Statement by Dr.Bimal Jalan,Governor,
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on

Mid-Term Review of Monetary and Credit Policy for 1998-99

Introduction

It will be recalled that in the last Monetary and Credit Policy Statement on April 29, 1998, it was indicated that a review of credit and monetary developments in the first half of the year will be undertaken in October of each year. It was also indicated that the October review would generally be in the nature of a mid-term review of monetary developments during the year, and will not necessarily involve changes in credit policy measures.

2. This statement consists of three parts: (i) Mid-term review of Macro-Economic and Monetary Developments in 1998-99, (ii) Stance of Monetary Policy for the second half of 1998-99, and (iii) Monetary and Financial Sector Reforms. No changes in short-term measures such as the Bank Rate, CRR, Repo rate are being announced at this point of time. As pointed out in the April Statement, these credit and regulatory measures will continue to be subject to change at short notice in the light of actual domestic developments and emerging external market conditions.

3. The Committee on Banking Sector Reforms (Narasimham Committee), which submitted its report earlier this year, has made certain far-reaching recommendations. The detailed recommendations of the Committee have now been considered in consultation with the Government of India, and decisions in regard to several of them are being announced in this statement.

4. In order to deliberate on issues relating to harmonising the operations of banks and financial institutions, the Reserve Bank of India (RBI) had, in December 1997, set up a Working Group comprising Chairmen of some commercial banks and development financial institutions under the

Chairmanship of Shri S.H.Khan, the then Chairman of the Industrial Development Bank of India. The Group submitted its full report in May, 1998. As announced in the April Monetary and Credit Policy Statement, a "Discussion Paper" is under preparation, which would contain Reserve Bank's views on the Working Group's recommendations/suggestions. This paper will be circulated for discussion shortly. The final decision on the issues raised in this paper will be taken in the light of the suggestions/comments received on it.

Mid-term Review of Macro-economic and Monetary Developments in 1998-99.

i) Domestic Developments

5. Monsoon has been good this year, and it is expected that agriculture will bounce back from a negative growth in 1997-98 to a positive one in 1998-99. However, at present, there is some uncertainty about the extent of likely increase in agricultural production during the year as some parts of the country have been affected by floods and late rains. Taking this factor into account, a rate of growth of 3 per cent in agricultural production over the depressed level of 1997-98 seems a reasonable estimate at this point of time, pending further confirmation about the effect of late rains. As regards industrial growth, although there are some incipient signs of recovery, it is not yet clear whether the rate of growth in industrial output will be substantially higher than last year's growth of 6.5 per cent. Allowing for the turnaround in agriculture and some recovery in industrial production, at present the best estimate for GDP growth for 1998-99 is in the region of 6 per cent (as compared with 5.1 per cent in 1997-98). In view of the global slow-down in economic activity, this order of growth will place India as one of the very few countries, developed or developing, which will show a relatively high positive rate of growth during the current year.

6. The rate of inflation, as measured by the wholesale price index on a point-to-point basis, is currently ruling at over 8 per cent, which is significantly

higher than the rate which, as pointed out in the April Statement, should not exceed 5 to 6 per cent per annum. So far, the increase in the rate of inflation is concentrated in a few primary commodities, particularly fruits and vegetables and edible oils. Hopefully, with the arrival of the new crop, and the beginning of the period of seasonal decline in prices, the annual rate of inflation would decelerate in the next three - four months. However, recent trends in inflation are a matter of concern, and there can be no room for complacency on this account.

7. The rate of growth of Money Supply (M_3) during the current financial year upto October 9, 1998 has been 10.1 per cent compared with 7.3 per cent in the corresponding period of the previous year, partly due to inflows of receipts on account of Resurgent India Bonds (RIBs). If RIB inflows are excluded, M_3 expansion during the current financial year so far would be around 7.9 per cent. On a year-on-year basis, M_3 growth (October 9, 1998 over October 10, 1997) was 20.6 per cent (and excluding RIB receipts, 18.3 per cent) as against 16.8 per cent in the comparable period of the preceding year. Thus, even if the impact of RIB inflows is excluded, there has been a strong growth in money supply during the current financial year so far. The current year's M_3 expansion is mainly reflective of the sharp increase in aggregate deposits of scheduled commercial banks which showed an increase of Rs.66,563 crore (11.0 per cent) as compared with Rs.37,687 crore (7.5 per cent). Time deposits have increased by Rs.68,480 crore (13.6 per cent) as compared with Rs.42,824 crore (10.3 per cent) last year. Thus, the increase in aggregate deposits is attributable to growth in time deposits which was even higher than the increase in aggregate deposits.

8. Reserve money which essentially represents liquid cash balances in the economy rose by Rs.8,343 crore (3.7 per cent) in the current financial year upto October 9, 1998, as compared with Rs.5,640 crore (2.8 per cent) in the corresponding period of the previous financial year. With net foreign exchange assets of the Reserve Bank growing by a lower amount in the current financial year upto October 9, 1998 (Rs.8,967 crore as against

Rs.13,337 crore last year), net RBI credit to Government had assumed significance in the reserve money creation, having gone up by Rs.11,010 crore in contrast to a decline of Rs.8,947 crore in the same period of last year.

9. The Budget for 1998-99, presented to Parliament on June 1, 1998 projected a fiscal deficit of 5.6 per cent of GDP. Accordingly, the gross borrowing requirement of Central Government for the year is placed at Rs.79,376 crore. Net borrowing requirements were placed at Rs.48,326 crore. The corresponding actuals for 1997-98 were Rs.59,637 crore and Rs.40,494 crore, respectively. The borrowing requirements estimated for 1998-99 are undoubtedly high and account for a substantial portion of the incremental deposits in the banking system. In order to minimise the impact of such high borrowing requirements on the interest rate outlook, the Reserve Bank had indicated on June 11, 1998, its intention to accept private placement of securities from time to time (in the event of market bids being at relatively high levels due to uncertainties in the market) and then release them to the market as conditions improve.

10. This approach has worked reasonably well. As on October 29, 1998, nearly 84.9 per cent of the gross and 93.0 per cent of the net borrowing programme has been completed. Despite a steep hike in the repo rate of 300 basis points on August 20, 1998 and an increase in cash reserve ratio (CRR) by 1 percentage point effective the fortnight beginning August 29, 1998, the yields on primary auctions of longer term Central Government papers issued in September 1998 have increased by only three basis points each for 6-year security and 10-year security over the yields on issues of same tenor made earlier in July 1998. The Reserve Bank has also taken measures to minimise the impact of RIB inflows on money markets by offering special repo and other facilities for temporary parking of excess liquid funds with banks.

11. Despite some additional pressures on the fiscal position, the Government has announced its firm intention to contain the fiscal deficit, and its borrowing requirements, to the levels announced in the Budget for 1998-

99. This is a welcome development, as the importance of containing fiscal deficit to budgeted levels in the current year cannot be over-emphasised. The current inflation rate is a matter of concern and the outlook for industrial growth continues to be uncertain. The external environment is also highly unfavourable. In this situation, any increase in the fiscal deficit during the year would put further pressure on the outlook for medium and long-term interest rates, besides adding to the already high rate of monetary growth. Looking beyond the current year, it is becoming increasingly evident that a significant reduction in fiscal deficit over the next 2 to 3 years is now a high national priority. Beyond a point, it is simply not feasible for banks and financial institutions to increase the share of Government securities in their overall asset portfolio without affecting their own viability - and indeed the viability of the productive sectors of the economy.

12. There was a substantial increase in food credit extended by scheduled commercial banks. Food credit has expanded by Rs.3,464 crore (upto October 9, 1998) as against Rs.1,455 crore in the corresponding period of last year, reflecting in part the increase in food procurement operations and the build-up of buffer stocks of foodgrains. Non-food credit has also shown a substantial increase during the current year. Most of the increase has taken place in the last two fortnights (upto October 9, 1998). The increase in non-food credit to the commercial sector by scheduled commercial banks was of the order of Rs.6,972 crore (2.2 per cent) in the current financial year upto October 9, 1998 as against Rs.4,686 crore (1.7 per cent) in the corresponding period of last year. The total resources flow to commercial sector including banks' investments in shares and debentures, capital issues, borrowings from financial institutions, etc., have shown a sharper increase. Scheduled commercial banks' investments in commercial paper, shares, debentures, etc., increased by Rs.8,787 crore in the current financial year so far as compared with Rs.8,506 crore in the comparable period of last year. Together with such investments, the total flow of resources from the scheduled commercial banks to the commercial sector went up by Rs.15,759 crore (4.6 per cent) compared with Rs.13,192 crore (4.5 per cent) in the

corresponding period of 1997-98. The total resources flow to commercial sector including capital issues, GDRs and borrowings from financial institutions was much higher at Rs.41,792 crore upto October 9, 1998 as against Rs.34,645 crore in the corresponding period of last year.

13. It will be recalled that, following the April 1998 monetary and credit policy, there was some disappointment that, in the absence of a CRR cut, there could be a shortage of liquidity resulting in substantially higher interest rates. At that time, the Reserve Bank had drawn attention to the prevailing easy liquidity conditions and had given an assurance that CRR would be reduced in case there was any evidence of tight liquidity conditions. As it happened, liquidity conditions eased further during the period May to August 1998. Outstanding amounts of repos on a daily basis during this period averaged Rs.5,064 crore. In retrospect, it is clear that the decision not to cut the CRR at that time proved to be the correct one. In view of subsequent developments, it is arguable that CRR should have in fact been raised in April itself. However, given the state of market expectations at that time, such a move could have been highly destabilising, possibly resulting in a sharp jump in interest rates. The events of the last few months illustrate the delicate balance that has to be struck between conflicting considerations in deciding on changes in monetary policy measures in the short-term. Monetary policy has to facilitate growth while at the same time maintaining external and internal stability. In the long run, these objectives are mutually reinforcing; however, in the very short run, they may point in different directions.

(ii) External Developments

14. The period since the April monetary and credit policy was announced has presented major challenges for management of the external sector. The East Asian economic crisis, which appeared to be coming under control during the earlier part of the year, continues to remain serious. The contagion spread to Russia in August and could affect some Latin American countries as well. The economic outlook in Japan appears uncertain. Equity, bond and

forex markets in the United States and Europe have also been affected. Although there has been some upward movement in global stock markets in the past fortnight, the world economy, as a whole, continues to be faced with considerable uncertainty. In addition to the unfavourable external situation, India was also confronted with certain other developments after the Pokhran test. Among these developments were the economic sanctions imposed by certain industrial countries, the suspension of fresh multilateral lending (except for some sectors), the downgrade by rating agencies, and the reduction in net investment of foreign institutional investors.

15. Viewed against the above background, developments in respect of India's foreign exchange market have been orderly and generally satisfactory. A major positive development has been the success of the Resurgent India Bonds (RIBs) floated by the State Bank of India. Foreign currency resources amounting to US $ 4.2 billion were raised under the RIB scheme. India's present foreign currency assets are higher than at the beginning of January 1998 in both gross and net terms (i.e., after excluding forward liabilities). Considering the unfavourable international environment, this is a matter of some satisfaction. The level of reserves also substantially exceeds the total stock of short-term debt and portfolio flows. As a matter of cautious policy, India has kept its short-term as well as forward liabilities at a low level in relation to the size of its reserves.

16. In the earlier part of the year, there was considerable discussion on movements in the Real Effective Exchange Rate of the rupee (REER). As pointed out in the Reserve Bank of India's statement on June 11, 1998, the RBI does not consider REER to be an effective tool for management of short-term movements in the exchange rate. REER movements are subject to various influences, including capital flows, and the estimation of REER raises several methodological issues, e.g., the choice of a basket of currencies, the choice of the base period, the choice of trade-based weights, and the choice of a price index. Nevertheless, in view of the interest in this measure, the Reserve Bank has been publishing movements in the REER of the rupee

using trade based weights for 36 countries. In order to make this data more up-to-date, in the last few months, the Reserve Bank has also been releasing supplemental information on REER based on 5-country trade based weights with more recent base years. The latest statistics, since June 1998, in regard to the market rate of the rupee (i.e., RBI Reference Rate) and the imputed REER, with the base year 1993-94, are given below for information. It is, however, reiterated that while these data have some information content, the Reserve Bank does not use short-term movements in REER as indicator of appropriateness or otherwise of exchange rate movements.

Month & Year	**RBI Reference Rate**	**Imputed value of Rupee Based on REER** (Base 1993-94=100)
	(Rupees per US dollar)	
June, 1998	42.25	42.05
July, 1998	42.51	42.55
August, 1998	42.75	43.04
September, 1998	42.52	42.11
October 29, 1998	42.29	41.12

17. The primary objective of the Reserve Bank and the Government in management of the exchange rate is to maintain orderly conditions in the foreign exchange market, and to prevent the emergence of destabilising speculative activities. To this end, as in the past, the Reserve Bank will continue to closely monitor developments in the financial markets at home and abroad, and take such monetary and administrative actions as may be considered necessary from time to time. The Reserve Bank will not hesitate to use its reserves, when warranted, to meet sharp day-to-day supply-demand imbalances in the market. As before, it will ensure that lumpy and uneven demand, particularly for oil imports and debt servicing obligations of Government, does not cause any disturbance in the orderly functioning of foreign exchange market.

18. A reduction in interest rates for pre-shipment and post-shipment credit to exporters by 2 percentage points (from the prevailing levels) was announced by Government in August 1998, to be effective upto the end of March 1999. Thus, for most categories of export credit, the interest rate is 9 per cent per annum. In order to facilitate the implementation of this decision, the Reserve Bank announced a corresponding reduction of 2 percentage points in the refinance rate available to banks for export credit (to 7 per cent from 9 per cent per annum). The average utilisation of export credit refinance during the fortnight ended October 9, 1998 was Rs.4,838 crore as compared with Rs.24 crore during the corresponding fortnight last year, which has added to the growth of liquidity in the system. While the importance of accelerating the rate of growth of exports can hardly be over-emphasised, it must be stressed that provision of rupee export credit at present rates is not sustainable in the long run. As already announced, these rates will revert to earlier levels after March 1999. In order to ensure internationally competitive interest cost for exporters, on June 11, 1998, the Reserve Bank had advised banks to charge a spread of not more than 1.5 percentage points over LIBOR on foreign currency loans (as against 2.0/2.5 percentage points over LIBOR prior to this date). Such foreign currency loans can be serviced out of foreign currency export receipts. Exporters are advised to make maximum use of this facility. Banks are also requested to make this facility easily accessible without any procedural hassles.

19. In order to create an exporter-friendly environment and to simplify procedures for delivery of credit to exporters, the Reserve Bank will be setting up a Working Group of bankers. This group of officials will interact with exporters as well as local bank officials by visiting bank branches in some of the major exporting centres especially where small and medium size exporters are located. On the basis of such interactions, the Working Group will suggest changes designed to reduce repetitive documentation requirements and improve the quality and reduce cost of non-fund based services to exporters. The objective would be to make available export credit “on line”, including foreign currency loans mentioned above, on the basis of

performance with minimum paper work, and provide related services efficiently.

20. Exporters currently enjoy a facility to retain a portion of their earnings repatriated to India to be utilised for certain purposes under the scheme of Exchange Earners Foreign Currency (EEFC) accounts. Over a period, improvements have been made in the EEFC scheme by enhancing the retention percentage as also purposes for which the balances in the account can be utilised. Presently, the entitlement is 50 per cent for all foreign exchange earners and 70 per cent for exporters coming under the categories of export oriented units (EOUs) or of those who operate in export processing zones, etc. The balances can be presently utilised for all trade related expenses outside India as also for payment to residents in foreign exchange in consideration of supply of goods and services, and approved capital account transactions. The Working Group of bankers being constituted to simplify procedures for credit delivery to exporters will also review the operation of the EEFC scheme with a view to suggesting improvements in the scheme and making it more exporter friendly.

Stance of Monetary Policy for October 1998 - March 1999

21. As the preceding review has brought out, there are several areas of concern in respect of current monetary trends in the economy. Money supply growth, attributable largely to growth in the banking sector's credit to Government, is too high in relation to the expected growth of the real sector of the economy. The rate of inflation is also higher than the initial projections. Although the price rise during the current financial year so far is largely concentrated on a few food items (e.g., fruits and vegetables and edible oils), there is no denying the fact that such a high rate of monetary growth is inconsistent with the objective of maintenance of general price stability. In this situation, a case could be made out for monetary tightening through measures, such as, increasing the interest rates or a further increase in the CRR.

22. However, it has to be recognised that industrial slowdown is still persisting, and as far as possible nothing should be done to dampen emerging signs of incipient recovery in the real sector. This view is reinforced by the fact that growth of bank credit to the commercial sector has not been a primary cause of expansion in money supply in the current year. These conflicting considerations, viz., the need to reduce monetary expansion while at the same time nurturing real growth, starkly illustrate the monetary policy dilemma that the RBI faces at the present juncture.

23. On balance of considerations, for the time being, it is not proposed to change the CRR or interest rates. RBI will continue to manage liquidity through Open Market Operations and repo operations. The Reserve Bank will not hesitate to resort to further monetary tightening if inflationary pressures increase or if external developments so warrant.

24. In the past year, as indicated in the April Statement, there has been a pro-active management of liquidity in the system through open market operations and more frequent variations in the repo rate. Fixed rate repos were first introduced as a regular monetary policy instrument on November 29, 1997 at the rate of 4.5 per cent. In view of excess liquidity in the system and forex market developments, the repo rate was raised in three stages to 9 per cent on January 16, 1998. After the return of stability in the forex market, the repo rate was reduced in stages to 5 per cent by June 1998. On August 20, 1998, however, in response to external market developments and anticipated large inflows of additional liquidity on account of RIB funds, the repo rate was increased to 8 per cent. As a consequence, the outstanding repo of RBI averaged Rs.6,329 crore per day in September, 1998. The repo rate, has thus, served as a reference point for market expectations about the movement in short-term interest rates. This is reflected in the fact that the inter-bank call rates have generally tracked above the fixed rate repo in recent months. Since April 1997, the Bank Rate has also been used flexibly, although less frequently. It is proposed to continue with the policy of flexible

use of interest rate instruments to signal RBI’s stance regarding monetary conditions and management of the flow of liquidity in the system.

Monetary and Financial Sector Reforms

25. The financial crisis in South-East Asia and Japan has brought to the fore the problems that weak and fragile domestic financial sector can pose for the real economy. It is now established beyond reasonable doubt that while a persistent and unexpected downturn in the real economy creates difficult problems for the financial sector, a fragile financial sector can deepen the real economy crisis and impose heavy social costs. It is, therefore, of utmost importance to strengthen capital adequacy, income recognition and provisioning norms for banks as well as other financial institutions and to move towards full disclosure and transparency in banking operations in line with international best practices.

26. As a part of economic reforms, since the early nineties, the capital adequacy and other prudential norms of banks have been strengthened and currently are close to the international standards. The quality and standards of supervision have also been upgraded substantially under the direction of a separate Board for Financial Supervision under the aegis of the Reserve Bank of India. Barring the performance of a select few weak banks, whose problems are being addressed separately, the improvement in the banking sector as a whole is impressive. In terms of inherent robustness, it is well recognised that the Indian banking system’s exposure to real estate or shares is negligible, while open foreign currency exposure limits are severely restricted. Their off-balance sheet liabilities are also very small due to regulatory restrictions and a relatively large part of banking system’s assets are in secure investments particularly in Government and approved securities. These features of the Indian banking system are important strengths and contribute to their long-term financial viability.

27. While substantial progress has already been made as a result of implementation of several recommendations made by the first Narasimham

Committee Report (i.e., the Report of the Committee on Financial System), it is now necessary to go further. The second Narasimham Committee Report, submitted to Government earlier this year, provides the basis for doing so.

(i) Narasimham Committee II

28. In consultation with the Government of India, the Reserve Bank has finalised its views on a large number of specific recommendations, which are within its purview. The aspects on which decisions taken by RBI along with a brief summary of the Committee's recommendations are given separately as a part of this statement (Annexure). Some of the important decisions, which will be implemented in phases over a period of time, are as follows:

- In line with the international best practices, the minimum capital to risk asset ratio is being raised from the existing 8 per cent to 9 percent which would take effect from the year ending March 31, 2000.

- With a view to further improving the quality of asset portfolio and enhancing the financial soundness of banks, income recognition and provisioning norms on Government guaranteed advances are being brought on par with those on other advances with effect from the financial year 2000-2001. Provisions on existing and old government guaranteed advances which would consequently become NPA are to be fully provided for over a period of four years beginning March 31, 1999.

- For enhancing the inherent strength of banks' balance sheets, provisioning requirements are being introduced for standard assets with effect from financial year ending March 31, 2000. The time frame for categorising an advance as doubtful debt is being shortened. The banks would be permitted to achieve the said provisioning norms in two phases, during the years 2000-2001 and 2001-2002.

- By the year ending March 31, 2000, Government/approved securities will have to be provided for a risk weight of 2.5 per cent. The balance of 2.5

per cent risk weight on Government/approved securities will be announced at a later date. Going a step beyond the recommendations of the Second Narasimham Committee on introduction of market risk on Government and approved securities, an additional risk weight of 20 per cent on investments in the government guaranteed securities of Government undertakings which do not form part of the market borrowing programme is also being introduced. In order to provide sufficient time to banks to make this provision, this requirement will come into effect year after next, i.e., financial year 2000-2001. In respect of the outstanding stock of such securities in the portfolio as on March 31, 2000, banks will implement this decision in two phases of 10 per cent each in 2001-2002 and 2002-2003.

- The risk weight for Government guaranteed advances which go into default is being introduced with effect from the year ending March 31, 2000. (Please see Annexure for details).

- Foreign exchange open positions will carry 100 per cent risk weight with effect from March 31, 1999.

- Banks are advised to introduce effective risk management systems to cover credit risk, market risk and operational risk on a priority basis. To this end, a comprehensive risk measurement approach should be adopted and a detailed structure of operating limits, guidelines and other parameters should be put in place. Banks have also been advised recently to address market risks in a structured manner by adopting a more comprehensive Asset-Liability Management Practices with effect from April 1, 1999. Guidelines on management of credit risk, market risk, operational risk, etc., will be issued soon.

- Banks are being requested to ensure a loan review mechanism for larger advances soon after its sanction and monitor any weakness that may develop in such accounts for initiating timely corrective action.

29. In implementing the recommendations of the Narasimham Committee, care has been taken to phase them in a manner that reduces the risk exposures of banks, strengthens financial soundness and contributes to improved profitability outlook. RBI recognises that strengthening of capital adequacy and prudential norms could pose some immediate resource management problems, in particular for some public sector banks which are constrained by legislation in their ability to raise further capital from the market. The issue of capital support from Government and enhancing public sector banks' ability to access the capital market to meet their capital requirements deserves to be debated and resolved at an early date as it is central to ensuring the future financial viability of the banking sector.

30. The Narasimham Committee had also made certain important recommendations regarding reduction in Government/RBI shareholding in public sector banks and on some other matters on which final decisions have to be taken by Government of India. Decisions on these as well as certain other recommendations would, however, entail amendments to the existing Statutes/Acts.

(ii) Risk Weights and Exposure Norms on Securities of Public Financial Institutions

31. While investments in bonds/securities of some of the Public Financial Institutions (PFIs) carry zero risk weight due to their status as `Approved Securities' under the special statutes governing them, investments in bonds/debentures of certain other PFIs carry 100 per cent risk weight as the relevant Act/Statute does not confer the status of an `Approved Security'. With a view to removing this anomaly, risk weights on investments in bonds/debentures of PFIs as defined under Section 4A of the Companies Act, 1956 (and certain other FIs notified by RBI) are being given a uniform risk weight of 20 per cent.

32. Investments in Central/State Government securities or in securities guaranteed by them have hitherto been assigned zero risk weight. It is now

proposed to assign a risk weight of 2.5 per cent on account of market risk, as stated earlier by March 31, 2000. However, in case of advances guaranteed by the Government, non payment of guaranteed amount or a default in interest/principal would attract risk weights as given in Annexure.

33. It has also been decided that henceforth investments by banks in bonds or debentures of a corporate guaranteed by a PFI will be treated as an exposure by banks on the PFI and not on the corporate as is the practice at present. Consequently, for the purpose of calculation of exposure norms, the exposure of the bank on the PFI guaranteeing the bond or debenture issued by corporates will be 100 per cent, whereas the exposure by the PFI on the corporate will be to the extent of 50 per cent.

(iii) <u>Payment and Settlement System</u>

34. For improving the conduct of monetary policy in the context of financial market reforms and opening up of the economy, it is necessary to set in place a robust integrated payment and settlement system. It is essential to eliminate the costs to the financial system presently in existence due to payment system floats, and large delays in processing and settling systems and legal hurdles in settlements. The objective should be to bring about operational efficiency, speed, better accuracy and timeliness of payment transactions as also to contain financial risks in the national payments system. For attaining this objective, the Reserve Bank has gone in for a reliable communication backbone through the establishment of VSAT-network. This network will expand in phases and over time, encompass the entire financial sector. The setting up of this network provides us with an opportunity as well as a challenge to carefully plan and design a strategy to move towards real time gross settlement (RTGS) system which is adopted by many major countries in the world. The RTGS system would cover all the banking and financial market transactions, reduce transaction costs, and

improve efficiency in the transmission of channels of monetary policy. The Reserve Bank has already instituted a Payment System Group (PSG) and a VSAT user Group to deal with issues relating to RTGS system. Successful implementation of RTGS system will, however, require active co-operation of all the market participants, including commercial banks. The Reserve Bank will take major initiatives in establishing such a system under the guidance of a high level National Payments Council which will be set up soon.

(iv) Money and Government Securities Markets

Money Market

35. Development of an efficient and vibrant money market is an integral part of financial liberalisation and often considered a pre-requisite for efficient transmission of monetary policy. As development of instruments, institutions and operating procedures form a vital part of money market development, the Reserve Bank had taken a series of measures in recent years, which include introduction of new instruments like the Certificates of Deposit (CDs), Commercial Paper (CP) and inter-bank participations (IBPs), widening the scope of participation and strengthening the institutional infrastructure. With a view to providing an additional short-term avenue to investors, the scheme of Money Market Mutual Funds (MMMFs) was introduced. Measures have also been taken to increase the instruments and investor base in the Repo market and to develop a term money market. The participants in the call/notice money, bills rediscounting market and MMMFs have also been increased.

36. Measures relating to money market announced in the April 1998 statement, viz., reduction in the minimum size of operation per transaction from Rs.5 crore to Rs.3 crore for entities routing their call money transactions through primary dealers, and reduction from 30 days to 15 days in the minimum lock-in period for Money Market Mutual Funds (MMMFs) and in the

period for transferability of Certificates of Deposit (CDs) have already been implemented.

37. The Narasimham Committee II had made some specific suggestions relating to money market in order to facilitate an efficient integration of financial markets.

- The Committee's suggestions that the minimum period of fixed deposits could be reduced to 15 days and all money market instruments should like-wise have a similar duration have already been implemented.

- The Committee has observed that the call money market in India, unlike in most well developed markets, is not strictly an inter-bank market and since non-bank participants are not subjected to reserve requirements, the market is often subject to volatility. In this context, the Committee has recommended that the call/notice money market and term money market should be strictly restricted to banks and primary dealers. In the Committee's view, non-bank parties can be provided free access to other money market instruments like Commercial Paper (CP), CDs, bills rediscounts, Treasury bills and MMMFs. The Reserve Bank concurs, in principle, with the Committee on this matter, and aims to ultimately move towards a pure inter-bank call/notice/term-money market including primary dealers. This will be implemented in a manner that the existing lenders in the market will have operational flexibility to adjust their asset-liability structure. Simultaneously, measures will be taken to widen the repo market and improve non-bank participation in a variety of other instruments.

- The RBI also agrees with the Committee's suggestion that there must be clearly defined prudent limits for banks' reliance on the call money market. It is expected that the Asset-Liability Management guidelines would enable banks to organise their treasury operations without placing heavy reliance on call money borrowings.

- The RBI broadly agrees with the Committee's suggestion that the RBI support to the market should be through a Liquidity Adjustment Facility (LAF) operated by way of repo providing a reasonable corridor for market play. While it is recognised that the repo is technically an efficient route for LAF, in view of certain procedural and technological constraints in transfer and settlement of securities, it may not be possible to introduce a scheme of LAF immediately. However, it has been decided to take all actions that will enable, in due course, to replace the present general refinance facility. The export credit refinance will continue as a separate scheme and reviewed independently. Besides, collateralised intra-day/over-night facility with adequate margin is also being considered to facilitate smooth operation of payment and settlement system to be placed eventually on real time gross settlements (RTGS) basis.

- In line with the Committee's view that the money market lacks a well defined yield curve for short-term to long-term maturity and that an inter-bank reference rate like a LIBOR has to emerge, RBI has taken initiatives in the recent past to develop a term money market as also to evolve a reference rate. The most important of them is the initiative taken in April 1997 whereby inter-bank liabilities were exempted from the maintenance of reserve requirements. It is expected that term money market will develop once banks put in place proper ALM systems. A reassuring feature has been that some agencies have already developed call money linked reference rates.

38. It may be recalled that the Reserve Bank of India had placed a restriction of a minimum period of 3 days for ready-forward (repo) transactions effective September 30, 1995. In the backdrop of the inter-bank liabilities having been exempted from the requirements of maintenance of CRR (except for the statutory minimum requirement of 3 per cent) and with a view to enabling banks and other participants in the repo market to adjust their liquidity in a more flexible manner, it has been decided to withdraw the

restriction of the minimum period for ready-forward (repo) transactions effective from October 31, 1998.

39. Product development is an integral part of improving market efficiency. Some banks have proposed that interest rate swaps may be permitted with a view to enabling them to hedge against interest rate risk arising out of asset-liability mismatches. With a view to further deepen the money market as also to enable banks, primary dealers and all-India financial institutions to hedge interest rate risks, the Reserve Bank has decided, in principle, to create an environment that would facilitate introduction of interest rate swaps. Those who participate in the call/notice money market either as direct lenders or borrowers are proposed to be permitted to undertake interest rate swaps. RBI will examine, in consultation with market participants, relevant aspects such as standard documentation, the back-up by underlying transactions between parties, the bench-mark rate and maturity, and prudential prescriptions before allowing the product in the market.

Government Securities Market

40. The Government securities market constitutes the principal segment of the debt market and serves as the benchmark for pricing corporate papers of varying maturities. With the objectives of broadening the market with a diversified investor base and imparting greater liquidity and turnover, concerted efforts have been made by Government of India and the Reserve Bank in the direction of instrument development, institutional development and towards improving market efficiency and transparency. The most significant steps were the introduction of the auction system and of innovative products as well as the setting up of a system of primary and satellite dealers.

41. Some of the policy measures implemented since April 1997 include, expansion of instruments eligible for repo/reverse repo transactions, permitting a number of non-bank entities to enter into reverse repo transactions, introduction of 14 day Treasury Bills, notifying of amounts in the case of all the auctions, keeping “non-competitive” bids outside the notified

amount and entry of Foreign Institutional Investors (FIIs) in the government securities market. A few announcements, such as, the introduction of 28 day Treasury Bills, reintroduction of 182 day Treasury Bills and changes in frequency of Treasury Bills auctions had to be put on hold since there was reduced investor interest in Treasury Bills due to unprecedented market developments. With the continuous availability of fixed rate repos for absorption of liquidity, the proposal to use one day repos/reverse repos for liquidity adjustment has also been deferred.

42. The other recent initiatives for developing the Government securities market include the move towards repeal of the Public Debt Act, 1944 and its replacement by the Government Securities Act. The revised Bill has already been approved by the Cabinet and is awaiting Parliament Clearance. Further, the proposed changes in the Securities Contracts (Regulation) Act, 1956 will pave way for a more active repos market and introduction of new market features like when issued trading. It is also proposed to introduce a uniform price auction method in respect of 91 day Treasury Bill auctions.

(v) Regulation of Non-banking Financial Companies (NBFCs)

43. Pursuant to the amendment to the RBI Act 1934 by Parliament, RBI had instituted a comprehensive regulatory framework for NBFCs in January 1998 in respect of their deposit acceptance activities, prudential norms on income recognition, accounting standard, asset classification, provisioning for bad and doubtful debts, capital adequacy, credit and investment concentration. In order to ensure that only the financially sound and well run NBFCs could mobilise public deposits, obtaining of minimum investment grade credit rating from one of the credit rating agencies was made mandatory and ceilings on the quantum of public deposits were correlated to the level of their credit rating. Of about 9,000 applications of NBFCs found to be eligible for registration on the basis of minimum Net Owned Fund (NOF) of Rs.25 lakh, RBI has already decided on the applications of 7,300 companies.

The entire process of registration is expected to be completed by the end of December, 1998.

44. The appropriate regulation of NBFCs is a complex task in view of the large number of NBFCs which are spread all over the country. NBFCs perform an important financing role in the economy particularly in respect of small scale and decentralised sector and provide important employment and entrepreneurial opportunities at the ground level. However, prevalence of unethical financial practices as well as lack of transparency in operations have also been marked in the case of some sections of the NBFC sector. These have resulted in widespread complaints from depositors about their functioning. Taking into account both the positive as well as the negative aspects of the NBFC sector, RBI and Government have been open to suggestions and advice from experts and market participants to further refine the regulatory framework for NBFCs, develop self-regulatory mechanism for smaller NBFCs, and improve operational effectiveness.

45. In order to undertake a comprehensive examination of the regulatory experience so far and the problems that have arisen on the ground, the government had set up a Task Force to make further recommendations for effective regulation of the NBFC sector. RBI was closely associated with the work of the Task Force. Proposals of the Task Force are now under consideration of the Government. RBI will make appropriate changes in the regulatory framework as soon as decisions of the Government, including any legislative changes that may be required to give effect to Task Force recommendations become available. Until then, NBFCs are advised to strictly adhere to the current regulations in force.

46. An investors' information programme is also being carried out by RBI to ensure that investors are fully aware of the prescribed ceiling on interest rates, disclosure requirements, unsecured nature of deposits and other features of NBFC operations.

Mumbai,

October 30, 1998

.ANNEXURE

Recommendations of the Committee on Banking Sector Reforms

	Recommendations	Decisions taken
(i)	5 per cent weight for market risk for Government/approved securities (Para No.3.11)	To be implemented in phases: 2.5 per cent risk weight by the year ending March 31, 2000. Balance of 2.5 per cent will be announced later. An additional risk weight (of 20 per cent) is proposed for securities of government undertakings which do not form part of the approved market borrowing programme with effect from the financial year 2000-2001. This will be implemented in the case of outstanding

		stock of such securities as on March 31, 2000, in two phases at the rate of 10 per cent each in 2001-2002 and 2002-2003.
(ii)	The risk weight for Government guaranteed advances to be the same as for other advances (Para No.3.12)	Risk weights will be assigned for Govt. guaranteed advances sanctioned from April 1, 1999 as under: Against the guarantee of the : [a] Central Government : 0 per cent [b] State Governments : 0 per cent [c] Governments who remained defaulters as on March 31, 2000 : 20 per cent [d] Governments who continued to be defaulters after March 31, 2001 : 100 per cent
(iii)	Foreign exchange open position limit to carry 100 per cent risk weight. (Para No.3.13)	To be implemented from the current financial year ending March 31, 1999.
(iv)	A minimum target of 9 per cent CRAR to be achieved in the year 2000 and 10 per cent by 2002. (Para No.3.15 & 3.16)	Banks should achieve a minimum CRAR of 9 per cent as on March 31, 2000. Decision about further enhancement of CRAR will be announced later.
(v)	An asset be classified as doubtful if it is in the sub standard category for 18 months in the first instance and eventually for 12 months and loss if it has been so identified but not written off. (Para No.3.18)	An asset will be treated as doubtful, if it has remained in substandard category for 18 months instead of 24 months, by March 31, 2001. Banks may make provisions therefor, in two phases as under: As on March 31, 2001: Provisioning of not less than 50 per cent on the assets which have become doubtful on account of the new norms, i.e., reduction of the period from 24 months to 18 months. As on March 31, 2002 : Balance 50 per cent of the provisions should be made in addition to the provisions needed as on March 31, 2002. The proposal to introduce the norm of

		12 months will be announced later.
(vi) [a]	The Government guaranteed advances which have turned sticky to be classified as NPAs. (Para No.3.21)	The Government guaranteed advances which have turned sticky are to be classified as NPAs as per the existing prudential norms with effect from April 1, 2000.
[b]	Income recognition, asset classification and provisioning norms should apply to Government guaranteed advances in the same manner as for any other advances. (Para No.3.37)	Provisions on these advances should be made over a period of 4 years as detailed below: Existing/old Government guaranteed advances which would become NPA on account of asset classification norms are to be fully provided for during the next four years from the year ending March 1999 to March 2002 with a minimum of 25 per cent, each year.
(vii)	A general provision of 1per cent on standard assets be introduced. (Para No.3.36)	To start with, banks should make a general provision of a minimum of 0.25 per cent for the year ending March 31, 2000. The decision to raise further the provisioning requirement on standard assets would be announced in due course.
(viii)	Banks and Financial Institutions should avoid the practice of evergreening. (Para No.3.22)	The Reserve Bank reiterates that banks and financial institutions should adhere to the prudential norms on asset classification, provisioning, etc., and avoid the practice of “evergreening”.
(ix)	Any effort at financial restructuring must go hand in hand with operational restructuring. With the cleaning up of the Balance sheet, simultaneously steps to be taken to prevent/limit re-emergence of new NPAs. (Para No.3.27)	The banks are advised to take effective steps for reduction of NPAs and also put in place risk management systems and practices to prevent reemergence of fresh NPAs.
(x)	To enable banks in difficulties to issue bonds for Tier II capital. Government will need to guarantee these instruments which would then make them eligible for SLR investment. (Para No.3.29)	Public Sector Banks are encouraged to raise their Tier II capital. Government guarantee to these instruments does not seem appropriate.
(xi)	There is a need for disclosure in a	Banks have already been advised to

	phased manner of the maturity pattern of asset and liabilities, foreign currency assets and liabilities, movements in provision account and NPAs. (Para No.3.38)	put in place a formal Asset-Liability Management (ALM) system with effect from April 1, 1999. Instructions on further disclosures will be issued in due course.
(xii)	Concentration ratios need to be indicated in respect of bank's exposure to any particular industrial sector as also to sectors sensitive to asset price fluctuations such as stock market and real estate. These exposure norms need to be carefully monitored. (Para No.3.40)	Banks are advised to strictly comply with instructions which are already in place.
(xiii)	Banks should bring out revised operational manuals and update them regularly. (Para No.4.3)	Arrangements should be put in place for regular updating. Compliance has to be reported to RBI by April 30, 1999.
(xiv)	There is need to institute an independent loan review mechanism especially for large borrowal accounts and to identify potential NPAs. (Para 4.12-4.16)	Banks should ensure a loan review mechanism for larger advances soon after its sanction and continuously monitor the weaknesses developing in the accounts for initiating corrective measures in time.

Note: Detailed circulars where necessary on the above decisions are being issued separately.