 per cent (Rs.3,500 crore) in the corresponding period of the previous year. Together with such investments, the increase in **total flow of resources** from scheduled commercial banks to the commercial sector, net of mergers, was 7.4 per cent (Rs.45,800 crore) as against 5.1 per cent (Rs.27,900 crore) in the corresponding period of the previous year. The year-on-year growth in resource flow, net of mergers, was also higher at 15.2 per cent as against 12.7 per cent a year ago.

9. Scheduled commercial banks' investments in instruments issued by financial institutions and mutual funds this year (upto September 20, 2002) increased by Rs.2,000 crore in contrast to a decline of Rs.300 crore in the corresponding period of last year. The total resource flow to the commercial sector including capital issues, Global Depository Receipts (GDRs) and borrowings from financial institutions was Rs.1,01,400 crore during the financial year so far (upto October 4, 2002) as compared with Rs.66,400 crore in the corresponding period of the previous year.

10. In the current financial year upto October 4, 2002, **money supply** (M_3) rose by 10.3 per cent (Rs.1,54,500 crore) and by 7.5 per cent (Rs.1,11,900 crore), net of mergers, as compared with 8.4 per cent (Rs.1,10,100 crore) in the corresponding period of the previous year. On an annual basis, growth in M_3 at 13.2 per cent, net of mergers, was in line with the projected trajectory and was lower than that of 14.8 per cent, net of India Millennium Deposits (IMDs), observed a year ago. The aggregate deposits of scheduled commercial banks increased by 12.6 per cent (Rs.1,38,800 crore) [8.7 per cent (Rs.96,200 crore), net of mergers], as compared with an increase of 9.4 per cent (Rs.90,600 crore) in the corresponding period of the previous year. On an annual basis, net of mergers, growth in aggregate deposits at 13.9 per cent was lower than that of 16.0 per cent a year ago (net of IMDs). Thus, the growth in deposits has been consistent with the projections made at the beginning of the year in the annual policy Statement.

11. An important feature of monetary development during this year has been the reduction in reserve money despite liquidity pressure emanating from increase in RBI's foreign currency assets as also primary support to the Government's borrowing programme. **Reserve money** declined by 0.7 per cent (- Rs.2,400 crore) in the current financial year upto October 18, 2002 as compared with an increase of 2.3 per cent (Rs.7,100 crore) in the corresponding period of the previous year. While currency in circulation increased by 5.9 per cent (Rs.14,700 crore) as compared with 6.3 per cent (Rs.13,700 crore) in the previous year, bankers' deposits with RBI declined by 20.8 per cent (- Rs.17,500 crore) as compared to a decline of 7.4 per cent (- Rs.6,100 crore) reflecting the impact of reduction in Cash Reserve Ratio (CRR). On the sources side, net RBI credit to the Central Government showed a large decline of 18.5 per cent (- Rs.26,200 crore) as compared with an increase of 2.9 per cent (Rs.4,300 crore) in the corresponding period of the previous year reflecting substantial open market operations (OMO). RBI's subscription to primary issues of Central Government dated securities of Rs.23,200 crore was neutralised by net OMO sales of Rs.27,000 crore. RBI's net foreign exchange assets increased significantly by 17.4 per cent (Rs.46,100 crore) as compared to an increase of 9.9 per cent (Rs.19,500 crore) during the corresponding period of the previous year. RBI's credit to banks and commercial sector showed a decline due to reduced reliance on standing facilities on account of comfortable liquidity conditions. On balance, reserve money expansion is expected to remain moderate during 2002-03.

12. Annual **inflation**, as measured by variations in the Wholesale Price Index (WPI) (base: 1993-94=100) on a point-to-point basis, was 2.8 per cent on October 12, 2002 as against 3.0 per cent a year ago. On an average basis, it was even lower at 2.3 per cent as against 6.3 per cent in the previous year. Annual inflation, as measured by variations in the Consumer Price Index (CPI) for industrial workers on a point-to-point basis, was 3.9 per cent in August 2002 as against 5.2 per cent a year ago.

13. The relatively lower inflation rates in the recent period have helped in creating a favourable environment for moving towards softer interest rates in the economy. An important objective of macroeconomic policy, including monetary policy, must continue to be avoidance of resurgence of inflationary pressures.

14. Inflation in the current year is more evenly spread across major sub-groups. Annual inflation on 'fuel, power, light and lubricants' sub-group (weight: 14.2 per cent) was lower at 4.0 per cent this year as compared with 5.6 per cent last year. The annual inflation rate, excluding the impact of price increases witnessed in this energy related sub-group, at 2.5 per cent was slightly higher than that of 2.4 per cent in the preceding year. While prices of primary articles (weight: 22.0 per cent) recorded a lower increase of 2.2 per cent as against 4.0 per cent last year, manufactured products (weight: 63.7 per cent) registered a higher increase of 2.7 per cent as against 1.8 per cent last year. Among primary articles, the increase in prices was mainly due to an increase in prices of oilseeds. In manufactured products, the increase in prices of edible oils was relatively high.

15. The deficiency in rainfall, which was more pronounced in the first two months of this year's monsoon season, exerted pressure on the prices of many agricultural commodities. Whereas a large stock of foodgrains and comfortable foreign exchange position will help supply management, the prices of 'fuel, power, light and lubricants' sub-group are likely to be affected adversely by increase in international oil prices. On balance, the domestic inflation outlook still looks comfortable and the inflation rate is likely to be around 4.0 per cent, which is in line with the expectations in the annual policy Statement of 2002-03.

16. The Union Budget for 2002-03 placed the net and gross market borrowings of the Central Government at Rs.95,859 crore and Rs.1,42,867 crore, respectively. The Central Government completed net market borrowings of Rs.74,065 crore (77.3 per cent of the budgeted amount) and gross borrowings of Rs.1,10,032 crore (77.0 per cent of the budgeted amount) upto October 25, 2002. Because of the existing liquidity conditions in the market and low inflation, the Government has been able to borrow at a substantially lower cost during 2002-03. The weighted average yield on government borrowings through dated securities at 7.52 per cent this year, was significantly lower by 192 basis points than 9.44 per cent last year. As part of the debt management strategy, RBI continued to combine auction issues with acceptance by private placement of dated securities consistent with market conditions. The total private placement of dated securities with RBI during the current year (upto October 25, 2002) was Rs.23,200 crore. The monetary impact of private placement, however, was neutralised by conduct of outright OMO sales of government securities to the tune of Rs.27,000 crore (upto October 25, 2002).

17. The gross **fiscal deficit** of the Central Government, at Rs.55,496 crore upto August 2002, was lower by about 1.0 per cent over the corresponding period of last year and constituted about 41 per cent of the budget estimate for the current year. Similarly, revenue deficit at Rs.45,525 crore accounted for about 48 per cent of the budget estimate for the whole year. The Government's budgeted borrowing programme may get affected by lower than anticipated real economic activity, shortfall in disinvestment proceeds and higher expenditure on account of drought relief.

18. Scheduled commercial banks' investment in government securities at Rs.66,700 crore this year (upto October 4, 2002) has been much higher than Rs.43,400 crore in the corresponding period of the previous year. Commercial banks already hold government and other approved securities much in excess of the prescribed Statutory Liquidity Ratio (SLR), to the extent of Rs.1,66,200 crore, constituting 12.3 per cent of their net demand and time liabilities (NDTL).

19. During 2002-03 so far, financial markets in India have been generally stable, liquidity has been adequate, and the interest rate environment has also been favourable to promote investments. There are emerging signs of an upturn in industrial output as reflected in positive growth in the capital goods sector and infrastructure industries. Equity markets started on a positive note with a sharp increase in the BSE Sensex but weakened subsequently on account of cross-border tensions, monsoon uncertainties and subdued trends in the international stock markets. On an average basis, the BSE Sensex declined by 3.8 per cent to 3228 during April-September 2002 from 3355 during the corresponding period of the previous year. A steady increase in net foreign currency assets of the Reserve Bank combined with lower than anticipated level of real economic activity, created a situation of excess liquidity during most part of the current year so far. The Reserve Bank, therefore, had to

actively manage liquidity not only through outright OMO sales of securities but also through its daily Liquidity Adjustment Facility (LAF). The average daily absorption through repo transactions under LAF during the year (upto October 25, 2002) amounted to about Rs.14,800 crore.

20. Reflecting easy liquidity conditions, **interest rates** continued to maintain their downward trend. The overnight average call money rate moved down from 6.58 per cent in April 2002 to 5.75 per cent by July 2002 and has since remained around that level. The repo rate was also reduced from 6.0 per cent to 5.75 per cent on June 27, 2002. The 91-day Treasury Bill rate, after firming upto 7.0 per cent by mid-May, dipped below the repo rate to 5.68 per cent in the auction of September 4, 2002. Similarly, the 364-day Treasury Bill rate has also declined from 6.99 per cent to 5.86 per cent over the same period. The weighted average discount rate on Commercial Paper (CP) of 61 to 90-day maturity declined sharply by as much as 293 basis points from 9.46 per cent in end-March 2002 to 6.53 per cent by mid-October 2002.

21. The government securities market also continued to show a softening trend. The **yield on government securities** with 1-year residual maturity declined from 6.10 per cent at end-March 2002 to 5.92 per cent by October 25, 2002. The yield on government securities with 10-year residual maturity showed a similar decline from 7.36 per cent to 7.07 per cent. The April 2002 policy Statement had mentioned the widening spread between AAA rated corporate bonds and government securities during 2001-02 reflecting 'flight to quality'. This spread has, however, narrowed considerably over the last six months in the wake of the improved industrial outlook.

22. The public sector banks have reduced their deposit rates over one year from a range of 7.25 - 8.75 per cent in March 2002 to 6.50 - 8.25 per cent by October 2002. The typical interest rate on 1-year Certificates of Deposit (CDs) has also declined from 10.0 per cent in March 2002 to 7.0 per cent by September 2002. In consonance with lower cost of funds, some banks have reduced their prime lending rates (PLRs) by 25 - 100 basis points. The range of PLR of the public sector banks is between 10.0 and 12.5 per cent. Since banks are lending below their PLRs and have also reduced their maximum spread over PLR, the effective lending rates of banks have also shown some moderation. The sub-PLR lending of the banking system (excluding exports, the bulk of which is at sub-PLR) constituted over one-third of their total lending. Since foreign banks have higher PLRs, sub-PLR lending accounted for about 60 per cent of their total lending. The **spreads around PLRs** of public sector banks normally ranged from (-) 3.0 per cent to 4.75 per cent for the quarter ended June 2002 whereas such spreads (excluding 5 per cent of the credit sanctioned at extreme rates on either side of lending) ranged from (-) 3.0 per cent to 4.0 per cent.

23. In recent years, there has been a persistent downward trend in the **interest rate structure** reflecting moderation of inflationary expectations and comfortable liquidity situation. Changes in policy rates reflected the overall softening of interest rates as the Bank Rate has been reduced in stages from 8.0 per cent in July 2000 to 6.5 per cent by October 2001, which is the lowest rate since May 1973. Similarly, the repo rate has been moderated from 8.0 per cent in March 1999 to 5.75 per cent in June 2002. Simultaneously, the weighted average call money rate has come down from over 13.06 per cent in August 2000 to 5.74 per cent by October 2002.

24. Similarly, the **cut-off yields** on 91-day and 364-day Treasury Bills have declined from 10.47 per cent and 10.91 per cent in August 2000 to 5.72 and 5.80 per cent, respectively, by October 2002. While the weighted average discount rate on 3-month CP declined from 12.1 per cent in August 2000 to 6.53 per cent in mid-October 2002, typical interest rate on 3-month CD fell from 10.25 per cent in August 2000 to 6.2 per cent in September 2002.

25. The yields on government securities with 1-year and 10-year residual maturities fell from 10.82 per cent and 11.47 per cent in August 2000 to 5.92 per cent and 7.07 per cent, respectively, by October 25, 2002. The yield on AAA rated corporate bonds with 5-year residual maturity has declined from 12.15 per cent in September 2000 to 7.0 per cent by October 2002. The interest rates on term deposits of public sector banks over one year have declined from 8.0 - 10.5 per cent in September 2000 to 6.5 - 8.25 per cent by October 2002. Similarly, the PLRs of public sector banks have declined from 11.75 - 13.0 per cent to 10.0 - 12.5 per cent.

26. By and large, in line with the announced policy of the Reserve Bank, in the recent period, there has been substantial reduction in interest rates on various types of paper. The average lending

rates of banks are also lower, although to a lesser extent. The reduction in interest rates has been across all maturities, from the short-term money market and Treasury Bill rates to long-term securities. This, combined with a benign inflationary environment, is a welcome development which augurs well for industrial recovery and sustained growth in the economy.

External Developments

27. At the time of the annual policy Statement in April 2002, the prospects for recovery in the **world economy**, after the September 11 events, had improved. The recovery process, however, now appears to be somewhat slower than that anticipated earlier. The International Monetary Fund (IMF) has also noted some emerging issues that would affect the investment climate adversely. These include: the risk averse behaviour of financial institutions in the current uncertain economic climate; a sharp slowdown of investment into the US; and some signs of contagion from South America to other emerging markets. However, in terms of relative performance, India and China are anticipated to perform better than the global trend.

28. The Indian forex market generally witnessed orderly conditions during the current financial year (April–October 2002) with the Indian rupee exhibiting an appreciating trend against the US dollar on account of moderate demand coupled with a comfortable supply position resulting in large accretion to reserves. Foreign exchange reserves increased by US $ 9.9 billion from US $ 54.1 billion in end-March 2002 to US $ 64.0 billion by October 25, 2002.

29. In recent years, the annual monetary policy Statements as well as mid-term Reviews have attempted to bring into sharper focus the main lessons emerging from our experience in managing the external sector during periods of external and domestic uncertainties. The recent experience has once again highlighted the need for developing countries to keep a continuous vigil on market developments, and the importance of building adequate safety nets that can withstand the effects of unexpected shocks and market uncertainties. In this context, India's current **exchange rate policy** seems to have stood the test of time. It has focused on the management of volatility without a fixed rate target, while the underlying demand and supply conditions are allowed to determine the exchange rate movements over a period in an orderly way. Despite several unexpected adverse developments on the external and domestic front, India's external situation has remained satisfactory. The Reserve Bank will continue to follow the approach of watchfulness, caution and flexibility by closely monitoring the developments in the financial markets at home and abroad. It will co-ordinate its market operations carefully, particularly in regard to the forex market with appropriate monetary, regulatory and other measures as considered necessary from time to time. It is heartening to note that recent international research on viable exchange rate strategies in emerging markets has also lent considerable support to the exchange rate policy followed by India.

30. India's **foreign exchange reserves** have increased sharply from US $ 45.2 billion as on October 26, 2001 to US $ 64.0 billion by October 25, 2002, an increase of US $ 18.8 billion. India's sustained efforts to build an adequate level of foreign exchange reserves in the last few years have also been fully vindicated by recent developments. As pointed out in previous policy Statements, the overall approach to the management of India's foreign exchange reserves in recent years has reflected the changing composition of balance of payments, and has endeavoured to reflect the "liquidity risks" associated with different types of flows and other requirements. The policy for reserve management is thus judiciously built upon a host of identifiable factors and other contingencies. Such factors, *inter alia,* include: the size of the current account deficit; the size of short-term liabilities (including current repayment obligations on long-term loans); the possible variability in portfolio investment and other types of capital flows; the unanticipated pressures on the balance of payments arising out of external shocks; and movements in the repatriable foreign currency deposits of Non-Resident Indians (NRIs). Taking these factors into account, India's foreign exchange reserves are at present comfortable and consistent with the rate of growth, the share of the external sector in the economy and the size of risk-adjusted capital flows.

31. As a signatory to the Special Data Dissemination Standards (SDDS) of the IMF, the Reserve Bank is making available relevant information on the foreign exchange market and on RBI's operations in the foreign exchange market as per internationally accepted standards. The data template provides information on international reserves with break-up into various categories (e.g., securities, deposits with central banks and commercial banks etc.) and foreign currency liquidity in

respect of countries which have subscribed to SDDS. These data are disseminated at monthly intervals with a lag of one month and are available on the RBI website. The latest such data available are as on August 31, 2002.

32. The substantial growth in reserves in the recent period has generated a welcome debate regarding the costs and benefits of holding reserves. In any **cost-benefit analysis of holding reserves**, it is essential to keep in view the objectives of holding reserves which, *inter alia*, cover: (a) maintaining confidence in monetary and exchange rate policies; (b) enhancing the capacity to intervene in forex markets; (c) limiting external vulnerability so as to absorb shocks during times of crisis; (d) providing confidence to the markets that external obligations can always be met; and (e) adding to the comfort of the market participants by demonstrating the backing of domestic currency by external assets. Sharp exchange rate movements can be highly disequilibrating and costly for the economy during periods of uncertainty or adverse expectations, whether real or imaginary. These economic costs are likely to be substantially higher than the net financial cost, if any, of holding reserves. In this context, it is important to note that in India, in the last few years, almost the whole addition to reserves has been made without increasing the overall level of external debt. The increase in reserves largely reflects higher remittances, quicker repatriation of export proceeds and non-debt inflows. Even after taking into account foreign currency denominated NRI flows (where interest rates are linked to LIBOR), the financial cost of additional reserve accretion in India in the recent period is quite low, and is likely to be more than offset by the return on additional reserves.

33. It may also be mentioned that most of the increase in reserves in the recent period is through net purchases by RBI in the domestic forex market, for which an equivalent amount of domestic currency has been released to the concerned domestic entities, including public sector units, corporates and individuals. The decision on the use of this **counterpart domestic currency** released by RBI (i.e., for investment, deposits or as liquid assets, etc.) is the responsibility of the above mentioned entities and, not that of RBI, or for that matter, the Government. Needless to add that to the extent that this counterpart local currency is used by recipient entities for further investment in the economy, the impact on industrial demand and growth would be favourable.

34. The broad principles that have guided India after the Asian crisis of 1997 are:

- Careful monitoring and management of exchange rates without a fixed target or a pre-announced target or a band. Flexibility in the exchange rate together with ability to intervene, if and when necessary;
- A policy to build a higher level of foreign exchange reserves which takes into account not only anticipated current account deficits but also ‘liquidity at risk’ arising from unanticipated capital movements;
- A judicious policy for management of capital account.

35. In view of the Medium Term Export Strategy (MTES) announced in January 2002 and in order to further liberalise the movement of cross-border capital flows, especially in the area of outward foreign direct investment, inward direct and portfolio investment, non-resident deposits and external commercial borrowings, RBI, *inter alia*, announced the following important **measures relating to current and capital account** during the current financial year:

- Considerable liberalisation of release of foreign exchange for individual residents, with minimum documentation requirements, for most purposes including travel, education, medical expenses and other current account transactions.

- Non-Resident Indians/Persons of Indian Origin (NRIs/PIOs) have been permitted to repatriate assets in India acquired by way of inheritance/legacy, in addition to other facilities. Full repatriation of current income like rent, dividend, pension and interests of NRIs, even without holding a Non-Resident Ordinary (NRO) account in India is also permitted.

- Status Holder Exporters may credit upto 100 per cent of their eligible receipts of foreign exchange to their Exchange Earners Foreign Currency (EEFC) account.

- Corporates are permitted to prepay External Commercial Borrowings (ECBs) upto US $ 100 million without permission from RBI upto end-March 2003. No prior permission of RBI is required for prepayment of ECBs out of balances held in EEFC accounts or foreign exchange inflow for

fresh equity for amounts exceeding US $ 100 million.

- Remittances towards premium for general insurance policies taken by units located in Special Economic Zones (SEZs) from insurers outside India are permitted.

- Insurance companies registered with Insurance Regulatory and Development Authority (IRDA) are allowed issuance of general insurance policies denominated in foreign currency.

36. **Export performance** during the current year has been encouraging so far. India's exports during the first five months of the current financial year at about US $ 19.8 billion, increased by 13.4 per cent over the corresponding period of the previous year. During the same period, imports increased by only 1.7 per cent as against an increase of 3.8 per cent in the corresponding period of last year. As a result, the trade deficit narrowed to US $ 2.7 billion from US $ 4.6 billion in the same period last year. Oil imports increased by 5.3 per cent in US dollar terms as compared with a decline of 5.4 per cent in the corresponding period of the previous year. Non-oil imports increased by 0.3 per cent as against an increase of 8.3 per cent in the corresponding period of the previous year. While the surplus on the non-oil account widened from US $ 1.1 billion to US $ 3.2 billion, the deficit on oil account increased marginally from US $ 5.8 billion to US $ 5.9 billion during April-August 2002. The current account deficit which averaged 1.0 per cent of GDP over the past ten years, recorded a modest surplus in 2001-02. On present reckoning, it is expected that the current account deficit for the year 2002-03 would be below 1.0 per cent of GDP and no significant pressures on balance of payments are expected on this account.

37. The annual policy Statement of April 2002 highlighted the use of the **euro** as an intervention currency in addition to the US dollar. The Reserve Bank has started making available on its website the reference rate for the euro in addition to the US dollar with effect from January 1, 2002. The euro zone is India's second largest trading partner, and it is desirable that more and more of our trade to the euro area is also invoiced in the euro.

38. Sustained efforts towards accelerating the growth of exports become imperative for long-term viability of the balance of payments as well as for increasing income and employment opportunities. The recent experience suggests subtle shifts in international comparative advantage with software, business and commercial services exceeding the performance of merchandise exports, and even providing support in phases of contraction in external demand. The Medium Term Export Strategy has set out a road map that is co-terminus with the Tenth Five-Year Plan period. It aims at raising India's share in world trade to 1.0 per cent by 2006-07 from the present level of 0.67 per cent. This entails doubling of exports from their present level.

39. The Reserve Bank has been making concerted efforts to encourage banks to improve the export credit delivery system. In this context, the annual policy Statement of April 2002 had mentioned a **survey on exporters' satisfaction** conducted with the help of the National Council of Applied Economic Research (NCAER). While the survey results indicated a high level of satisfaction by exporters, certain suggestions were made for further improving credit delivery to exporters. The report was forwarded to all banks and was also placed on the RBI website. Banks have to be sensitised about the need for bringing improvements in the credit delivery system as suggested by NCAER. Consequently, a small committee consisting of officers from banks, RBI and the Export Credit Guarantee Corporation of India Ltd. visited 5 centres that account for a large volume of exports and had discussions with bankers. On the basis of the 'Action Taken Report' submitted by bankers, it is observed that the banks have complied with most of the suggestions made by NCAER. Banks should continue with their efforts to make the export credit delivery system customer-friendly and efficient at the branch level, particularly, in areas with concentration of small and medium sized exporters.

40. **Procedures for financial transactions** such as remittances, investments and maintenance of bank account etc., for non-residents have been simplified considerably in the recent past. The policy framework governing inward Foreign Direct Investment (FDI) was substantially liberalised under the automatic route. FDI upto 100 per cent was permitted under the automatic route for manufacture of glass and pharmaceuticals, in the hotel and tourism sector and for mass rapid transport systems in all metropolitan cities. FDI upto 49 per cent from all sources was permitted in private sector banks under the automatic route. Continuing with the policy of progressive liberalisation of the capital

account, NRI deposit schemes were also rationalised and are now fully convertible [with the exception of Non-Resident Ordinary (NRO) accounts].

41. The existing limit for **Indian direct investment outside India** under the automatic route was raised to US $ 100 million. Two-way fungibility of American Depository Receipts (ADRs)/Global Depository Receipts (GDRs) has became operational. Foreign Currency Convertible Bonds (FCCB) upto US $ 50 million were brought under the automatic route. In order to facilitate the external commercial borrowings of corporates, the Reserve Bank allowed corporates, on a case by case basis, to credit even higher proportions of export proceeds to their EEFC accounts so that they can take advantage of lower interest rates and prepay their ECBs. It is, however, observed that sometimes a noticeable portion of the corporate foreign currency commitments tend to remain unhedged by the corporates on the basis of their perceptions of the market and these could severely impact the overall financial status of the corporates in case conditions change. In this context, the mid-term Review of October 2001 had emphasised the need for banks to monitor large exposures to such corporates against unhedged exposures.

II. Stance of Monetary Policy for the Second Half of 2002-03

42. The annual policy Statement of April 2002 had indicated that 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.

43. Monetary management in the first half of 2002-03 was largely in conformity with the monetary policy stance announced in the annual policy Statement of April 2002. As spelt out in the policy Statement, RBI has been able to maintain a stable interest rate regime throughout the first half of the year with a bias towards softening of interest rates. The **yields on government securities** in the secondary market ruled much lower than the yields at the beginning of the financial year. Nearly two-thirds of the market borrowing programme of the Government could be completed at a lower cost, with longer maturities, without any adverse impact on the general interest rate structure.

44. Commensurate with some visible signs of revival in industrial activity and an upturn in the export sector, there has been a substantial pick up in non-food credit which is expected to continue in the remaining part of the year. The growth in infrastructure industries is expected to boost industrial activity with a lag and as such, the index of industrial production this year may be higher than what was expected at the beginning of the year. However, the delayed monsoon and its subsequent impact on agricultural production may slightly dampen rural demand for both durable and non-durable goods. Nevertheless, as exports are buoyant, the outlook for industry seems to be better than it was last year.

45. At the short end of the market, the **average call money rate** came down sharply from 6.82 per cent in early April to 5.74 per cent by October 2002. During this period, the LAF repo rate was also brought down from 6.0 per cent to 5.75 per cent. The CRR was reduced by 50 basis points to 5.0 per cent effective June 1, 2002 augmenting lendable resources of the banking system by Rs. 6,000 crore. The **interest rates in other money market instruments** also declined. For example, the primary yield on 91-day Treasury Bill declined by 41 basis points from 6.13 per cent to 5.72 cent between April and October 2002. During the same period, the primary yield on 364-day Treasury Bill and the yield on government securities with residual maturity of 1-year declined by 42 and 30 basis points, respectively. At the longer end, the **secondary market yields on government paper** in the maturity range of 10 to 20 years have softened from 7.37 – 7.91 per cent in April to 7.07 – 7.63 per cent by October 2002.

46. The softer interest rates prevailing in the economy in the recent period, is sustainable in the medium/long term if the rate of inflation continues to be low. An important objective of monetary, fiscal and supply management policies must be to ensure that there is no resurgence of inflationary pressures in the economy.

47. The Reserve Bank has taken significant steps towards **deepening and widening of the government securities** market, both in its primary and secondary segments, in recent years. These include elongation of the maturity profile in bond issuances, retailing of government securities through non-competitive bidding, and introduction of uniform price auctions on an experimental basis. The maximum maturity was gradually elongated from 20 years during 1998-99 to 30 years in 2002-03. Simultaneously, the weighted average maturity has increased substantially from 5.7 years in 1995-96 to 14.26 years in 2001-02. On the other hand, the average cost of issuance has come down from 13.75 per cent to 9.44 per cent over the same period. Further, certain innovations were also introduced through instruments like floating rate bonds and allowing put/call options in government securities. On the basis of the experience gained so far, RBI will consider issuance of such innovative products more frequently, depending on market conditions.

48. Recognising the fact that a substantial portion of deposits with banks is in the form of long-term deposits at fixed interest rates, the annual policy Statement of April 2002 had urged banks to introduce a flexible interest rate system for new deposits while continuing to make available the fixed rate option to depositors. The available information from banks suggests that banks are making efforts in this direction. The policy Statement had also urged banks to devise schemes for encouraging depositors to convert their existing long-term fixed rate past deposits into variable rate deposits. It is expected that such efforts would, over time, enable banks to reduce to some extent, the downward inflexibility in the interest rate structure.

49. The annual policy Statement of April 2002, stressed **customer protection and transparency** in regard to actual interest rates to depositors and borrowers. It urged banks to review the maximum spread over PLR and reduce their interest rates wherever unreasonably high so that credit could be available to borrowers at reasonable interest rates. Accordingly, RBI in consultation with banks, prescribed an information system on maximum and minimum interest rates charged to borrowers. According to the available information, there has been some reduction in the maximum and minimum interest rates charged by banks. The information would be put on the RBI website, as soon as the data system gets stabilised.

50. The measures to encourage greater **flexibility in domestic deposit rates**, reduction of spreads over PLR and transparency in the range of interest rates charged, apart from generating healthy competition among banks, are expected to improve banking facilities available to depositors and make them more responsive to changes in the overall financial and inflationary environment. The Reserve Bank will be pursuing these issues further and welcomes any suggestions in this regard.

51. In the current financial year so far, the forex market showed considerable stability without any undue pressure on the exchange rate. The Reserve Bank will continue to follow the same approach of watchfulness, caution and flexibility in regard to the forex market. The Reserve Bank will also endeavour to ensure that the quantum of reserves, as far as possible, is in line with the growth rate in the economy, the share of the external sector in the economy and the size of risk adjusted capital flows.

52. Consistent with price stability, RBI will continue to ensure that all legitimate requirements for credit are adequately met. Towards this end, RBI will continue its policy of active demand management of liquidity through Open Market Operations (OMO) including Liquidity Adjustment Facility (LAF), and using the policy instruments at its disposal as and when the situation warrants.

53. The outlook for industrial growth and exports during the year 2002-03 remains positive. In this scenario coupled with a moderate level of global inflation, the inflationary outlook for the domestic economy continues to be favourable. The Reserve Bank, therefore, proposes to **continue with the overall stance of monetary policy** announced in the April policy Statement for 2002-03 for the remaining half of the current year.

III. Financial Sector Reforms and Monetary Policy Measures

54. A major objective of the annual policy Statements and mid-term Reviews of RBI, in recent years, has been to review and assess the **progress of the reform process** in the financial sector and to provide some guideposts for the future. In recent years, there has been a move away from micro-regulation to macro-management with an emphasis on structural measures for strengthening the financial system and for improving the functioning of the various segments of financial markets. The policy measures announced in these Statements generally aim at increasing the operational efficiency of monetary policy, improving the regulatory and supervisory functions of the Reserve Bank and strengthening the prudential and supervisory norms along with developing technological and institutional infrastructure of the financial sector and improving the credit delivery system.

55. The Reserve Bank has been generally adopting the practice of introducing policy measures after **extensive consultations** with experts and market participants in order to ensure that the proposed measures are capable of easy and effective implementation and are in accordance with the international best practices.

56. Against this background, an attempt has been made in this section to review the progress of implementation of the measures initiated so far. This would not only allow the process of fine-tuning the measures already initiated, but also facilitate the introduction of new measures as and when necessary to meet the emerging challenges.

Monetary Measures

(a) Bank Rate

- It is proposed to reduce the Bank Rate by 0.25 percentage point from 6.50 per cent with effect from the close of business today (October 29, 2002). At this level, it is the lowest Bank Rate since 1973.

57. It may be mentioned that over the last four and a half years, the Bank Rate has been reduced from 11.0 per cent to 6.25 per cent, i.e. by as much as 475 basis points. This is the sharpest reduction in the Bank Rate since Independence. The sharp reduction in the Bank Rate has also been reflected in a fall in call money rates and Treasury Bill rates as well as yields on government securities across all maturities. The yield on benchmark government securities of 10-year maturity is now 7.07 per cent, a little above 7.0 per cent. In nominal terms, as well as in "real" terms (in relation to the prevailing rate of inflation), it is reasonable to observe that the Bank Rate, call money rates as well as yields on government securities are now quite reasonable.

58. However, the average lending rates of banks, despite significant reduction in the recent period, continue to be substantially higher than the Bank Rate, yields on government securities in nominal as well as in "real" terms. This is due to various structural reasons which have been emphasised in earlier policy Statements (e.g., high proportion of long-term deposits at old and fixed interest rates with banks, relatively high transaction costs and continued depositors' preference for fixed rather than variable interest rates on term deposits). In view of the structural pattern, and the present substantial difference in the Bank Rate and lending rates of banks, the sensitively of the latter to further changes in the Bank Rate is now relatively weak.

59. Under the circumstances, as the present level of the Bank Rate as well as call money and other money market rates are quite comfortable and there is a sizeable gap between these rates and the average lending rates of banks, no useful purpose is likely to be served by a further reduction in the Bank Rate in the near future. Unless circumstances change, the policy bias in regard to the Bank Rate is to keep it stable at the present level at least until the end of the financial year.

(b) Repo Rate

- The repo rate under the Liquidity Adjustment Facility (LAF) of RBI to be made available on October 30, 2002, is also being reduced by 0.25 percentage point. Subsequently, the auction method for repos will continue as previously.

60. It may be recalled that while repo auctions are conducted without any preannounced rate and bids are accepted on the basis of uniform price method, RBI has retained the option to switch over to fixed rate repos on overnight basis. RBI will continue to use this flexibility of switching over between the options so as to make efficient use of the LAF system in the daily liquidity management.

(c) Cash Reserve Ratio - Reduction and Rationalisation

61. The Reserve Bank has been pursuing its medium-term objective of reducing Cash Reserve Ratio (CRR) to the statutory minimum level of 3.0 per cent. Taking into account the progress achieved in the areas of enforcing prudential standards and operationalising the LAF, RBI has reduced CRR from 11.0 per cent in August 1998 to 5.0 per cent in June 2002 while withdrawing certain exemptions. Further, the modalities of CRR maintenance have been rationalised with the introduction of a lagged (by one fortnight) maintenance system. In addition, RBI is remunerating the eligible CRR balances maintained by banks at the Bank Rate. As a further step in this direction of moving towards the statutory minimum level of CRR, it is proposed:

- To reduce CRR from 5.0 per cent to 4.75 per cent effective from the fortnight beginning November 16, 2002. (With this reduction, CRR has been reduced by as much as 3.75 percentage points over the past two years).

62. At present, banks are required to maintain a minimum of 50 per cent of the required reserves in the first week and a minimum of 65 per cent in the second week of the reporting fortnight. Despite this flexibility given to banks on the daily maintenance, the actual daily CRR maintenance of majority of banks in relation to the prescribed level is now quite high. While moving towards a low CRR, it is necessary that the demand for bank reserves in the inter-bank market is modulated and the volatility in CRR maintenance is minimised. In this direction:

- Banks will be required to maintain a minimum of 80 per cent of required CRR amount on a daily basis during a fortnight with effect from the fortnight beginning November 16, 2002. The minimum level of 80 per cent would be applicable for all the days in a reporting fortnight.

(d) Interest on Cash Balances Maintained with RBI under CRR

63. At present, all scheduled commercial banks are paid interest at the Bank Rate on eligible cash balances maintained with RBI under CRR requirement, without detailed scrutiny by RBI, on the basis of quarterly interest claim statement submitted by banks. Such interest payment is made to all banks within one month after the end of the quarter. Based on the recommendations of the Regulations Review Authority, it has been decided to:

- Pay interest on eligible CRR balances on a monthly basis with effect from April 2003. In order to facilitate this, banks are urged to put in place proper technology including adoption of the software package which will help transmission of Form A data by banks directly to RBI.

(e) Statutory Liquidity Ratio of Regional Rural Banks

64. Regional Rural Banks (RRBs) were required to maintain SLR at 25 per cent of their NDTL in cash or gold or in unencumbered government and other approved securities. In this regard, balances maintained in call or fixed deposits by RRBs with their sponsor banks were treated as “cash” and hence, reckoned towards their maintenance of SLR. As a prudential measure, it was considered desirable on the part of all RRBs to maintain their entire SLR portfolio in government and other approved securities. Accordingly, in the annual policy Statement of April 2002, it was decided that all RRBs should maintain their entire SLR holdings in government and other approved securities by converting their existing deposits with sponsor banks into government securities by March 31, 2003. While a number of RRBs have already achieved the minimum level of SLR in government securities, some RRBs and their sponsor banks have expressed difficulty in premature withdrawal of deposits reckoned for SLR purposes. Accordingly, it has been decided that:

- SLR holdings of RRBs in the form of deposits with sponsor banks maturing beyond March 31, 2003 may be allowed to be retained till maturity. These deposits may be converted into government securities, on maturity, in case the concerned RRBs have not achieved the 25 per cent minimum level of SLR in government securities by that time.

- Although deposits with sponsor banks contracted before April 30, 2002 would be reckoned for SLR purpose till maturity, RRBs are advised to achieve the target of maintaining 25 per cent SLR in government securities out of the maturity proceeds of such deposits with sponsor banks as well as from their incremental public deposits at the earliest.

Interest Rate Policy

(a) Interest Rate Flexibility

65. The recent monetary policy Statements have been drawing attention to the factors causing rigidities in the structure of interest rates, particularly in the lending rates of commercial banks. These factors, *inter alia,* include: a) fixed rate deposits contracted by commercial banks; b) high average cost of funds and non-interest operating expenses; c) large volume of NPAs; d) regulation of interest rates on small savings and provident funds; and e) persistent and large volume of market borrowing programme of the Government.

66. There has been some improvement with regard to NPAs, operating expenses and cost of funds of commercial banks. Gross NPAs of public sector banks as a percentage of gross advances declined from 12.4 per cent in March 2001 to 11.1 per cent in March 2002. The net NPAs as a percentage of advances also declined from 6.7 per cent to 5.8 per cent during the same period. The non-interest operating expenses of public sector banks as a percentage of assets declined from 2.72 per cent in 2000-01 to 2.29 per cent in 2001-02. The overall cost of funds of public sector banks has also declined from 6.8 per cent in 2000-01 to 6.7 per cent in 2001-02. This is an encouraging development in so far as it has opened up the scope for further improvement in these parameters and in bringing about a reduction in transaction costs and in lending rates of commercial banks.

67. The annual policy Statement of April 2002 had reviewed the issue and made certain suggestions which, *inter alia*, include: (a) introduction of flexible interest rate system (together with fixed rate option) for all new deposits with reset of interest rate at six-monthly intervals; and (b) enabling banks to pay interest at contracted rates on the existing long-term deposits for the period already run and to waive penalty for premature withdrawal if the same deposit is renewed at a variable rate.

68. In order to further improve flexibility, banks have been given freedom to decide the period of reset on variable rate deposits. According to the latest available information, some banks have already introduced variable rate deposits. Although the depositors' response to variable rate deposits has not been very favourable so far, banks are encouraged to make efforts to popularise flexible deposit schemes among the depositors as these are in the long-term interest of banks as well as depositors.

(b) Prime Lending Rate and Spread

69. The annual policy Statement of April 2002 had indicated that spreads over PLR of some banks are substantial. Banks were, therefore, urged to review the maximum spreads over PLR and reduce them wherever they were unreasonably high. A few banks have reduced marginally their maximum spreads. The Reserve Bank has been monitoring maximum spread over PLR and also the range of lending rates at which maximum business is contracted under a new information system. According to the latest available information, both PLR and spread are varying widely across banks/bank-groups. Ideally, in a competitive market, PLRs among various banks/bank-groups should converge to reflect credit market conditions. Moreover, spreads around the PLR should be reasonable. In the current environment of low inflation, unreasonably wide spreads could adversely affect the overall credit portfolio of banks. Furthermore, very wide spreads provide opportunities for non-transparency. In order to ensure appropriate pricing of loans, banks are encouraged to review both their PLRs and spreads and align spreads within reasonable limits around PLR subject to approval of their Boards.

(c) Interest Rates on Deposits by Co-operative Banks/Regional Rural Banks/Local Area Banks

70. Interest rates on deposits have been deregulated except deposits in savings bank accounts, which is currently prescribed by RBI at 4.0 per cent. However, discretion was given to Regional Rural Banks (RRBs)/Local Area Banks (LABs) to pay additional interest of half per cent per annum over and above the interest rate prescribed for scheduled commercial banks. Similarly, Urban Co-operative Banks (UCBs) are allowed to pay additional interest not exceeding one per cent on the savings deposits maintained with them.

71. Scheduled commercial banks are not allowed to pay interest on current accounts maintained with them. However, sponsor banks have been given the discretion to pay interest on current account at mutually agreed rate for RRBs sponsored by them. In a similar way, co-operative banks (Urban/Central/State) are permitted to offer at their discretion, interest rate not exceeding half per cent per annum on current accounts.

72. The above discretionary provisions generally add to increase in the cost of deposits to the concerned institutions. In order to remove the above anomalies, the following measures are suggested for implementation as early as possible:

- RRBs/LABs and co-operative banks are encouraged not to pay any additional interest on the savings bank accounts over and above what is payable by commercial banks.
- Co-operative banks are encouraged not to pay interest on current accounts.
- Sponsor banks are encouraged not to pay interest on the current accounts maintained by RRBs with them.

(d) Interest Rates on Rupee Export Credit

73. 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 in April 2001. Considering the unusual international developments, effective September 26, 2001, as a temporary measure, the ceiling rates on export credit were reduced to 2.5 percentage points below PLR for pre-shipment credit upto 180 days and post-shipment credit upto 90 days, and to PLR plus 0.5 percentage point for pre-shipment credit beyond 180 days and upto 270 days and post-shipment credit beyond 90 days and upto 180 days. In order to facilitate exporters to avail of credit at lower interest rates which are internationally competitive, the validity period of this policy measure was extended initially upto September 30, 2002 and subsequently upto April 30, 2003.

74. The spread between ceiling rates of export credit in rupee terms relating to two time buckets is as high as 3 percentage points. The actual interest rates charged by banks on export credit in rupee terms in many cases are actually lower than the ceiling rates stipulated by RBI. Moreover, the ceiling rate of 50 basis points above PLR for pre-shipment credit beyond 180 days and upto 270 days and post-shipment credit beyond 90 days and upto 180 days has lost its significance in view of the freedom given to banks for lending at sub-PLR rates to creditworthy borrowers. Exporters being prime borrowers could normally avail of export credit at sub-PLR rates.

75. In the annual policy Statement of April 2002, it was indicated that linking of domestic interest rates on export credit to PLR has become redundant in the present circumstances as effective interest rates on export credit in rupee terms are substantially lower than the PLR. Therefore, a proposal was mooted to deregulate ceiling rates on export credit in rupee terms and thereby encourage greater competition among banks to extend such credit at lower rates to exporters with good track record. In this direction, and with a view to encouraging competition among banks and also to increase flow of credit to the export sector, it is proposed to liberalise interest rates on export credit in rupee terms in two phases. Accordingly, it is proposed that:

- In the first phase, the ceiling rate of PLR plus 0.5 percentage point on pre-shipment credit beyond 180 days and upto 270 days and post-shipment credit beyond 90 days and upto 180

days will be deregulated with effect from May 1, 2003. Banks would have freedom to charge PLR or sub-PLR rates subject to approval of their Boards.

- In the second phase, with effect from a date to be announced later, it will be considered whether the ceiling rates on pre-shipment credit upto 180 days and post-shipment credit upto 90 days should also be discontinued to encourage greater competition in the interest of exports.

(e) Flexibility in the Repayment of Export Credit

76. At present, the pre-shipment credit granted to an exporter is liquidated out of export bills purchased/discounted after shipment of goods. Based on the representations received from exporters/export associations, it has been decided that:

- Subject to mutual agreement between the exporter and the banker, the repayment/prepayment of pre-shipment credit would henceforth be permitted. For this purpose, balances held in the EEFC account of the exporter can also be used.

While utilising this facility, exporters are advised to strictly adhere to the current regulations in regard to repatriation of export proceeds within the stipulated period. Detailed guidelines are being issued separately. This facility would be available until further notice.

(f) Interest Rate on FCNR(B) Deposits

77. In the annual policy Statement of April 2002, the ceiling rates on FCNR(B) deposits were revised downward to LIBOR/SWAP rates for the corresponding maturities minus 25 basis points. Keeping in view the representations received from banks about their difficulty in pricing Yen deposits due to very low LIBOR/SWAP rates, the ceiling rate for Yen deposits was relaxed. Banks are free to decide FCNR(B) deposit rates denominated in Yen which may be equal to or less than LIBOR/SWAP rates of corresponding maturities till further notice. Interest rate ceiling on FCNR(B) deposits denominated in other currencies will remain unchanged at the prevailing level of LIBOR/SWAP rates of corresponding maturities minus 25 basis points.

Short-term Liquidity Assessment Model

78. As mentioned in the annual policy Statement of April 2002, a short-term liquidity forecasting model, developed under the guidance of eminent academic experts, is currently being used for internal evaluation and information. The generic form of the model has also been made available on the RBI website for wider public debate. As any technical work of this type requires continuous refinements, RBI welcomes comments/suggestions on the model.

Money Market

79. A number of structural measures have been initiated to ensure balanced development of various segments of the money market as also to preserve its integrity and transparency. While implementing these measures, it is desirable to take cognisance of the progress of developments made in other market segments and payments system infrastructure.

80. In order to preserve the integrity of the financial system and to facilitate the development of term money and repo markets, the annual policy Statement of April 2002 had proposed the placing of prudential limits on both borrowing and lending of banks in call/notice money market. After further consultations with select banks, RBI stipulated these limits in a circular issued on June 27, 2002. These stipulations have come into effect in two stages from the fortnight beginning October 5, 2002. It is proposed to convene a meeting of the representatives of select banks in the second half of November 2002 to review money market developments. Non-banks may continue to lend, on an average in a reporting fortnight, upto 85 per cent of their average lending during 2000-01 as hitherto till further notice.

81. It was stipulated that the daily borrowings of State Co-operative Banks (SCBs) and District Central Co-operative Banks (DCCBs) in call/notice money market should not exceed 2.0 per cent of

their aggregate deposits as at the end of March of the previous financial year. Accordingly, their transactions in call/notice money market are being monitored on a daily basis by RBI.

82. A Working Group was constituted to recommend the criteria for fixing the limits for Primary Dealers (PDs) in the call/notice money market and to suggest a road map for phasing them out from this market, in consonance with the annual policy Statement of April 2002. The Working Group has since submitted its report and RBI has issued the necessary instructions on July 31, 2002. Accordingly, with effect from October 5, 2002, PDs are permitted to lend in call/notice money market upto 25 per cent of their net owned funds (NOF). The prudential limit stipulated on the borrowing of PDs from call/notice money market will, however, come into effect in two stages, conditional upon certain developments in the repo market, e.g., finalisation of uniform accounting and documentation procedures for repos, allowing rollover of repos, introduction of collateralised borrowing and lending obligation (CBLO), permitting repos out of available for sale (AFS) category etc.

83. In response to the representations received from PDs, and in order to facilitate a smooth transition and functioning of money market under the new prudential norms, PDs are permitted to adhere to the limits of lending in call/notice money market upto 25 per cent of their NOF on a fortnightly average basis.

(a) Rationalisation of Standing Facilities

84. With the emergence of Liquidity Adjustment Facility (LAF) as the primary instrument for modulating systemic liquidity on a day to day basis, the usage of standing facilities to banks comprising export credit refinance (ECR) facility and collateralised lending facility (CLF) has gone down substantially in the recent period. ECR facility remains the only standing facility after the complete phasing out of CLF since October 5, 2002.

85. At present, the total limit under ECR facility has been split into the normal facility (constituting two-thirds of the total limit) available at the Bank Rate and the back-stop facility (constituting remaining one-third) available at a variable rate (8.75 per cent now) announced by RBI from time to time linked to LAF operations or NSE-MIBOR.

86. The utilisation of the ECR facility has remained very low during the year so far in view of existing liquidity position in the economy. Since LAF has emerged as a very effective instrument in providing cushion to the market and with a view to furthering the process of phasing out sector-specific standing facility in an environment of low CRR, it is proposed that:

- Apportionment of normal and back-stop facilities which is presently in the ratio of two-thirds to one-third (67:33) will be changed to one-half each (50:50) from the fortnight beginning November 16, 2002.

(b) Certificates of Deposit

87. In order to increase investor base, minimum size of issues of Certificates of Deposit (CDs) by banks and Financial Institutions (FIs) to a single investor has been reduced to Rs.1 lakh and in multiples of Rs.1 lakh in June 2002. In consonance with the announcement of annual policy Statement of April 2002, FIMMDA has issued standardised procedures, documentation and operational guidelines for issue of CDs on June 20, 2002. In order to impart more transparency and to encourage secondary market transactions, the existing outstanding CDs were required to be converted into demat form by October 2002. As per extant regulations, CDs are required to be issued at a discount to face value and the issuing bank is free to determine the discount rate. With a view to providing more flexibility for pricing of CDs and to give additional choice to both investors and issuers, it is proposed that:

- Banks and FIs may issue CDs on floating rate basis provided the methodology of computing the floating rate is objective, transparent and market-based.

(c) OTC Rupee Derivatives

88. Foreign Exchange Management Act (FEMA), 2000 permits banks risk management tools like Swaps, Options, Caps, Collars and Forward Rate Agreements in order to hedge interest rate risks involving foreign currency liabilities in the over-the-counter (OTC) market. SEBI has allowed the use of options on indices and individual stocks on the exchanges. With regard to OTC rupee derivatives, RBI has also allowed, from July 1999, scheduled commercial banks (excluding RRBs), PDs and all-India financial institutions to undertake Forward Rate Agreements/Interest Rate Swaps (FRAs/IRS) as plain vanilla products for their balance sheet management and market making. Since then, there has been substantial increase in volume in the FRAs/IRS market with 5,700 contracts having notional principal amount of Rs.1,32,000 crore by September 2002. In order to enlarge the menu for managing interest rate risks for banks and other financial intermediaries as well as corporates in the rupee derivatives market, it is proposed:

- To set up a Working Group with appropriate representations from the market to look into, *inter alia*, the possible ways of extending types of derivatives that are available in the foreign currency segment to rupee derivatives. The Group will also review the guidelines for OTC rupee derivatives in India and suggest further developments in this market.

Government Securities Market

89. In an effort to provide further transparency and stability in government securities market, a number of measures have been put in place by RBI during 2002-03 so far. These measures, *inter alia,* include announcement of a half-yearly calendar for Government of India dated securities, mandatory holding of government securities by both wholesale and retail investors in dematerialised form, disseminating NDS data on near real-time basis on the RBI website. The Reserve Bank has also been making sustained efforts to increase the investor base of government securities market by encouraging retailing of government securities. Further, efforts have been made to impart greater flexibility to both issuer and investors of government securities through introducing STRIPS, floating rate bonds and bonds with call/put option. The progress in this direction is reviewed below.

(a) Calendar for Issuance of Dated Securities

90. In order to enable the institutional and retail investors to plan their investments in a better manner and also to provide further transparency and stability in government securities market, the system of releasing the issuance of calendar for Government of India dated securities has been introduced in the current fiscal year 2002-03. The calendar for the first half-year (April-September) was announced on March 27, 2002. This calendar was generally adhered to with some relatively minor deviations with regard to the timing of the auctions, amounts raised and also the tenor of the security from the scheduled issuances. In continuation of this, RBI has announced the calendar for the second half-year (October-March) of 2002-03 on September 18, 2002 in consultation with the Government. In future, the calendar would be issued every half-year. The calendar for the second half of the year will be based on the budgeted (i.e., as per Budget Estimates) borrowing programme of the Government which, as has been borne out by past experience, is generally completed by January.

(b) Holding of Government Securities in Dematerialised Form

91. In view of irregularities observed in some co-operative banks regarding their transactions in government securities, RBI instructed commercial banks, co-operative banks, PDs, FIs, LABs, RRBs and NBFCs to hold government securities in dematerialised mode and suggested measures for reducing the scope of transactions in physical form.

92. Further, RBI has also been encouraging holding of government securities by other investors such as provident funds, trusts, individuals etc., in dematerialised form in gilt accounts with custodians. Such investors are entitled to receive a statement of account from their authorised custodians periodically. The custodians should take adequate care to give authentic information to their customers and to regularly reconcile their books with the consolidated investment account held with RBI. The custodians are also required to subject the transactions in custodial accounts to rigorous audit mechanism.

(c) Primary Dealers

93. PDs, as a category of NBFCs, have become systemically important since (a) their number is now fairly large, (b) they are leveraged entities with mostly short-term funds and relatively high interest rate risk, (c) their share in government securities market is substantial and (d) their participation in the money markets is on par with banks and is quite significant. Accordingly, in order to strengthen the supervision of PDs, they have been brought under the oversight of BFS. Furthermore, PDs are now required to publish their audited annual results along with certain minimum disclosure in leading financial dailies and also on their website.

(d) Trading in Stock Exchanges

94. In order to enlarge the number of participants and to provide country-wide access to government securities, it is proposed to introduce anonymous screen based order driven trading in government securities on the stock exchanges. The scheme, which will follow accepted best practices relating to trading and settlement, is being worked out jointly with SEBI. The scheme will be placed for comments from market participants/public on the websites of RBI and SEBI.

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

95. The scheme of non-competitive bidding to encourage mid-segment investors like individuals, HUFs, PFs, UCBs, NBFCs, Trusts etc., to participate in the primary market of government securities, was operationalised in January 2002. While most of the auctions of central government securities in the first half of the current year had a provision for the scheme, the scheme has been made an integral part of the auctions, announced as per the calendar for the second-half of the current year. In the annual policy Statement of April 2002, RBI had urged banks and PDs to introduce sale and purchase facilities for government securities along with schemes for automatic finance by banks against such investments to improve liquidity for the retail investors. Subsequently, a few PDs have introduced schemes for retailing using the network of bank branches/post offices. It is expected that banks/PDs will actively involve themselves in introducing schemes to promote retailing of government securities. This will become even more important on the introduction of trading of government securities on the stock exchanges.

(f) Extension of Repo to CSGL Account Holders

96. Currently, only entities maintaining SGL accounts with RBI in Mumbai are permitted to undertake repo transactions in government securities. This requirement excludes a large number of potential users of repo who maintain 'gilt accounts' with banks etc., which, in turn, maintain CSGL accounts with RBI on their behalf. However, with a view to making call/notice money market a pure inter-bank market, non-bank participants are being phased out and instead, they are being allowed to participate in the repo market. In order to facilitate this process, particularly in the context of their not having an SGL facility, the issue of extending repo eligibility to CSGL/gilt account holders has been under RBI's consideration for quite some time. Based on the advice of the Technical Advisory Committee (TAC) on Money and Government Securities Markets, it is proposed to extend repo eligibility to a select category of non-SGL account holders, with adequate safeguards, to ensure Delivery Versus Payment (DVP) and transparency. Operative guidelines are being issued separately.

(g) Guidelines for Uniform Accounting of Repo/ Reverse Repo Transactions between Banks

97. In the mid-term Review of October 2000, revised guidelines were issued on categorisation and valuation of banks' investments in consonance with best international practices. As banks are not following a uniform accounting system for repo/reverse repo transactions, draft guidelines on 'Uniform Accounting Norm for Repo Transactions' on the lines suggested by a Sub-Group of TAC were circulated to banks and FIMMDA for their comments. Based on the feedback, the draft guidelines would be finalised.

(h) Development of the Repo Market

98. The repo market in India has been developed gradually with proper safeguards. Since 1994, the repo market has been expanded in terms of products and participants. In the early stages, repos

were allowed only in central government securities. Only banks holding SGL and current accounts with RBI were allowed to participate. Later, all SGL account holders were permitted and state government securities were also made eligible for repos. Operation of Liquidity Adjustment Facility through repos by means of daily auctions sets the benchmark for collateralised lending and borrowing in the money market. This mechanism has helped in providing liquidity to the government securities market.

99. The Reserve Bank will continue to explore, in consultation with market participants, further measures to deepen the repo market and make it more liquid. In this direction, RBI proposes, in the first stage, to extend repos to all regulated entities with gilt/CSGL accounts as long as all transactions are mandatorily reported and settled through the Delivery Versus Payment mechanism. Further, RBI proposes to allow rollover of repo contracts using the same securities between the same counterparties. These measures are expected to develop the repo market further.

100. While ensuring transparency and safe settlement procedures, further measures may be considered, in consultation with experts and participants at a later stage, such as (a) allowing sale of securities purchased under repo, (b) widening of the repo market to all entities including corporates and (c) extending the eligibility to all debt instruments including corporate bonds.

(i) Collateralised Borrowing and Lending Obligation (CBLO)

101. The Reserve Bank has been promoting collateralised lending/ borrowing operations by market participants so that their reliance on call/notice money market may be reduced. The use of such collateralised products is expected to minimise the credit risk of lenders and help in evolving a short-term rupee yield curve. In this direction, Collateralised Borrowing and Lending Obligation (CBLO), a product developed by CCIL for its members was discussed in various fora including the TAC. As proposed by TAC, an inter-departmental Group has worked out the regulatory and prudential aspects to be put in place before the introduction of CBLO. Accordingly :

- CBLO would be considered as a money market instrument with original maturity between one day and upto one year. There will be no restrictions on the minimum denomination as well as lock-in period for its secondary market transactions. The regulatory provisions for CBLO will be the same as applicable to other money market instruments. Since CBLO is fully collateralised by government securities, the risk weight as applicable to government securities for market risk will be applicable to CBLO. Detailed operating instructions in this regard will be issued by RBI separately.

(j) Negotiated Dealing System

102. As indicated in the annual policy Statement of April 2002, in order to ensure full-fledged operations of NDS/CCIL, all entities having SGL accounts with RBI were advised to become members of NDS by end-May 2002. However, in the light of the representations received from some market participants indicating difficulties in adhering to the time schedule, it was decided to continue to allow each of such market participants to submit physical SGL transfer forms till the date specifically agreed in respect of each of them as the last date for such submission. As on October 23, 2002, 141 SGL account holders have become members of NDS. Further, data on SGL transactions settled in Public Debt Office (PDO), RBI, Mumbai are put on the RBI website on a daily basis. With operationalisation of NDS, price and trade information on government securities and related data reported on NDS is now available on the RBI website (www.nds.rbi.org.in) on near real time basis.

(k) Call/Put Option and Floating Rate Bonds

103. For the first time, on July 17, 2002, RBI issued (6.72 per cent Government Stock 2007/12) a bond with embedded put and call options exercisable on or after 5 years from the date of issue. In order to facilitate investors to manage their increased duration risk arising out of their large investments in government securities, another Floating Rate Bond (FRB) was issued on July 1, 2002 for Rs.3,000 crore at a spread of 34 basis points above the variable base rate based on the cut-off yields in the last six auctions of 364-day Treasury Bill. The coupon for the first half of 2002-03 stood at

6.84 per cent. It may be noted that the two FRBs issues of November and December 2001 had negative cut-off spread of 5 and 1 basis point, respectively.

104. On the experience gained so far, RBI will consider more frequent issuance of FRBs with some modifications in design based on feedback received from market participants. The fresh issues of FRBs will provide for annual reset of base rate instead of semi-annual reset as is the case for outstanding FRBs. The base rate for the fresh issues will be determined on the basis of average cut-off yields of 364-day Treasury Bill in the preceding three auctions as against preceding six auctions as applicable for existing FRBs. The new features are expected to improve the pricing of the bonds in secondary market and enhance their liquidity.

105. Though FRBs enable banks to hedge their interest rate risk, apart from facilitating ALM and offering products with flexible interest rates, they have not attracted adequate attention of banks. Banks are urged to take advantage of floating rate bonds and develop a market for this instrument.

Credit Delivery Mechanism

106. It has been the endeavour of the Reserve Bank to improve the credit delivery mechanism by simplifying procedures, encouraging decentralised decision making and enhancing competition. As a further step in this direction, the following measures are proposed.

(a) Priority Sector Lending

(i) Agriculture

107. In order to improve credit delivery to the priority sector and in particular to agriculture, the following measure is proposed:

- The limit on advances granted to dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, located in rural/semi-urban areas is being increased from Rs.10 lakh to Rs. 20 lakh under priority sector lending for agriculture.

(ii) Small Business and Weaker Sections

108. In order to further increase credit flow to the small business and to weaker sections, it is proposed:

- To increase the existing overall limit of Rs.10 lakh in respect of small business to Rs.20 lakh without any ceiling for working capital. Further, banks are free to fix individual limits for working capital depending upon the requirements of different activities.

- To increase the individual credit limit to artisans, village and cottage industries to Rs.50,000 from the existing limit of Rs.25,000. The limits will be under the overall limit of 25 per cent advances to weaker sections under priority sector or 10 per cent of net bank credit.

(iii) Repairs of Damaged Houses in Rural and Other Areas

109. In order to increase credit flow to the housing sector, it is proposed:

- To increase the existing limit of housing loans for repairing damaged houses from Rs.50,000 to Rs.1 lakh in rural and semi-urban areas and to Rs.2 lakh in urban areas.

(b) Kisan Credit Cards

110. The annual policy Statement of April 2002 had proposed a survey for assessing the impact of the Kisan Credit Cards (KCC) Scheme on the beneficiaries. Accordingly, preparatory work has been initiated to conduct a survey with the help of an outside agency.

(c) Micro Finance

111. The annual policy Statement of April 1999 and the mid-term Review in October 1999 emphasised the importance of Micro-credit Institutions and Self Help Groups (SHGs) as important vehicles for credit delivery to self-employed persons, particularly women in rural and semi-urban areas. The Reserve Bank's objective was to accelerate the flow of bank credit to micro-finance institutions while maintaining their decentralised, voluntary and non-bureaucratic character.

112. Accordingly, a number of initiatives have been taken by RBI. Comprehensive guidelines were issued to banks for mainstreaming micro-credit and enhancing the outreach of micro-credit providers. Banks were permitted to treat micro-finance extended by them as part of their priority sector lending. Banks were also allowed to classify their credit under the SHG-bank linkage programme as advances to weaker sections. As a result of these initiatives, significant strides have been made in purveying of micro-finance across the country and in providing micro-finance intermediaries substantial access to bank credit. The SHG-bank linkage programme has proved that banking with the poor is a viable proposition. It also benefited the banks by externalising the credit delivery process and ensuring more than 95 per cent recoveries, besides being cost effective.

113. During the current year 2002-03, RBI is planning a series of interactive sessions to review the progress made in this vital area and to put in place a more vibrant micro-finance delivery environment in the country where complementary and competitive models of micro-finance would be encouraged. The Reserve Bank will also like to identify any policy or co-ordination gap for giving further impetus to the on-going micro-finance movement. In this context, RBI has been interacting on all micro-finance related policy issues with a wider group of experts and micro-finance professionals.

(d) Exemption of Advances granted to Self Help Groups (SHGs) against Group Guarantee from the Limit of Unsecured Guarantees and Advances

114. At present, banks are required to limit their commitment by way of unsecured advances in such a manner that 20 per cent of banks' outstanding unsecured guarantees together with total of outstanding unsecured advances should not exceed 15 per cent of their total outstanding advances. Banks generally lend to SHGs against group guarantee without insisting on any security. Considering the high recovery rate in respect of banks' advances to SHGs and that this programme helps the poor, it has been decided that:

- Unsecured advances given by banks to SHGs against group guarantees would be excluded for the purpose of computation of the prudential norms on unsecured guarantees and advances until further notice. The matter would be reviewed after a year in the light of growth in aggregate unsecured advances, and the recovery performance of advances to SHGs.

Urban Co-operative Banks

(a) Proposal for an Apex Supervisory Body

115. 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. Subsequently, RBI has submitted a draft Bill which is under consideration of the Government.

116. In the annual policy Statement of April 2002, RBI had again drawn attention to the present system of dual/triple regulatory and supervisory control (involving the Centre, States and RBI) and stated that it 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 the above, RBI mooted a proposal to set up a separate supervisory

authority in the interest of the public depositors, with representatives of the Centre, States and other interested elements.

117. This important issue was examined recently by a Committee under the Chairmanship of Hon. Minister of State for Finance. While RBI will do its best in implementing the final decisions of the Government in this regard, it may be kept in view that in case immediate measures are not taken to remove duality of control, it will be difficult to make the supervisory system effective.

(b) Supervisory Rating System for UCBs

118. In order to strengthen the supervisory regime for UCBs, as announced in the annual policy Statement of April 2002, based on the recommendations of the Working Group set up for the purpose of rating system for UCBs, RBI has finalised a CAMELS based supervisory rating system for UCBs. This would be implemented on trial basis for scheduled UCBs from March 2003.

Supervision and Monitoring

119. Progress made in respect of certain announcements made in the annual policy Statement of April 2002 is reviewed below.

(a) Risk Based Supervision

120. The annual policy Statement of April 2002 had indicated that RBI would switch over to risk based supervision (RBS) of banks by 2003 and accordingly, certain change management processes were initiated by the Project Implementation Group formed for the purpose. A review of the progress made revealed that banks have initiated steps for implementation of actions required to switch over to RBS. The risk profile template (RPT) developed covering various business and control risks was circulated among banks for their suggestions as also for identification of information gaps, if any, which need to be addressed for compilation of risk profile. The RPT would be finalised in the light of the feedback received from banks. Specialised trainings with focus on risk management and RBS have been imparted to the officials of commercial banks and RBI. The compilation of supervision manual for the use of supervisors is in progress and the RBS approach is scheduled to be operationalised during 2003.

(b) Prompt Corrective Action

121. It was indicated in the annual policy Statement of April 2002 that the scheme of prompt corrective action (PCA) developed as a supervisory tool based on certain trigger points, was cleared by the Government with some suggestions. An internal Group has been set upto study the impact of the PCA framework on select weak banks.

(c) Macro-prudential Indicators

122. It was indicated in the annual policy Statement of April 2002 that pilot reviews using macro-prudential indicators (MPIs) were prepared for internal circulation. Subsequently, the scope and coverage of MPIs were enhanced in the review for the half-year ended March 2002. The salient features of the MPI report are proposed to be published in the RBI Bulletin.

(d) Consolidated Accounting and Supervision

123. As indicated in the annual policy Statement of April 2002, draft guidelines on consolidated accounting and supervision were circulated to banks in June 2002 seeking their views. In the light of feedback received from banks, the guidelines are being finalised. Pending legislative amendments to various Acts, in order to provide enabling provisions to facilitate consolidated accounting and quantitative methods under Indian conditions, a working arrangement with other regulators, viz. SEBI and IRDA, for sharing of information by way of Memorandum of Understanding (MoU) is being explored.

Prudential Measures

124. Prudential regulation and supervision have formed a critical component of the financial sector reform process since the beginning and these norms have been progressively tightened over the years in line with international best practices. Despite a turbulent global economy and series of challenges, noteworthy progress has been made towards developing a stable financial system. The progress made in the implementation of prudential measures announced so far along with further measures considered necessary are indicated below.

(a) Time-table for Adoption of 90 days Norm for Recognition of Loan Impairment by State Co-operative Banks/ District Central Co-operative Banks

125. With a view to moving towards international best practices and to ensure greater transparency, commercial banks were advised to adopt 90 days norm for recognition of loan impairment from the year ending March 31, 2004. The 90 days norm has also been made applicable to urban co-operative banks and regional rural banks with effect from March 31, 2004. In order to have a consistent and uniform approach towards all segments of the banking system, it has been decided:

- To extend the 90 days norm for recognition of loan impairment to the State Co-operative Banks and District Central Co-operative Banks from the year ending March 31, 2006. To facilitate smooth transition, banks are advised to move over to charging interest on monthly rests effective April 1, 2004. Detailed guidelines in this regard will be issued separately.

(b) Adoption of 90 days Norm for Recognition of Loan Impairment - Charging of Interest at Monthly Rests

126. As indicated in the annual policy Statement of April 2001, in order to facilitate adoption of 90 days norm for recognition of loan impairment from the year ending March 31, 2004, banks were advised to switch over to a system of charging interest on advances at monthly rests with effect from April 1, 2002. Based on the suggestions received and discussions with banks on some operational and procedural issues, consolidated instructions were issued in July 2002. Accordingly, banks were advised, *inter alia,* as under:

- Banks have the option to charge interest at monthly rests effective either from April 1, 2002 or July 1, 2002 or April 1, 2003.

- As emphasised in the July 2002 circular, with effect from the quarter beginning July 1, 2002, banks should ensure that the effective rate does not go up merely on account of the switchover to a system of charging/compounding interest at monthly rests.

- Charging of interest at monthly rests shall not be applicable to agricultural advances and banks would continue to follow the existing practice of charging/compounding of interest linked to crop seasons.

- In respect of advances to short duration crops and allied agricultural activities such as dairy, fishery, piggery, poultry, bee-keeping etc., banks should take into consideration due dates fixed on the basis of fluidity with borrowers and harvesting/marketing season while charging interest and compounding the same if the loan/instalment becomes overdue.

(c) New Capital Accord

127. The Reserve Bank is continuing its efforts towards obtaining international agreement on the proposals on the New Capital Accord so that in its final version due next year, it would provide sufficient flexibility for national regulation to take into account the differences in institutional framework and capacity in different countries, including developing countries. In various international fora where this issue is being discussed, RBI and several other supervisory agencies have proposed that for non-complex banks, national authorities should have the discretion to use simpler methodologies for calculation of risk-weighted capital requirements. It is encouraging to note that in its further

deliberations, the Basel Committee is responding to these concerns and it is expected that a consensus would emerge to make the New Accord primarily focused on the international banks that compete in the global capital markets and that there could be different, and yet perfectly valid, choices available for the capital regulation of banks that are neither highly complex in their operations nor internationally active.

128. India is also participating in the Quantitative Impact Study (QIS 3) being conducted by the Basel Committee to assess the impact of the New Accord. As mentioned in the annual policy Statement of April 2002, RBI has since constituted a group of seven banks (three public sector banks, two new private banks and two old private banks) that have begun participating in the exercise.

(d) Banks' Entry into Insurance Business
- Referral Arrangement

129. It may be recalled that with the passage of Insurance Regulatory and Development Authority (IRDA) Act, 1999, guidelines for entry of banks into insurance business were issued in the annual policy Statement of April 2000. With subsequent amendments to the IRDA Act, banks are now allowed to undertake referral business through their network of branches with prior permission from IRDA and RBI. Under the referral arrangement, banks provide physical infrastructure within their select branch premises to insurance companies for selling their insurance products to the banks' customers with adequate disclosure and transparency, and in turn earn referral fees on the basis of premia collected. Accordingly, a few banks have been permitted to enter into referral arrangements with insurance companies subject to certain conditions to protect the interests of their customers.

(e) Technical Group on Market Integrity

130. The Standing Committee on International Financial Standards and Codes constituted an internal Technical Group which assessed India's position vis-à-vis international standards on 'market integrity'. The report of the Group has been placed on the RBI website for wider dissemination.

(f) Guidelines on 'Know Your Customer'
Norms and Cash Transactions

131. As indicated in the annual policy Statement of April 2002, guidelines on 'Know Your Customer' (KYC) norms and cash transactions, reinforcing the existing instructions in this regard were issued in consultation with banks. The guidelines covered both domestic and foreign currency accounts/transactions. Banks are advised to put in place a sound KYC policy, adopt anti-money laundering measures comprising systems and procedures for customer identification while opening accounts, institute internal control and audit mechanism and lay down risk management and monitoring procedures. Detailed guidelines are available on the RBI website.

(g) Offshore Banking Units in Special Economic Zones

132. The EXIM Policy for 2002-07 has announced the setting up of Offshore Banking Units (OBUs) in SEZs. Accordingly, RBI formulated a scheme of OBUs in SEZs as branches of banks operating in India and obtained the approval of the Government. Detailed guidelines in this regard would be issued to banks shortly.

(h) Prudential Guidelines on Non-SLR Investments
by Banks and Financial Institutions

133. As indicated in the annual policy Statement of April 2002, the draft prudential guidelines on management of non-SLR investment portfolio were circulated to banks for their comments. Subsequently, the Working Group (Chairman: Shri S.R. Iyer, Chairman, CIBIL) to evolve a framework for collecting and sharing of information on private placement of debt had recommended that the investing banks/FIs should invest only if the issues are rated by a rating agency. The draft guidelines as modified after taking into account the recommendations of the Working Group as also the feedback received from banks were referred to the RBI-SEBI Technical Committee to take a view on the disclosure and regulation of private placement.

(i) Country Risk Management

134. With a view to moving further in complying with the Core Principles of Banking Supervision, it was indicated in the annual policy Statement of April 2002 that RBI would be issuing draft guidelines on country risk management and provisioning. Accordingly, the draft guidelines on country risk management together with a 'Note for Discussion' were forwarded to banks and were also placed on the RBI website seeking comments/views thereon. Based on the feedback, the final guidelines would be issued.

(j) Investment Fluctuation Reserve

135. As indicated in the annual policy Statement of April 2002, with a view to building up of adequate reserves to guard against any possible reversal of interest rate environment in future, banks were advised to build up Investment Fluctuation Reserve (IFR) with reference to investments, in two categories, viz., 'Held for Trading' (HFT) and 'Available for Sale' (AFS). The IFR as at end-March 2002 constituted 0.91 per cent of the investment held under HFT and AFS categories. The distribution of IFR holdings of banks showed that while about 47 per cent of the banks have built up reserve upto one per cent, about 16 per cent of banks are yet to make any provisions for IFR. As per the extant guidelines, banks are required to build up IFR of a minimum 5 per cent within a period of 5 years.

Deposit Insurance

136. As indicated in the annual policy Statement of April 2000, the Deposit Insurance and Credit Guarantee Corporation (DICGC), in consultation with RBI, examined the recommendations of the Advisory Group on Reforms in Deposit Insurance in India and forwarded a draft outline of the proposed new Bill to the Government for their consideration. In the Budget 2002-03, it was announced that the DICGC would be converted into the Bank Deposits Insurance Corporation (BDIC). In order to evolve a suitable system for India, a joint team of officials from the Government, RBI and DICGC studied the Federal Deposit Insurance Corporation (FDIC) model and other regulatory and supervisory agencies in the US. Further legislative changes, if any, would be referred to the Government for consideration after finalisation of the report of the team.

Working Groups on Prudential and Supervisory Norms, etc.

137. As a part of the consultative process in initiating financial sector reforms, RBI constituted a number of Working Groups on various policy issues, with members drawn from banks, market participants and experts in the relevant areas. Working Groups were also set up for suggesting road maps for implementation of international best systems and practices in the financial sector with particular reference to the banking sector. The reports of the Working Groups were examined internally and were also put on the RBI website where necessary for wider dissemination and comments. Constitution of new working groups and the progress made in respect of some of the Working Groups is given in the Annex I to the Review.

Technology Upgradation

138. An important objective of the programme for technology upgradation in the financial sector is to link various payment and settlement systems into an efficient and integrated system. The roadmap for development is provided in the 'Payment System Vision Document', prepared by RBI and is available on the RBI website. The reform process in payment and settlement system is gaining momentum with the implementation of Negotiated Dealing System (NDS), Centralised Funds Management System (CFMS), forex clearing by Clearing Corporation of India Limited (CCIL) and a secured message transfer system through Structured Financial Messaging Solution (SFMS). In addition, Electronic Funds Transfer (EFT) facilities have been extended to multiple settlements in a day and preparatory work for RTGS system has been completed. Further details on the development of technology are given in Annex II.

Legal Reforms

139. In the recent period, with the advancement in information and communication technologies, the financial system has been undergoing a continuous process of change. It is important for RBI to have sufficient flexibility in orienting the operative, regulatory, and supervisory framework appropriately so as to keep pace with the developments. Accordingly, RBI has proposed for consideration of the Government various amendments to the existing Acts in order to provide more flexibility in day to day operations. Some Working Groups have also been constituted to suggest further changes in the legal framework, as necessary, and some of the proposed changes are at various levels of consideration of the Government. Details of proposed changes are in Annex III.

Mumbai
October 29, 2002

Annex I

Working Groups: Progress Report

Expert Committee on Bank Frauds

The Expert Committee on Bank Frauds (Chairman: Dr. N. L. Mitra) submitted its report in September 2001 to RBI. The recommendations of the Committee consist of two parts. Part I covers the recommendations which could be implemented without any legislative changes and these were forwarded to banks in May 2002 for implementation. The recommendations in Part II require legislative changes. 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 comments.

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

The consultative Group of Directors of Banks and FIs (Chairman: Dr. A.S. Ganguly, Director, Central Board, RBI) has submitted its report which contains important recommendations to strengthen the supervisory role of the Boards of banks. The Reserve Bank has advised the banks to place the report before their Board and adopt and implement the recommendations which were within the regulatory ambit of RBI. Recommendations of the Group which require legislative amendments have been forwarded to the Government for consideration.

Working Group to Recommend the Criteria for Fixing the Limits for Primary Dealers in Call/Notice Money Market

A Working Group was constituted (Chairman: Shri Mohammad Tahir, Executive Director, RBI) to recommend the criteria for fixing the limits for PDs in call/notice money market and suggest a road map for phasing them out of the call/notice money market. The Working Group also reviewed the apportionment of liquidity facilities to PDs as between normal and back-stop. The Group has since submitted its report and based on the recommendations, RBI has issued a circular stipulating prudential limits on PDs' lending and borrowings in call/notice money market which are linked to their net owned funds.

Informal Working Group on Separate Trading of Registered Interest and Principal of Securities (STRIPS)

As announced in the annual policy Statement of April 2002, RBI had constituted a Working Group (Chairman: Shri M.R. Ramesh, Managing Director, CCIL) with representatives from banks and other market participants to suggest operational and prudential guidelines on STRIPS. The Working Group has since submitted its report which is placed on the RBI website for wider dissemination. The Group's recommendations are under examination of RBI. The proposed Government Securities Act, which will enable Stripping, is under consideration of the Government.

Securitisation of Housing Loans

As proposed in the annual policy Statement of April 2002, a Working Group (Chairman: Shri R.V. Verma, Executive Director, NHB) was set up with members from banks, HDFC and RBI to examine the modalities for widening the investor base, improving the quality of assets, creating liquidity for trading in Mortgage Backed Securities (MBS) of Housing Finance Companies (HFCs) and other related issues. The Group is yet to submit its report.

Corporate Debt Restructuring (CDR)

As announced in the Union Budget 2002-03, a Working Group was constituted (Chairman: Shri Vepa Kamesam, Deputy Governor, RBI) to suggest various measures for making the operations of CDR mechanism more efficient. The Working Group has submitted its report on July 31, 2002 which is under examination of RBI and the Government. As on date, the CDR Cell has received 32 references, of which 8 restructuring packages have been approved for implementation with an

aggregate exposure of banks/institutions of Rs.2,018 crore. Of the balance 24 references, 7 have been rejected or withdrawn and the remaining cases are under various stages of processing. So far, all domestic banks (except 8 private sector banks) have signed the agreements. However, foreign banks have not yet signed the legal agreements as they are seeking clarifications.

New Working Groups

Provisioning Requirements - Review

Some banks in India have published their financial results under Indian Accounting Standards, as also under United States-Generally Accepted Accounting Practices (USGAAP). In order to review the entire issue of provisioning requirements and in the context of some of the banks exploring conformity with USGAAP, a Working Group has been constituted to suggest changes in tune with the emerging international practices and suitable to the Indian financial system.

Working Group on Cheque Truncation

The annual policy Statement of April 2001 had mentioned about legal requirements for cheque truncation. One of the bottlenecks in the realisation of cheques sent for collection pertains to the actual physical movement of paper based instruments. Cheque truncation will usher in the capacity to drastically reduce the time needed for realisation of cheques and other paper based instruments and will facilitate straight through processing, benefiting banks and customers. Since various models of cheque truncation are available the world over, it has been decided to constitute a Working Group to suggest an appropriate model suitable for Indian conditions.

Annex II

Technology Upgradation: Review of Developments

Introduction of National Electronic Funds Transfer

The annual policy Statement of April 2002 had emphasised the usage of Electronic Funds Transfer (EFT) on a large scale to bring about greater efficiency in the movement of funds, and reduction in risks in funds transfer. In order to ensure that the benefits of electronic modes of funds transfer are available across almost all the locations of the country and to provide for transfer of messages relating to EFT in a safe and secure manner, it is proposed to commence a National EFT (NEFT) using the facilities available under the Structured Financial Messaging Solution (SFMS) over the Indian Financial Network (INFINET). This would result in EFT being available from any branch of a bank which has connectivity to INFINET with the settlement taking place in the books of account of the Reserve Bank at a single location.

Branch Automation and Networking

The annual policy Statement of April 2002 emphasised the need for banks bestowing special attention on the computerisation and networking of the branches on a time-bound basis, in order to fully prepare themselves to participate effectively in the new products aimed at better payment and settlement services. While about 80 per cent of the banking business of Public Sector Banks is captured though computerisation, most of these efforts are on stand alone basis. However, integration and consolidation have immense benefits for customers in terms of 'anytime banking' and 'anywhere banking' facilities. As these are built up on total branch automation and networking of branches, it is essential that the pace of internal computerisation of branches of banks and their inter-connectivity, providing for core banking solutions or centralised data base access/clustered solutions needs to be expedited.

Sharing of Payment System Delivery Points

Developments in the delivery channels in the banking sector show the proliferation of multiple payment delivery points such as branch banking, Automated Teller Machines (ATMs), Tele-banking, Internet-banking, Mobile-banking etc. While such separate efforts by individual banks ensure competition and product differentiation, in respect of providing ATM services, these efforts have very often been proved to be sub-optimal and high cost services. In order that competition and variety of services are not reduced and that the services are provided in a cost effective manner, banks which are maintaining sub-optimal ATMs are encouraged to join shared and strong network of ATMs operated by a service provider or other banks.

Information Security (IS) on the Network in the Banking and Financial Sector

The banking and financial sector is increasingly depending on internal and external networks for their operations. In order to protect information on the networks, a variety of tools like firewalls, intrusion detection, anti-virus authentication, public key infrastructure (PKI) etc. are available. The Institute for Development and Research in Banking Technology (IDRBT) has been approved as the certification authority (CA) for the banking and financial sector. The secured network, INFINET established by IDRBT for the financial sector uses the PKI for enhancing information security. Banks are encouraged to use the PKI by creating the required Registration Authority (RA).

Forex Clearing by CCIL

Clearing Corporation of India Limited (CCIL) is on the threshold of launching net forex clearing in India on a guaranteed settlement basis. All the participants are advised to contribute to the Settlement Guarantee Fund so as to enable CCIL to collateralise the facility and commence operations in early November.

Annex III

Legal Reforms: Review of Developments

- A new Bill on Negotiable Instruments (Amendment) Bill, 2002 (replacing the Negotiable Instruments Bill, 2001) has been introduced in the Parliament after incorporating the changes recommended by the Standing Committee on Finance which took into consideration the recommendations of the Working Group on Negotiable Instrument (NI) Act, 1881. The Bill provides for the introduction of 'Electronic Cheque' and 'Cheque Truncation'.

- The Securitisation and Reconstruction of Financial Asset and Enforcement of Security Interest Ordinance, 2002 which was promulgated on June 21, 2002, has been repromulgated on August 21, 2002. The Ordinance provides for: (a) legal framework as well as the machinery for securitisation and reconstruction of financial assets of banks and financial institutions, (b) enforcement of security interest by banks and financial institutions by taking over the possession of the secured assets and its sale directly without the intervention of the court, (c) creation of a Central Registry for registering the security interest created in favour of the secured creditors, and (d) empowers RBI for registering the Securitisation Companies (SCs) and Reconstruction Companies (RCs), determining the policy and giving directions in respect of prudential norms and framing guidelines for measures covering asset reconstruction. Accordingly, Rules have been notified by the Government in so far as the Enforcement of Security Interest is concerned. The Reserve Bank has constituted two Working Groups for stipulating suitable norms for registration, prescribing prudential norms, recommending proper and transparent accounting and disclosure standards and framing appropriate guidelines for the conduct of asset reconstruction/securitisation.

- The Committee constituted to consider draft legislation on the payment system has since submitted its report.

- A Bill on Factoring of Debts due to Industrial and Commercial Undertakings has been submitted to the Government for consideration.

- Amendments have been proposed to the State Bank of India Act, 1955 to facilitate the enhancement of authorised capital, bring the voting rights of the shareholders in conformity with the provisions of Banking Regulations Act, rationalise the powers of Local Board, acquisition of the business of other banks and to provide for procedural matters relating to shares on the lines of Companies Act. Also, similar amendments have been proposed in the State Bank of India (Subsidiary Banks) Act, 1959 to enhance the authorised capital and reduce SBI stake in its subsidiaries to 51 per cent. The Reserve Bank has submitted its views on the same to the Government.

- Based on the recommendations of the Mathur Committee's report, the proposal for amendments to SBI Act, NHB Act and NABARD Act for disinvestment of RBI holdings in these institutions has been sent to the Government.

- Prevention of Money Laundering Bill, 1999, which was cleared by Rajya Sabha with certain amendments, is awaiting clearance of Lok Sabha.

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* In this Part, figures on monetary and banking aggregates have generally been rounded off to the nearest hundred crore.