Reserve Bank of India
Monetary Policy Statement 2010-11

By

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The Monetary Policy for 2010-11 is set against a rather complex economic backdrop. Although the situation is more reassuring than it was a quarter ago, uncertainty about the shape and pace of global recovery persists. Private spending in advanced economies continues to be constrained and inflation remains generally subdued making it likely that fiscal and monetary stimuli in these economies will continue for an extended period. Emerging market economies (EMEs) are significantly ahead on the recovery curve, but some of them are also facing inflationary pressures.

2. India's growth-inflation dynamics are in contrast to the overall global scenario. The economy is recovering rapidly from the growth slowdown but inflationary pressures, which were triggered by supply side factors, are now developing into a wider inflationary process. As the domestic balance of risks shifts from growth slowdown to inflation, our policy stance must recognise and respond to this transition. While global policy co-ordination was critical in dealing with a worldwide crisis, the exit process will necessarily be differentiated on the basis of the macroeconomic condition in each country. India's rapid turnaround after the crisis induced slowdown evidences the resilience of our economy and our financial sector. However, this should not divert us from the need to bring back into focus the twin challenges of macroeconomic stability and financial sector development.

3. This statement is organised in two parts. Part A covers *Monetary Policy* and is divided into four Sections: Section I provides an overview of global and domestic macroeconomic developments; Section II sets out the outlook and projections for growth, inflation and monetary aggregates; Section III explains the stance of monetary policy; and Section IV specifies the monetary measures. Part B covers *Developmental and Regulatory Policies and* is organised into six sections: *Financial Stability* (Section I), *Interest Rate Policy* (Section II), *Financial Markets* (Section III), *Credit Delivery and Financial Inclusion (*Section IV), *Regulatory and Supervisory Measures for Commercial Banks* (Section V*) and Institutional Developments* (Section VI).

4. Part A of this Statement should be read and understood together with the detailed review in *Macroeconomic and Monetary Developments* released yesterday by the Reserve Bank.

Part A. Monetary Policy

I. The State of the Economy

Global Economy

5. The global economy continues to recover amidst ongoing policy support and improving financial market conditions. The recovery process is led by EMEs, especially those in Asia, as growth remains weak in advanced economies. The global economy continues to face several challenges such as high levels of unemployment, which are close to 10 per cent in the US and the Euro area. Despite signs of renewed activity in manufacturing and initial improvement in retail sales, the prospects of economic recovery in Europe are clouded by the acute fiscal strains in some countries.

6. Core measures of inflation in major advanced economies are still moderating as the output gap persists and unemployment remains high. Inflation expectations also remain well-anchored. In contrast, core measures of inflation in EMEs, especially in Asia, have been rising. This has prompted central banks in some EMEs to begin phasing out their accommodative monetary policies.

Domestic Economy

7. The Reserve Bank had projected the real GDP growth for 2009-10 at 7.5 per cent. The advance estimates released by the Central Statistical Organisation (CSO) in early February 2010 placed the real GDP growth during 2009-10 at 7.2 per cent. The final real GDP growth for 2009-10 may settle between 7.2 and 7.5 per cent.

8. The uptrend in industrial activity continues. The index of industrial production (IIP) recorded a growth of 17.6 per cent in December 2009, 16.7 per cent in January 2010 and 15.1 per cent in February 2010. The recovery has also become more broad-based with 14 out of 17 industry groups recording accelerated growth during April 2009-February 2010. The sharp pick-up in the growth of the capital goods sector, in double digits since September 2009, points to the revival of investment activity. After a continuous decline for eleven months, imports expanded by 2.6 per cent in November 2009, 32.4 per cent in December 2009, 35.5 per cent in January 2010 and 66.4 per cent in February 2010. The acceleration in non-oil imports since November 2009 further evidences recovery in domestic demand. After contracting for twelve straight months, exports have turned around since October 2009 reflecting revival of external demand. Various lead indicators of service sector activity also suggest increased economic activity. On the whole, the economic recovery, which began around the second quarter of 2009-10, has since shown sustained improvement.

9. A sharp recovery of growth during 2009-10 despite the worst south-west monsoon since 1972 attests to the resilience of the Indian economy. On the demand side, the contribution of various components to growth in 2009-10 was as follows: private consumption (36 per cent), government consumption (14 per cent), fixed investments (26 per cent) and net exports (20 per cent). The monetary and fiscal stimulus measures initiated in the wake of the

global financial crisis played an important role, first in mitigating the adverse impact from contagion and then in ensuring that the economy recovered quickly.

10. However, the developments on the inflation front are worrisome. The headline inflation, as measured by year-on-year variation in Wholesale Price Index (WPI), accelerated from 0.5 per cent in September 2009 to 9.9 per cent in March 2010, exceeding the Reserve Bank's baseline projection of 8.5 per cent for March 2010 set out in the Third Quarter Review. Year-on-year WPI non-food manufactured products (weight: 52.2 per cent) inflation, which was (-) 0.4 per cent in November 2009, turned marginally positive to 0.7 per cent in December 2009 and rose sharply thereafter to 3.3 per cent in January 2010 and further to 4.7 per cent in March 2010. Year-on-year fuel price inflation also surged from (-) 0.7 per cent in November 2009 to 5.9 per cent in December 2009, to 8.1 per cent in January 2010 and further to 12.7 per cent in March 2010. Despite some seasonal moderation, food price inflation remains elevated.

11. Clearly, WPI inflation is no longer driven by supply side factors alone. The contribution of non-food items to overall WPI inflation, which was negative at (-) 0.4 per cent in November 2009 rose sharply to 53.3 per cent by March 2010. Consumer price index (CPI) based measures of inflation were in the range of 14.9-16.9 per cent in January/February 2010. Thus, inflationary pressures have accentuated since the Third Quarter Review in January 2010. What was initially a process driven by food prices has now become more generalised.

12. Growth in monetary and credit aggregates during 2009-10 remained broadly in line with the projections set out in the Third Quarter Review in January 2010. Non-food bank credit expanded steadily during the second half of the year. Consequently, the year-on-year non-food credit growth recovered from its intra-year low of 10.3 per cent in October 2009 to 16.9 per cent by March 2010. The increase in bank credit was also supplemented by higher flow of financial resources from other sources. Reserve Bank's estimates show that the total flow of financial resources from banks, domestic non-bank and external sources to the commercial sector during 2009-10 at Rs.9,71,000 crore, was higher than the amount of Rs.8,34,000 crore in the previous year.

13. Scheduled commercial banks (SCBs) raised their deposit rates by 25-50 basis points between February and April 2010 so far, signalling a reversal in the trend of reduction in deposit rates. On the lending side, the benchmark prime lending rates (BPLRs) of SCBs have remained unchanged since July 2009 following reductions in the range of 25-100 basis points between March and June 2009. However, data from select banks suggest that the weighted average yield on advances, which is a proxy measure for effective lending rates, is projected to decline from 10.8 per cent in March 2009 to 10.1 per cent by March 2010. The Base Rate system of loan pricing, which will replace the BPLR system with effect from July 1, 2010, is expected to facilitate better pricing of loans, enhance transparency in lending rates and improve the assessment of monetary policy transmission.

14. Financial markets functioned normally through the year. Surplus liquidity that prevailed throughout the year declined towards the end of the year consistent with the monetary policy stance. The Reserve Bank absorbed about Rs.1,00,000 crore on a daily average basis under the liquidity adjustment facility (LAF) during the current financial year up to February 12, 2010, *i.e.,* before the first stage of increase in the cash reserve ratio (CRR) came into effect. During February 27- March 31, 2010, the average daily absorption of surplus liquidity declined to around Rs. 38,200 crore reflecting the increase in the CRR, year-end advance tax outflows and higher credit demand from the private sector. However, as the overall liquidity remained in surplus, overnight interest rates generally stayed close to the lower bound of the LAF rate corridor.

15. The large market borrowing by the Government put upward pressure on the yields on government securities during 2009-10. However, this was contained by active liquidity management by the Reserve Bank. Lower credit demand by the private sector also cushioned the yield. Equity markets generally remained firm during the year with intermittent corrections in line with the global pattern. Resource mobilisation through public issues increased sharply. Housing prices rebounded during 2009-10. According to the Reserve Bank's survey, they surpassed their pre-crisis peak levels in Mumbai.

16. During 2009-10, the Central Government raised Rs.3,98,411 crore (net) through the market borrowing programme while the state governments mobilised Rs.1,14,883 crore (net). This large borrowing was managed in a non-disruptive manner through a combination of active liquidity management measures such as front-loading of the borrowing calendar, unwinding of securities under the market stabilisation scheme (MSS) and open market operation (OMO) purchases.

17. The Union Budget for 2010-11 has begun the process of fiscal consolidation by budgeting lower fiscal deficit (5.5 per cent of GDP in 2010-11 as compared with 6.7 per cent in 2009-10) and revenue deficit (4.0 per cent of GDP in 2010-11 as compared with 5.3 per cent in 2009-10). As a result, the net market borrowing requirement of the Central Government in 2010-11 is budgeted lower at Rs.3,45,010 crore as compared with that in the previous year.

18. Historically, fiscal deficits have been financed by a combination of market borrowings and other sources. However, in 2009-10 and 2010-11, reliance on market borrowings for financing the fiscal deficit increased in relative terms. The large market borrowing in 2009-10 was facilitated by the unwinding of MSS securities and OMO purchases, as a result of which fresh issuance of securities constituted 63.0 per cent of the total budgeted market borrowings. However in 2010-11, almost the entire budgeted borrowings will be funded by fresh issuance of securities. Therefore, notwithstanding the lower budgeted net borrowings, fresh issuance of securities in 2010-11 will be Rs.3,42,300 crore, higher than the corresponding figure of Rs.2,51,000 crore last year. The large government borrowing in 2009-10 was also facilitated by sluggish private credit demand and comfortable liquidity conditions. However, going

forward, private credit demand is expected to pick up further. Meanwhile, inflationary pressures have also made it imperative for the Reserve Bank to absorb surplus liquidity from the system. Thus, managing the borrowings of the Government during 2010-11 will be a bigger challenge than it was last year.

19. The current account deficit during April-December 2009 was US$ 30 billion as compared with US$ 28 billion for the corresponding period of 2008. Net capital inflows at US$ 42 billion were also substantially higher than US$ 7 billion in the corresponding period last year. Consequently, on a balance of payments basis (i.e., excluding valuation effects), foreign exchange reserves increased by US$ 11 billion as against a decline of US$ 20 billion during the corresponding period a year ago. Foreign exchange reserves stood at US$ 279 billion as on March 31, 2010. The six-currency trade-based real effective exchange rate (REER) (1993-94=100) appreciated by 15.5 per cent during 2009-10 up to February as against 10.4 per cent depreciation in the corresponding period of the previous year.

II. Outlook and Projections

Global Outlook

Growth

20. In its World Economic Outlook Update for January 2010, the International Monetary Fund (IMF) projected that global growth will recover from (-) 0.8 per cent in 2009 to 3.9 per cent in 2010 and further to 4.3 per cent in 2011. Organisation for Economic Co-operation and Development's (OECD) composite leading indicators (CLIs) in February 2010 continued to signal an improvement in economic activity for the advanced economies. Three major factors that have contributed to the improved global outlook are the massive monetary and fiscal support, improvement in confidence and a strong recovery in EMEs.

21. US GDP rose by 5.6 per cent on an annualised basis during Q4 of 2009. However, household spending remains constrained by high unemployment at 9.7 per cent. Though business fixed investment is turning around and housing starts are picking up, investment in commercial real estate is declining. Growth in the euro area, on a quarter-on-quarter basis, was 0.1 per cent in Q4 of 2009. It may remain moderate in 2010 because of the ongoing process of balance sheet adjustment in various sectors, dampened investment, low capacity utilisation and low consumption. Though exports are improving and the decline in business fixed investment is moderating, several euro-zone governments are faced with high and unsustainable fiscal imbalances which could have implications for medium and long-term interest rates. In Japan, improved prospects on account of exports have been offset by the levelling off of public investment and rise in unemployment.

22. Amongst EMEs, China continues to grow at a rapid pace, led mainly by domestic demand. Malaysia and Thailand have recovered to register positive growth in the second half of 2009. Indonesia recorded positive growth throughout 2009.

Inflation

23. Globally, headline inflation rates rose between November 2009 and January 2010, softened in February 2010 on account of moderation of food, metal and crude prices and again rose marginally in some major economies in March 2010. Core inflation continued to decline in the US on account of substantial resource slack. Inflation expectations in advanced countries also remain stable. Though inflation has started rising in several EMEs, India is a significant outlier with inflation rates much higher than in other EMEs.

Domestic Outlook

Growth

24. The Indian economy is firmly on the recovery path. Exports have been expanding since October 2009, a trend that is expected to continue. The industrial sector recovery is increasingly becoming broad-based and is expected to take firmer hold going forward on the back of rising domestic and external demand.

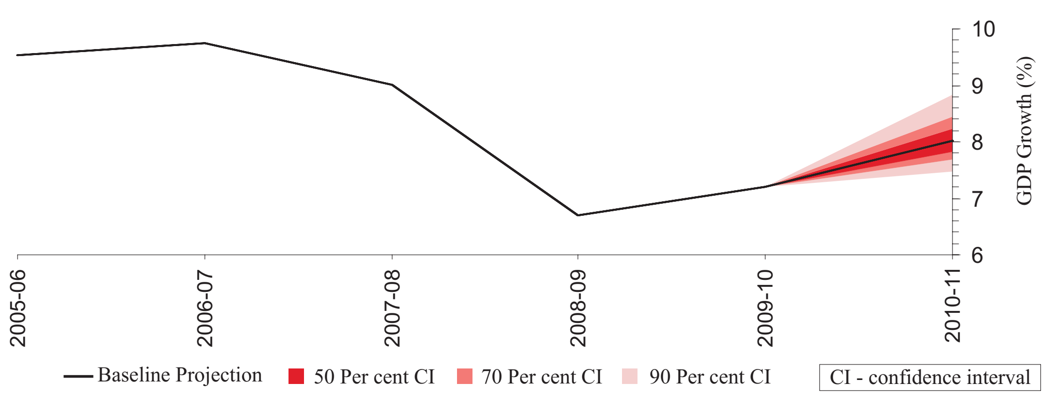
25. Surveys generally support the perception of a consolidating recovery. According to the Reserve Bank's quarterly industrial outlook survey, although the business expectation index (BEI) showed seasonal moderation from 120.6 in Q4 of 2009-10 to 119.8 in Q1 of 2010-11, it was much higher in comparison with the level of 96.4 a year ago. The improved performance of the industrial sector is also reflected in the improved profitability in the corporate sector. Service sector activities have shown buoyancy, especially during the latter half of 2009-10. The leading indicators of various sectors such as tourist arrivals, commercial vehicles production and traffic at major ports show significant improvement. A sustained increase in bank credit and in the financial resources raised by the commercial sector from non-bank sources also suggest that the recovery is gaining momentum.

26. On balance, under the assumption of a normal monsoon and sustenance of good performance of the industrial and services sectors on the back of rising domestic and external demand, for policy purposes the baseline projection of real GDP growth for 2010-11 is placed at 8.0 per cent with an upside bias (Chart 1).

Inflation

27. Headline WPI inflation, which moderated in the first half of 2009-10,

Chart 1: Projection of GDP Growth for 2010-11



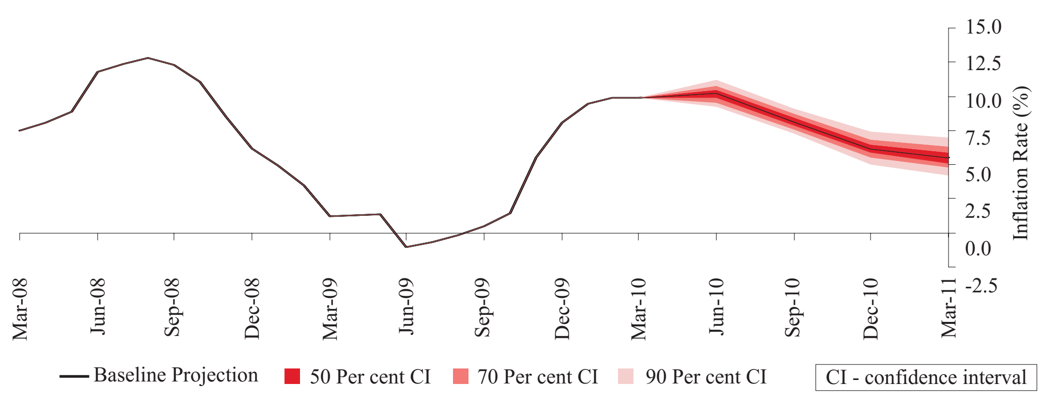
firmed up in the second half of the year. It accelerated from 1.5 per cent in October 2009 to 9.9 per cent by March 2010. The deficient south-west monsoon rainfall accentuated the pressure on food prices. This, combined with the firming up of global commodity prices from their low levels in early 2009 and incipient demand side pressures, led to acceleration in the overall inflation rate – both of the WPI and the CPIs.

28. The Reserve Bank's baseline projection of WPI inflation for March 2010 was 8.5 per cent. However, some subsequent developments on both supply and demand sides pushed up inflation. Enhancement of excise duty and restoration of the basic customs duty on crude petroleum and petroleum products and the increase in prices of iron ore and coal had a significant impact on WPI inflation. In addition, demand side pressures also re-emerged as reflected in the sharp increase in non-food manufactured products inflation from 0.7 per cent to 4.7 per cent between December 2009 and March 2010.

29. There have been significant changes in the drivers of inflation in recent months. First, while there are some signs of seasonal moderation in food prices, overall food inflation continues at an elevated level. It is likely that structural shortage of certain agricultural commodities such as pulses, edible oils and milk could reduce the pace of food price moderation. Second, the firming up of global commodity prices poses upside risks to inflation. Third, the Reserve Bank's industrial outlook survey shows that corporates are increasingly regaining their pricing power in many sectors. As the recovery gains further momentum, the demand pressures are expected to accentuate. Fourth, the Reserve Bank's quarterly inflation expectations survey for households indicates that household inflation expectations have remained at an elevated level.

30. Going forward, three major uncertainties cloud the outlook for inflation. First, the prospects of the monsoon in 2010-11 are not yet clear. Second, crude prices continue to be volatile. Third, there is evidence of demand side pressures building up. On balance, keeping in view domestic demand-supply balance and the global trend in commodity prices, the baseline projection for WPI inflation for March 2011 is placed at 5.5 per cent (Chart 2).

Chart 2: Projected Path of Y-o-Y WPI Inflation



31. It would be the endeavour of the Reserve Bank to ensure price stability and anchor inflation expectations. In pursuit of these objectives, the Reserve Bank will continue to monitor an array of measures of inflation, both overall and disaggregated components, in the context of the evolving macroeconomic situation to assess the underlying inflationary pressures.

32. Notwithstanding the current inflation scenario, it is important to recognise that in the last decade, the average inflation rate, measured both in terms of WPI and CPI, had moderated to about 5 per cent from the historical trend rate of about 7.5 per cent. Against this background, the conduct of monetary policy will continue to condition and contain perception of inflation in the range of 4.0-4.5 per cent. This will be in line with the medium-term objective of 3.0 per cent inflation consistent with India's broader integration into the global economy.

Monetary Aggregates

33. During 2009-10, money supply (M_3) growth decelerated from over 20.0 per cent at the beginning of the financial year to 16.4 per cent in February 2010 before increasing to 16.8 per cent by March 2010, slightly above the Reserve Bank's indicative projection of 16.5 per cent. This was reflected in non-food credit growth of 16.9 per cent, above the indicative projection of 16.0 per cent.

34. Keeping in view the need to balance the resource demand to meet credit offtake by the private sector and government borrowings, monetary projections have been made consistent with the growth and inflation outlook. For policy purposes, M_3 growth for 2010-11 is placed at 17.0 per cent. Consistent with this, aggregate deposits of SCBs are projected to grow by 18.0 per cent. The growth in non-food credit of SCBs is placed at 20.0 per cent. As always, these numbers are provided as indicative projections and not as targets.

Risk Factors

35. While the indicative projections of growth and inflation for 2010-11 may appear reassuring, the following major downside risks to growth and upside risks to inflation need to be recognised:

First, uncertainty persists about the pace and shape of global recovery. Fiscal stimulus measures played a major role in the recovery process in many countries by compensating for the fall in private demand. Private demand in major advanced economies continues to be weak due to high unemployment rates, weak income growth and tight credit conditions. There is a risk that once the impact of public spending wanes, the recovery process will be stalled. Therefore, the prospects of sustaining the recovery hinge strongly on the revival of private consumption and investment. While recovery in India is expected to be driven predominantly by domestic demand, significant trade, financial and sentiment linkages indicate that a sluggish and uncertain global environment can adversely impact the Indian economy.

Second, if the global recovery does gain momentum, commodity and energy prices, which have been on the rise during the last one year, may harden further. Increase in global commodity prices could, therefore, add to inflationary pressures.

Third, from the perspective of both domestic demand and inflation management, the 2010 south-west monsoon is a critical factor. The current assessment of softening of domestic inflation around mid-2010 is contingent on a normal monsoon and moderation in food prices. Any unfavourable pattern in spatial and temporal distribution of rainfall could exacerbate food inflation. In the current context, an unfavourable monsoon could also impose a fiscal burden and dampen rural consumer and investment demand.

Fourth, it is unlikely that the large monetary expansion in advanced economies will be unwound in the near future. Accommodative monetary policies in the advanced economies, coupled with better growth prospects in EMEs including India, are expected to trigger large capital flows into the EMEs. While the absorptive capacity of the Indian economy has been increasing, excessive flows pose a challenge for exchange rate and monetary management. The rupee has appreciated sharply in real terms over the past one year. Pressures from higher capital flows combined with the prevailing rate of inflation will only reinforce that tendency. Both exporters, whose prospects are just beginning to turn, and producers, who compete with imports in domestic markets, are getting increasingly concerned about the external sector dynamics.

36. Our exchange rate policy is not guided by a fixed or pre-announced target or band. Our policy has been to retain the flexibility to intervene in the market to manage excessive volatility and disruptions to the macroeconomic situation. Recent experience has underscored the issue of large and often volatile capital flows influencing exchange rate movements against the grain of economic fundamentals and current account balances. There is, therefore, a need to be vigilant against the build-up of sharp and volatile exchange rate movements and its potentially harmful impact on the real economy.

37. The resumption of the process of fiscal consolidation has been a significant positive development. This will help avoid crowding out of private sector credit demand and facilitate better monetary management. However, the overall size of the government borrowing programme is still very large and can exert pressure on interest rates. Going forward, fiscal consolidation has to shift from one-off gains to structural improvements on both tax and expenditure sides, and focus increasingly on the quality of fiscal consolidation.

III. The Policy Stance

38. In the wake of the global economic crisis, the Reserve Bank pursued an accommodative monetary policy beginning mid-September 2008. This policy instilled confidence in market participants, mitigated the adverse impact of the global financial crisis on the economy and ensured that the economy started recovering ahead of most other economies. However, in view of the rising food inflation and the risk of it impinging on inflationary expectations, the Reserve Bank embarked on the first phase of exit from the expansionary monetary policy by

terminating some sector-specific liquidity facilities and restoring the statutory liquidity ratio (SLR) of scheduled commercial banks to its pre-crisis level in the Second Quarter Review of October 2009.

39. The process was carried forward by the second phase of exit when the Reserve Bank announced a 75 basis points increase in the CRR in the Third Quarter Review of January 2010. As inflation continued to increase, driven significantly by the prices of non-food manufactured goods, and exceeded the Reserve Bank's baseline projection of 8.5 per cent for March 2010 (made in the Third Quarter Review), the Reserve Bank responded expeditiously with a mid-cycle increase of 25 basis points each in the policy repo rate and the reverse repo rate under the LAF on March 19, 2010.

40. The monetary policy response in India since October 2009 has been calibrated to India's specific macroeconomic conditions. Accordingly, our policy stance for 2010-11 has been guided by the following three major considerations:

First, recovery is consolidating. The quick rebound of growth during 2009-10 despite failure of monsoon rainfall suggests that the Indian economy has become resilient. Growth in 2010-11 is projected to be higher and more broad-based than in 2009-10. In its Third Quarter Review in January 2010, the Reserve Bank had indicated that our main monetary policy instruments are at levels that are more consistent with a crisis situation than with a fast recovering economy. In the emerging scenario, lower policy rates can complicate the inflation outlook and impair inflationary expectations, particularly given the recent escalation in the prices of non-food manufactured items. Despite the increase of 25 basis points each in the repo rate and the reverse repo rate, our real policy rates are still negative. With the recovery now firmly in place, we need to move in a calibrated manner in the direction of normalising our policy instruments.

Second, inflationary pressures have accentuated in the recent period. More importantly, inflation, which was earlier driven entirely by supply side factors, is now getting increasingly generalised. There is already some evidence that the pricing power of corporates has returned. With the growth expected to accelerate further in the next year, capacity constraints will re-emerge, which are expected to exert further pressure on prices. Inflation expectations also remain at an elevated level. There is, therefore, a need to ensure that demand side inflation does not become entrenched.

Third, notwithstanding lower budgeted government borrowings in 2010-11 than in the year before, fresh issuance of securities will be 36.3 per cent higher than in the previous year. This presents a dilemma for the Reserve Bank. While monetary policy considerations demand that surplus liquidity should be absorbed, debt management considerations warrant supportive liquidity conditions. The Reserve Bank, therefore, has to do a fine balancing act and ensure that while absorbing excess liquidity, the government borrowing programme is not hampered.

41. Against this backdrop, the stance of monetary policy of the Reserve Bank is intended to:

- Anchor inflation expectations, while being prepared to respond appropriately, swiftly and effectively to further build-up of inflationary pressures.
- Actively manage liquidity to ensure that the growth in demand for credit by both the private and public sectors is satisfied in a non-disruptive way.
- Maintain an interest rate regime consistent with price, output and financial stability.

IV. Monetary Measures

42. On the basis of the current assessment and in line with the policy stance as outlined in Section III, the Reserve Bank announces the following policy measures:

Bank Rate

43. The Bank Rate has been retained at 6.0 per cent.

Repo Rate

44. It has been decided to:

- increase the repo rate under the Liquidity Adjustment Facility (LAF) by 25 basis points from 5.0 per cent to 5.25 per cent with immediate effect.

Reverse Repo Rate

45. It has been decided to:

- increase the reverse repo rate under the LAF by 25 basis points from 3.5 per cent to 3.75 per cent with immediate effect.

Cash Reserve Ratio

46. It has been decided to:

- increase the cash reserve ratio (CRR) of scheduled banks by 25 basis points from 5.75 per cent to 6.0 per cent of their net demand and time liabilities (NDTL) effective the fortnight beginning April 24, 2010.

47. As a result of the increase in the CRR, about Rs. 12,500 crore of excess liquidity will be absorbed from the system.

48. The Reserve Bank will continue to monitor macroeconomic conditions, particularly the price situation, closely and take further action as warranted.

Expected Outcomes

49. The expected outcomes of the actions are:

(i) Inflation will be contained and inflationary expectations will be anchored.

(ii) The recovery process will be sustained.

(iii) Government borrowing requirements and the private credit demand will be met.

(iv) Policy instruments will be further aligned in a manner consistent with the evolving state of the economy.

First Quarter Review of Monetary Policy 2010-11

50. The First Quarter Review of Monetary Policy for 2010-11 will be announced on July 27, 2010.

Part B. Developmental and Regulatory Policies

51. The global financial crisis has underscored the importance of pursuing financial sector policies in the broader context of financial stability and to serve the interests of the real economy. A major lesson is that no indicator or action is foolproof, which points to the need for continuous monitoring, regular review of processes, proactive oversight and pre-emptive actions. Thus, periodic assessment of regulatory comforts and effective supervision are critical elements for developing the financial sector on a sound footing.

52. Over the last several years, the Reserve Bank has undertaken wide-ranging financial sector reforms to improve financial intermediation and maintain financial stability. This process has now become more intensive with a focus on drawing appropriate lessons from the global financial crisis and putting in place a regulatory regime that is alert to possible build-up of financial imbalances. The focus of the Reserve Bank's regulation will continue to be to improve the efficiency of the banking sector while maintaining financial stability. Simultaneously, it will vigorously pursue the financial inclusion agenda to make financial sector development more inclusive.

53. A synopsis of the action taken on the past policy announcements together with a list of fresh policy measures is set out below.

I. Financial Stability

Financial Stability Report

54. As announced in the Annual Policy Statement of April 2009, the Reserve Bank established a Financial Stability Unit in August 2009 for carrying out periodic stress testing and for preparing financial stability reports.

55. The first Financial Stability Report (FSR) was released on March 25, 2010. This Report is an attempt at institutionalising the focus on financial stability and making it an integral part of the policy framework. The first FSR makes an assessment of the strength of the financial sector, with particular focus on banks, and has raised some concerns, including rising inflation, high government borrowings and likely surge in capital flows, from the financial stability standpoint. The FSR observed that the banks remained well-capitalised with higher core capital and sustainable financial leverage. Further, stress tests for credit and market risk confirmed banks' resilience to withstand high stress. The FSR also emphasised the need for evolving a stronger supervisory regime for systemically important non-deposit taking non-banking financial companies (NBFCs-ND-SI) and strengthening the monitoring and oversight framework for systemically important financial conglomerates. Overall risk to financial stability was found to be limited. However, the recent financial turmoil has clearly demonstrated that financial stability cannot be taken for granted, and that the maintenance of financial stability requires constant vigilance, especially

during normal times to detect and mitigate any incipient signs of instability. Going forward, the Financial Stability Reports will be published half-yearly.

II. Interest Rate Policy

Base Rate: Introduction

56. As indicated in the Annual Policy Statement of April 2009, the Reserve Bank constituted a Working Group on Benchmark Prime Lending Rate (Chairman: Shri Deepak Mohanty) to review the present benchmark prime lending rate (BPLR) system and suggest changes to make credit pricing more transparent. The Working Group submitted its report in October 2009 and the same was placed on the Reserve Bank's website for public comments. Based on the recommendations of the Group and the suggestions from various stakeholders, the draft guidelines on Base Rate were placed on the Reserve Bank's website in February 2010.

57. In the light of the comments/ suggestions received, it has been decided to mandate banks to switch over to the system of Base Rate from July 1, 2010. Guidelines on the Base Rate system were issued on April 9, 2010. It is expected that the Base Rate system will facilitate better pricing of loans, enhance transparency in lending rates and improve the assessment of transmission of monetary policy.

III. Financial Markets

Financial Market Products

Interest Rate Futures

58. The Interest Rate Futures contract on 10-year notional coupon bearing Government of India security was introduced on August 31, 2009. Based on the market feedback and the recommendations of the Technical Advisory Committee (TAC) on the Money, Foreign Exchange and Government Securities Markets, it is proposed:

- to introduce Interest Rate Futures on 5-year and 2-year notional coupon bearing securities and 91-day Treasury Bills. The RBI-SEBI Standing Technical Committee will finalise the product design and operational modalities for introduction of these products on the exchanges.

Regulation of Non-Convertible Debentures (NCDs) of Maturity of Less than One Year

59. As indicated in the Second Quarter Review of October 2009, the draft guidelines on the regulation of non-convertible debentures (NCDs) of maturity of less than one year were placed on the Reserve Bank's website on November 3, 2009 for comments/feedback. The comments/ feedback received were examined and also deliberated by the TAC on the Money, Foreign Exchange and Government Securities Markets. Accordingly, it is proposed:

- to issue the final guidelines on the issuance of NCDs of maturity less than one year by end-June 2010.

Introduction of Credit Default Swaps (CDS)

60. As indicated in the Second Quarter Review of October 2009, the Reserve Bank constituted an internal Working Group to finalise the operational framework for introduction of plain vanilla over-the-counter (OTC) single-name CDS for corporate bonds for resident entities subject to appropriate safeguards. The Group is in the process of finalising a framework suitable for the Indian market, based on consultations with market participants/experts and study of international experience. Accordingly, it is proposed:

- to place the draft report of the internal Working Group on the Reserve Bank's website by end-July 2010.

Guidelines on Forex Derivatives

61. As indicated in the Second Quarter Review of October 2009, the draft guidelines on OTC foreign exchange derivatives were placed on the Reserve Bank's website on November 12, 2009 for public comments. The feedback received from stakeholders and industry associations was discussed in the meeting of the TAC on the Money, Foreign Exchange and Government Securities Markets. On the basis of the discussions, it is proposed:

- to issue final guidelines by end-June 2010.

Introduction of Exchange-Traded Currency Option Contracts

62. Currently, residents in India are permitted to trade in futures contracts in four currency pairs on two recognised stock exchanges. In order to expand the menu of tools for hedging currency risk, it has been decided:

- to permit the recognised stock exchanges to introduce plain vanilla currency options on spot US Dollar/Rupee exchange rate for residents.

63. The risk management and operational guidelines will be finalised by the RBI-SEBI Standing Technical Committee.

Separate Trading for Registered Interest and Principal of Securities (STRIPS): Status

64. As indicated in the Annual Policy Statement for 2009-10, the draft guidelines on stripping/reconstitution of government securities prepared in consultation with market participants were placed on the Reserve Bank's website on May 14, 2009 for comments and feedback. Taking into consideration the feedback received on the draft guidelines, the final guidelines on stripping/reconstitution of government securities were issued on March 25, 2010. The guidelines, which came into effect from April 1, 2010, will enable market participants to strip/reconstitute eligible Government of India dated securities through the negotiated dealing system (NDS) subject to certain terms and conditions.

Corporate Bond Market

65. In the recent period, the Reserve Bank initiated several measures to develop the corporate bond market as detailed below:

(i) To facilitate settlement of secondary market trades in corporate bonds on a delivery versus payment-1 (DVP-1) basis on the Real Time Gross Settlement (RTGS) system, the National Securities Clearing Corporation Limited (NSCCL) and the Indian Clearing Corporation

Limited (ICCL) have been permitted to maintain transitory pooling accounts with the Reserve Bank. Further, guidelines have been issued to all Reserve Bank regulated entities to mandatorily clear and settle all OTC trades in corporate bonds using the above arrangement with effect from December 1, 2009.

(ii) To facilitate the development of an active repo market in corporate bonds, the guidelines for repo transactions in corporate debt securities were issued on January 8, 2010. The guidelines, which came into force with effect from March 1, 2010, will enable repo in listed corporate debt securities rated 'AA' or above. Fixed Income Money Market and Derivatives Association of India (FIMMDA) is working on the development of reporting platform and also on the Global Master Repo Agreement to operationalise the repo in corporate bonds.

Non-SLR Bonds of companies engaged in infrastructure: Valuation

66. At present, banks' investments in non-SLR bonds are classified either under held for trading (HFT) or available for sale (AFS) category and subjected to 'mark to market' requirements. Considering that the long-term bonds issued by companies engaged in infrastructure activities are generally held by banks for a long period and not traded and also with a view to incentivising banks to invest in such bonds, it is proposed:

- to allow banks to classify their investments in non-SLR bonds issued by companies engaged in infrastructure activities and having a minimum residual maturity of seven years under the held to maturity (HTM) category.

Investment in Unlisted Non-SLR Securities

67. In terms of extant instructions, banks' investments in unlisted non-SLR securities should not exceed 10 per cent of their total investments in non-SLR securities as on March 31 of the previous year. Since there is a time lag between issuance and listing of security, banks may not be able to participate in primary issues of non-SLR securities, which are proposed to be listed but not listed at the time of subscription. In view of the above, it is proposed that:

- investment in non-SLR debt securities (both primary and secondary market) by banks where the security is proposed to be listed on the Exchange(s) may be considered as investment in listed security at the time of making investment.

68. If such security, however, is not listed within the period specified, the same will be reckoned for the 10 per cent limit specified for unlisted non-SLR securities. In case such investment included under unlisted non-SLR securities lead to a breach of the 10 per cent limit, the bank would not be allowed to make further investment in non-SLR securities (both primary and secondary market, including unrated bonds issued for financing infrastructure activities) till such time the limit is reached.

Financial Market Infrastructure

Reporting Platform for Certificates of Deposit (CDs) and Commercial Papers (CPs)

69. Although there is a large CD and CP market, there is currently little

transparency in the secondary market trades. In order to promote transparency in the secondary market transactions for CDs and CPs, it is proposed:

- to introduce a reporting platform for all secondary market transactions in CDs and CPs.

70. FIMMDA has been requested to start work on developing a platform similar to its existing platform for corporate bonds. Eventually, once the reporting system stabilises, a settlement mechanism similar to the one introduced for the OTC corporate bonds may be put in place.

Reporting of OTC Derivative Transactions

71. The issue of transparency and the need for information repositories for transactions in OTC derivatives have assumed sharper focus in the post-crisis scenario. In India, centralised reporting of OTC trades in interest rate derivatives [interest rate swap (IRS)/forward rate agreements (FRAs)] commenced in August 2007 on the Clearing Corporation of India Limited (CCIL) platform. To capture the trade data pertaining to all OTC derivative transactions for regulation, surveillance and transparency purposes, it is necessary to extend the existing reporting arrangement in respect of IRS to all OTC interest rate and forex derivatives. Accordingly, it is proposed:

- to set up a Working Group consisting of members of the Reserve Bank, the CCIL and market participants to work out the modalities for an efficient, single point reporting mechanism for all OTC interest rate and forex derivative transactions.

Revision of Repo Accounting: Status

72. As indicated in the Annual Policy Statement of April 2009, the revised guidelines for accounting of repo/reverse repo transactions were issued by the Reserve Bank on March 23, 2010. The revised accounting guidelines capture the economic essence of repo as a collateralised lending and borrowing instrument and not as outright sale and purchase. The revised accounting guidelines have been made applicable to market repo transactions with effect from April 1, 2010. These accounting norms will, however, not apply to repo/reverse repo transactions conducted under the Liquidity Adjustment Facility (LAF) with the Reserve Bank.

IV. Credit Delivery and Financial Inclusion

Credit Flow to the MSE Sector

Credit Guarantee Scheme for MSEs

73. Following the recommendations of the Working Group (Chairman: Shri V. K. Sharma) on credit guarantee scheme of the Credit Guarantee Fund Trust for Micro and Small Enterprises (CGFTMSE), it is proposed:

- to mandate banks not to insist on collateral security in case of loans up to Rs.10 lakh as against the present limit of Rs.5 lakh extended to all units of the micro and small enterprises (MSEs) sector.

High Level Task Force on MSMEs

74. A High Level Task Force was constituted by the Government of India

(Chairman: Shri T.K.A. Nair) to consider various issues raised by micro, small and medium enterprises (MSMEs) and draw up an agenda for action. The Task Force submitted its Report on January 30, 2010 to the Government of India. The Task Force recommended several measures having a bearing on the functioning of MSMEs, *viz.*, credit, marketing, labour, exit policy, infrastructure/technology/skill development and taxation. In particular, it recommended that: (i) all scheduled commercial banks should achieve a 20 per cent year-on-year growth in credit to micro and small enterprises to ensure enhanced credit flow; (ii) any shortfall in the achievement of sub-target of 60 per cent for lending to micro enterprises of the total advances granted to the micro and small enterprises, would also be taken into account for the purpose of allocating amounts for contribution to rural infrastructure development fund (RIDF) or any other Fund with other financial institutions as specified by the Reserve Bank, with effect from April 1, 2010; and (iii) all scheduled commercial banks should achieve a 15 per cent annual growth in the number of micro enterprise accounts.

75. Banks are urged to keep in view the recommendations made by the Task Force and take effective steps to increase the flow of credit to the MSE sector, particularly to micro enterprises. The Reserve Bank will monitor the performance of banks in this regard.

Rural Co-operative Banks

Revival of Rural Co-operative Credit Structure

76. Based on the recommendations of the Task Force on Revival of Rural Co-operative Credit Institutions (Chairman: Prof.A.Vaidyanathan) and in consultation with the state governments, the Government of India had approved a package for revival of the short-term rural co-operative credit structure. As envisaged in the package, so far 25 States have entered into Memoranda of Understanding (MoU) with the Government of India and the National Bank for Agriculture and Rural Development (NABARD). Fourteen States have made necessary amendments to their respective Co-operative Societies Acts. As on December 31, 2009, an aggregate amount of about Rs.7,000 crore was released by the NABARD as Government of India's share under the package to primary agricultural credit societies (PACS) in 11 States.

Financial Inclusion through Grass-root Co-operatives

77. There is a need for better understanding of the grass-root level rural co-operatives, which can play a more effective role as vehicles of financial inclusion. Besides, a large number of PACS, large *adivasi* multi-purpose co-operative societies (LAMPS) and farmers' service societies (FSS), a number of thrift and credit co-operative societies have been set up under the parallel Self-Reliant Co-operative Societies Acts in some States. There is a need to understand the operations of these co-operative societies with reference to their membership profile, management structure, range of services being offered by them, savings mobilised from members/non-members, percentage of non-borrower members, credit extended to tenant farmers, oral lessees and agricultural labourers to appreciate

the strengths of the well-functioning societies and their potential as an effective vehicle of financial inclusion. It is, therefore, proposed:

- to constitute a Committee comprising representatives from the Reserve Bank, the NABARD and a few State Governments to study the functioning of well-run PACS, LAMPS, FSS and thrift and credit co-operative societies set up under the parallel Self-Reliant Co-operative Societies Acts to gather information on their working and assess their potential to contribute to financial inclusion.

Financial Inclusion Plan for Banks

78. With a view to increasing banking penetration and promoting financial inclusion, domestic commercial banks, both in the public and private sectors, were advised to take some specific actions. First, banks were required to put in place a Board-approved Financial Inclusion Plan (FIP) in order to roll them out over the next three years and submit the same to the Reserve Bank by March 2010. Banks were advised to devise FIPs congruent with their business strategy and to make it an integral part of their corporate plans. The Reserve Bank has deliberately not imposed a uniform model so that each bank is able to build its own strategy in line with its business model and comparative advantage. Second, banks were required to include criteria on financial inclusion in the performance evaluation of their field staff. Third, banks were advised to draw up a roadmap by March 2010 to provide banking services in every village having a population of over 2,000. The Reserve Bank will discuss FIPs with individual banks and monitor their implementation.

Business Correspondents: Relaxations

79. Under the extant guidelines on the business correspondent (BC) model, only certain select categories of individuals are permitted to be engaged as BCs. With a view to providing more flexibility to banks, it is proposed:

- to permit banks to engage any individual, including those operating Common Service Centres (CSCs), as BC, subject to banks' comfort level and their carrying out suitable due diligence.

80. Operational guidelines to banks in this regard will be issued separately.

81. Furthermore, a suggestion has been received from various quarters to consider 'for profit' companies (other than NBFCs) as BCs of banks. Keeping in view the ramifications of the suggestion, it is proposed:

- to prepare a discussion paper on the subject which will be placed on the Reserve Bank's website. Based on the feedback, a final view will be taken in the matter.

High Level Committee on Lead Bank Scheme

82. On the basis of the recommendations of the High Level Committee on Lead Bank Scheme (Chairperson: Smt. Usha Thorat), the State Level Bankers' Committee (SLBC) convenor banks were advised on November 27, 2009 that the lead banks should constitute a sub-committee of the

District Consultative Committees (DCCs) to draw up a roadmap by March 2010 to provide banking services through a banking outlet in every village having a population of over 2,000. Such banking services need not necessarily be extended through a brick and mortar branch but through any of the various forms of information and communication technology (ICT)-based models, including through business correspondents (BCs). Based on the other recommendations of the Committee, the lead banks/scheduled commercial banks were advised on March 2, 2010 to (i) strengthen various fora under the Lead Bank Scheme; (ii) discuss specific issues enabling and inhibiting financial inclusion in the SLBC/ DCC machinery; (iii) set up separate sub-committees to work intensively on specific issues; and (iv) prepare district credit plans/annual credit plans linked with the business plans of the banks. For this purpose, it is proposed:

- to put in place an appropriate monitoring mechanism of the working of the SLBCs/DCCs.

Priority Sector Lending Certificates: Working Group

83. In pursuance of the announcement made in the Second Quarter Review of October 2009, a Working Group on Introduction of Priority Sector Lending Certificates (PSLCs) (Chairman: Shri V. K. Sharma) was constituted by the Reserve Bank in November 2009 to examine the pros and cons of the recommendation made by the Committee on Financial Sector Reforms (Chairman: Dr. Raghuram G. Rajan) relating to PSLCs and make suitable recommendations on its introduction and their trading in the open market. In this context, it is proposed:

- to expand the terms of reference of the Working Group to also review the pros and cons of inclusion of bank lending to micro-finance institutions (MFIs) under priority sector lending. The Group is expected to submit its Report by end-June 2010.

Urban Co-operative Banks

Establishment of New Urban Co-operative Banks

84. Taking into account the systemic financial health of urban co-operative banks (UCBs), it was decided in 2004 not to set up any new UCBs. With a view to improving the financial soundness of the UCB sector, memoranda of understanding (MoU) were signed with all State Governments. Following the consolidation, the financial condition of the UCB sector has improved considerably and UCBs have also been allowed to enter into new areas of business. With a view to increasing the coverage of banking services amongst local communities, it is proposed:

- to set up a Committee comprising all stakeholders for studying the advisability of granting new urban co-operative banking licences under Section 22 of the Banking Regulation Act, 1949 [as applicable to co-operative societies (AACS)].

Liberalisation of Off-site ATMs by UCBs

85. Under the extant policy of branch authorisation, UCBs, which are well-managed and meet the regulatory criteria, are required to submit annual business plans, based on which centres are allotted to them according to their choice for opening of branches. Centres where UCBs desire to open off-site ATMs are

also required to be included in their annual business plan. In order to further improve the banking infrastructure, it has been decided to liberalise the approach to setting up of off-site ATMs by UCBs. Accordingly, it is proposed:

- to allow well-managed UCBs to set up off-site ATMs without seeking approval through the annual business plans.

86. Detailed guidelines in this regard will be issued by mid-May 2010.

Customer Service

87. The issue of 'treating customers fairly' is assuming critical importance as the experience shows that consumer's interests are often not accorded full protection and properly attended to. Customer service in the banking industry is increasingly becoming important as banks are privileged institutions and banking is a special public utility service. The Reserve Bank and the Banking Ombudsman's offices have been receiving several complaints regarding levying of excessive interest rates and charges on certain loans and advances.

88. The Reserve Bank has, over the years, undertaken a number of initiatives for ensuring fair treatment to customers. This has taken the form of both regulatory fiats (such as reining in of recovery agents, introduction of comprehensive display board, banking facilities for the visually challenged, rationalisation of service charges on collection of outstation cheques and free use of ATMs) as also moral suasion and class action. The Code of Bank's Commitment to Customers was introduced in July 2006 to set a minimum standard of banking practices for banks to follow for their dealing with individual customers.

89. However, within the domain of necessary freedom to banks to choose the types of services to be offered to the customers and related costs, concerted efforts need to be made to further develop a credible and effective functional system of attending to customer complaints. In particular, banks' internal structure needs to be made functionally effective and scaled up to attend to not only basic customer needs, but the special needs of disadvantaged groups such as pensioners and small borrowers, including farmers. Though there exists a tiered mechanism for customer grievance redressal in the banks, its efficacy in terms of attending to customer complaints is far from satisfactory. Taking into account all these considerations, it is proposed:

- to set up a Committee to look into banking services rendered to retail and small customers, including pensioners. The Committee will also look into the system of grievance redressal mechanism prevalent in banks, its structure and efficacy, and suggest measures for expeditious resolution of complaints. The Committee will also examine the international experiences in this regard.
- to further strengthen the mechanism, for implementing the Reserve Bank's guidelines on customer service, through on-site and off-site inspections.
- to require banks to devote exclusive time in a Board meeting once every six months to review and deliberate on customer service.

V. Regulatory and Supervisory Measures for Commercial Banks

Strengthening the Resilience of the Banking Sector

90. In December 2009, the Basel Committee on Banking Supervision (BCBS) had issued two consultative documents for public comments. The document on 'Strengthening the Resilience of the Banking Sector' contains proposals for raising the quality, consistency and transparency of the capital base, enhancing risk coverage, prescribing leverage ratio and containing pro-cyclicality. The second document on 'International Framework for Liquidity Risk Measurement Standards and Monitoring' focuses on measures for further elevating the resilience of internationally active banks to liquidity stress across the globe as well as increasing international harmonisation of liquidity risk supervision. The Basel Committee is presently undertaking a Quantitative Impact Study (QIS) of these proposals. The QIS will form the basis for calibrating reforms proposed in the above two documents to arrive at an appropriate level and quality of capital and liquidity. The fully calibrated set of standards is expected to be developed by end-2010 with the aim of implementation by end of 2012. Ten large Indian banks are participating in the QIS.

Working Group on Valuation Adjustment and Treatment of Illiquid Positions

91. In the Second Quarter Review of October 2009, it was proposed to issue appropriate guidelines to banks for implementation of enhancements and revisions to Basel-II framework finalised by the Basel Committee in July 2009. Accordingly, the Reserve Bank issued guidelines to banks in February 2010. These guidelines require banks to make specified valuation adjustments for various risks/costs in their portfolios including derivatives, which are subject to 'mark to market' requirement and also for illiquidity of these positions. These guidelines also permit banks to follow any recognised models/methods for computing the amount of valuation adjustment. In order to ensure that a consistent methodology is adopted by banks for the purpose, it is proposed:

- to constitute a Working Group with members from the Reserve Bank, FIMMDA, the IBA and a few banks to recommend an appropriate framework in this regard.

Convergence of Indian Accounting Standards with International Financial Reporting Standards

92. As part of the efforts to ensure convergence of the Indian Accounting Standards (IASs) with the International Financial Reporting Standards (IFRSs), the roadmap for banking companies and non-banking financial companies (NBFCs) has been finalised by the Ministry of Corporate Affairs in consultation with the Reserve Bank. As per the roadmap, all scheduled commercial banks will convert their opening balance sheet as at April 1, 2013 in compliance with the IFRS converged IASs.

93. However, with regard to UCBs and NBFCs, a gradualist approach is considered appropriate. The roadmap envisages UCBs having net worth in excess of Rs. 300 crore and NBFCs which are part of NSE-Nifty 50 and BSE-Sensex 30 as well as those NBFCs having net worth in excess of Rs.1,000 crore to converge with IFRSs in tandem with the time schedule given for scheduled commercial banks. UCBs having net worth in excess of Rs. 200 crore but not exceeding Rs. 300 crore and other listed NBFCs as well as unlisted NBFCs having a net worth in excess of Rs. 500 crore shall convert their opening balance sheets as on April 1, 2014 in compliance with the IFRS converged IASs. Remaining UCBs, unlisted NBFCs not falling in the above categories and regional rural banks (RRBs) need to follow only the notified IASs which are not converged with IFRSs.

94. Considering the amount of work involved in the convergence process, it is expected that banks and other entities concurrently initiate appropriate measures to upgrade their skills, management information system (MIS) and information technology (IT) capabilities to manage the complexities and challenges of IFRSs. The implementation poses additional challenge as certain aspects of IFRSs, especially the standards on financial instruments, are under review and would take some time before they are finalised. In order to facilitate smooth migration to IFRSs, it is proposed:

- to undertake a study of the implications of the IFRSs convergence process and also to issue operational guidelines as appropriate.
- to disseminate information through learning programmes with a view to preparing banks and other entities to adhere to the roadmap.

Infrastructure Financing

95. With a view to meeting the increasing financing needs of infrastructure development, the Reserve Bank has taken a number of measures to facilitate adequate flow of bank credit to this sector. In order to give a further thrust to infrastructure financing by banks, some further measures are felt necessary.

96. In terms of extant instructions, rights, licenses and authorisations of borrowers, charged to banks as collateral in respect of project loans (including infrastructure projects) are not eligible for being reckoned as tangible security for the purpose of classifying an advance as secured loan. As toll collection rights and annuities in the case of road/highway projects confer certain material benefits to lenders, it is proposed:

- to treat annuities under build-operate-transfer (BOT) model in respect of road/highway projects and toll collection rights, where there are provisions to compensate the project sponsor if a certain level of traffic is not achieved, as tangible securities subject to the condition that banks' right to receive annuities and toll collection rights is legally enforceable and irrevocable.

97. Till June 2004, the Reserve Bank had prescribed a limit on banks' unsecured exposures. As a step towards deregulation, the above limit was withdrawn to enable banks' Boards to formulate their own policies on unsecured exposures. The provisioning requirement for unsecured sub-standard exposures, however, was increased to 20 per cent consequent to the

withdrawal of limits on banks' unsecured exposures (the provisioning requirement for secured sub-standard exposures stands at 10 per cent). In view of certain safeguards such as escrow accounts available in respect of infrastructure lending, it is proposed that:

- infrastructure loan accounts classified as sub-standard will attract a provisioning of 15 per cent instead of the current prescription of 20 per cent. To avail of this benefit of lower provisioning, banks should have in place an appropriate mechanism to escrow the cash flows and also have a clear and legal first claim on such cash flows.

Presence of Foreign Banks

98. In February 2005, the Reserve Bank had released the 'roadmap for presence of foreign banks in India' laying out a two-track and gradualist approach aimed at increasing the efficiency and stability of the banking sector in India. The first track was the consolidation of the domestic banking system, both in the private and public sectors, and the second track was the gradual enhancement of foreign banks in a synchronised manner. The roadmap was divided into two phases, the first phase spanning the period March 2005 – March 2009, and the second phase beginning after a review of the experience gained in the first phase. In the first phase, foreign banks wishing to establish presence in India for the first time could either choose to operate through branch presence or set up a 100 per cent wholly-owned subsidiary (WOS), following the one-mode presence criterion. Foreign banks already operating in India were also allowed to convert their existing branches to WOS while following the one-mode presence criterion. The WOS was to be treated on par with the existing branches of foreign banks for branch expansion in India. No foreign bank, however, applied to establish itself as a WOS or to convert to a WOS during the first phase.

99. When the revision of presence of foreign banks in India was due in April 2009, the global financial markets were in turmoil and there were uncertainties surrounding the financial strength of banks around the world. Accordingly, the Annual Policy Statement of April 2009 indicated the intent to continue with the current policy and procedures governing the presence of foreign banks in India and to review its roadmap after due consultation with the stakeholders once there was greater clarity regarding stability and recovery of the global financial system.

100. While global financial markets have been improving, various international fora have been engaged in setting out policy frameworks incorporating the lessons learnt from the crisis. Some of the lessons from crisis are to avoid organisational structures which become (i) too big to fail and (ii) too complex to fail. Furthermore, while there is a realisation that as international agreement on cross-border resolution mechanism for internationally active banks is not likely to be reached in the near future, there is considerable merit in subsidiarisation of significant cross-border presence. Apart from easing the resolution process, this will also provide greater regulatory control and comfort to the host jurisdictions. Drawing lessons from the crisis, it is proposed:

- to prepare a discussion paper on the mode of presence of foreign banks through branch or WOS by September 2010.

Licensing of New Banks

101. The Finance Minister, in his budget speech on February 26, 2010 announced that the Reserve Bank was considering giving some additional banking licenses to private sector players. NBFCs could also be considered, if they meet the Reserve Bank's eligibility criteria. In line with the above announcement, it is proposed:

- to prepare a discussion paper marshalling the international practices, the Indian experience as also the extant ownership and governance (O&G) guidelines and place it on the Reserve Bank's website by end-July 2010 for wider comments and feedback.

102. Thereafter, detailed discussions will be held with all stakeholders on the discussion paper and guidelines will be finalised based on the feedback. All applications received in this regard would be referred to an external expert group for examination and recommendations to the Reserve Bank for granting licenses.

Introduction of Bank Holding Company (BHC)/Financial Holding Company (FHC) in India

103. The Reserve Bank placed a Discussion Paper on Holding Companies in Banking Groups on its website in August 2007 for public comments. The feedback received on the Discussion Paper underscored the need for introduction of bank holding companies (BHCs)/financial holding companies (FHCs) in India to ensure an orderly growth of financial conglomerates and better insulation of a bank from the reputational and other risks of the subsidiaries/affiliates within the group. The Committee on Financial Sector Assessment (CFSA), in its report issued in March 2009, observed that given the lack of clarity in the existing statutes relating to the regulation and supervision of financial holding companies, the holding company structure as prevalent in the US for financial conglomerates is not currently in use in India. The Committee noted that the absence of the holding company structure in financial conglomerates exposes investors, depositors and the parent company to risks, strains the parent company's ability to fund its own core business and could restrict the growth of the subsidiary business. Considering the complexity of the issues involved and implications of the BHC/FHC model for the financial system in general and banking system in particular, it is proposed:

- to constitute a Working Group with the representatives from the Government, the Reserve Bank, the SEBI, the IRDA and the IBA to recommend a roadmap for the introduction of a holding company structure together with the required legislative amendment/framework.

Conversion of Term Deposits, Daily Deposits or Recurring Deposits for Reinvestment in Term Deposits

104. As per extant guidelines, banks should allow conversion of term deposits, daily deposits or recurring deposits to enable depositors to immediately reinvest the amount lying in the aforesaid deposits with the same bank in another term deposit. Banks are required to pay interest in respect of such term deposits without

reducing the interest by way of penalty, provided that the deposit remains with the bank after reinvestment for a period longer than the remaining period of the original contract. On a review of the extant regulatory norms and in order to facilitate better asset-liability management (ALM), it is proposed:

- to permit banks to formulate their own policies towards conversion of deposits.

Compensation Practices

105. It was indicated in the Second Quarter Review of October 2009 that in line with the steps taken by global community, particularly the initiatives taken by G-20 nations, the Reserve Bank would issue guidelines to private sector banks and foreign banks with regard to sound compensation policy. Accordingly, it is proposed:

- to issue comprehensive guidelines based on Financial Stability Board (FSB) principles on sound compensation practices by end-June 2010.

106. The guidelines will cover effective governance of compensation, alignment of compensation with prudent risk-taking and disclosures for whole time directors (WTDs)/chief executive officers (CEOs) as well as risk takers of banks.

Implementation of Pillar 2 of Basel II

107. All commercial banks, including foreign banks in India, migrated to the Basel II framework by March 31, 2009. The Reserve Bank has developed a framework to conduct the Supervisory Review and Evaluation Process (SREP) in banks under Pillar 2 of Basel II. One of the major objectives of SREP is to evaluate whether the capital maintained by the bank is adequate keeping in view its risk profile and to determine the supervisory capital ratio (SCR). The SCR would be determined for each bank separately. Under this framework, the adequacy of the risk management and internal control framework of banks would be subjected to in-depth assessment. In order to strengthen the supervisory process, it is proposed:

- to implement the SREP framework for banks from the inspection cycle 2010-11 as an integral part of the Annual Financial Inspection (AFI) of banks.

Cross-border Supervision

108. As indicated in the Mid-Term Review of October 2008, an Internal Working Group (Chairman: Shri S. Karuppasamy) examined the legal position on cross-border supervision arrangements and also explored the feasibility of executing memoranda of understanding with overseas supervisors. Subsequent to the submission of the recommendations of the Group, the Reserve Bank has comprehensively reviewed its existing practices for cross-border supervisory co-operation. With a view to ensuring effective cross-border supervision and supervisory co-operation, it is proposed:

- to enter into bilateral MoU with overseas supervisory authorities within the existing legal provisions, consistent with the Basel Committee on Banking Supervision (BCBS) principles.

Information Technology and Related Issues: Enhancement to the Guidelines

109. Information technology (IT) risk assessment and management are required to be made a part of the risk management framework of a bank, while internal audit/ information system audit needs to independently provide assurance that the IT-related processes and controls are working as intended. Given the increased incidents of cyber frauds in banks in the recent period, it is necessary to improve controls and examine the need for a pro-active fraud risk assessment and management processes in commercial banks. With the increase in transactions in electronic mode, it is also critical to examine the legal implications for banks arising out of IT-related legislations and other legislations such as IT Act 2000, IT Amendment Act 2008 and Prevention of Money Laundering Act, 2002 and also steps that are required to be taken to suitably mitigate the legal risks arising from such transactions. Accordingly, it is proposed:

- to set up a Working Group on information security, electronic banking, technology risk management, and tackling cyber frauds.

Credit Information Companies: Grant of Certificate of Registration

110. In April 2009, the Reserve Bank had issued in-principle approval to four entities to set up credit information companies. Out of the four companies, Experian Credit Information Company of India Private Ltd. and Equifax Credit Information Services Private Ltd. have been granted Certificate of Registration (CoR) to commence the business of credit information on February 17, 2010 and March 26, 2010, respectively. The applications of the remaining two companies for grant of CoR are under consideration.

VI. Institutional Developments

Non-Banking Financial Companies

Core Investment Companies (CICs): Regulatory Framework

111. The regulatory framework for NBFCs has evolved in the recent past with particular focus on inter-connectedness and systemic risk. Under this approach, access to public funds has been perceived as a systemic issue necessitating close regulation and monitoring of NBFCs, including systemically important non-deposit taking NBFCs (NBFCs-ND-SI). However, companies which have their assets predominantly as investments in shares not for trading but for holding stakes in group companies and also do not carry on any other financial activity [*i.e.,* Core Investment Companies (CICs)] justifiably deserve a differential treatment in the regulatory prescription applicable to NBFCs-ND-SI. In order to rationalise the policy approach for CICs, and based on feedback received from such companies, it is proposed to:

- treat CICs having an asset size of Rs.100 crore and above as systemically important core investment companies. Such companies will be required to register with the Reserve Bank.

112. The CICs fulfilling minimum capital and leverage criteria will be given exemption from maintenance of net owned fund and exposure norms applicable to NBFCs-ND-SI. They would be required to submit annual certificate from their statutory auditors regarding compliance with the prescribed norms. Draft guidelines will be placed on the Reserve Bank's website by April 30, 2010 for public comments.

Securitisation Companies/Reconstruction Companies set up under the SARFAESI Act, 2002: Changes in Regulations

113. The guidelines and instructions issued to the Securitisation Companies/ Reconstruction Companies (SCs/RCs) have been reviewed by the Reserve Bank in consultation with these companies. Accordingly, it is proposed to make the following modifications to the guidelines:

- SCs/RCs can acquire the assets either in their own books or directly in the books of the trusts set up by them.
- The period for realisation of assets acquired by SCs/RCs can be extended from five years to eight years by their Boards of Directors, subject to certain conditions. Asset/Security Receipts (SRs), which remain unresolved/not redeemed as at the end of five years or eight years, as the case may be, will henceforth be treated as loss assets.
- It will be mandatory for SCs/RCs to invest an amount not less than 5 per cent of each class of SRs issued under a particular scheme and continue to hold the investments till the time all the SRs issued under that class are redeemed completely.
- With a view to bringing transparency and market discipline in the functioning of SCs/RCs, additional disclosures relating to assets realised during the year, value of financial assets unresolved as at the end of the year, value of SRs pending redemption, among others, are being prescribed.

114. Detailed guidelines will be issued by April 30, 2010.

Guidelines on Change in or Takeover of the Management of the Business of the Borrower by the SCs/RCs

115. The draft guidelines on change in or takeover of the management of the business of the borrower by the SCs/RCs were placed on the Reserve Bank's website for public comments. The guidelines define the eligibility conditions and the grounds based on which SCs/RCs may exercise the powers. The guidelines provide for setting up of an Independent Advisory Committee (IAC) to evaluate the proposals of the SCs/RCs regarding the change in or taking over of the management of the business of the borrowers. Based on the feedback received and recommendations of the External Advisory Committee, it is proposed:

- to issue the final guidelines by April 30, 2010.

Payment and Settlement Systems

Payment System Vision Document 2009-12

116. Keeping in view the significant developments in payment systems and the Reserve Bank's responsibility with regard to regulation and supervision of payment systems, the 'Vision Document' for the period 2009-12 was released on February 16, 2010. The scope of the 'Vision Document' has been enhanced to ensure

that all the payment and settlement systems operating in the country are safe, secure, sound, efficient, accessible and authorised.

Membership to the Committee on Payment and Settlement Systems

117. The Committee on Payment and Settlement Systems (CPSS), constituted under the aegis of the Bank for International Settlements (BIS), was recently broadened to include India and also nine other countries as members. The Reserve Bank is also represented on three Working Groups of the CPSS set up for drawing up standards/guidelines towards efficient functioning of the payment and settlement systems and supporting market infrastructure across the world.

Standardisation of Security Features on Cheque Forms

118. Cheques continue to be a predominant instrument for retail payments. To act as a deterrent to cheque frauds and to bring about uniformity across cheques issued/used by the banking industry, it was decided to examine the need for standardisation of security features on cheque forms. A Working Group was accordingly constituted and based on its recommendations and the industry's feedback, cheque truncation system (CTS)–2010 Standard with benchmark specifications for security features on cheques and field placements on cheque forms has been prescribed.

Operationalisation of National Payments Corporation of India

119. The National Payments Corporation of India (NPCI), set up in December 2008 as an umbrella organisation for operating and managing retail payment systems, has the envisioned role to look at future innovations in the retail payment space in the country. Effective December 14, 2009, NPCI has taken over operations of the National Financial Switch (NFS) from Institute for Development and Research in Banking Technology (IDRBT). NPCI is also expected to take the lead role in rolling out the proposed CTS project at Chennai.

Phased Discontinuation of High Value Clearing

120. It has been the endeavour of the Reserve Bank to migrate from paper-based payments to electronic payment systems by creating the appropriate technological infrastructure. As a step towards encouraging migration of paper-based high value payments to more secure electronic modes, it was decided to discontinue high value clearing (HVC) in a phased and non-disruptive manner by March 31, 2010. This process has been completed as per schedule.

Enhancements in National Electronic Funds Transfer System

121. To further strengthen the National Electronic Funds Transfer (NEFT) system in terms of availability, convenience, efficiency and speed, significant enhancements were introduced in the operational procedures and process flow, effective March 1, 2010. These included: (i) increasing the operating window by two hours on weekdays and one hour on Saturdays; (ii) introducing the concept of hourly settlements; (iii) shortening the time window for return of uncredited transactions; and (iv) enabling positive confirmation to the remitter through SMS

or e-mail about the time and date of actual credit of funds to the beneficiary's account with the destination bank. The concept of positive confirmation to the remitter is perhaps unique across all retail electronic payment systems world-wide.

122. As at end-March 2010, over 66,500 branches of 95 banks had participated in NEFT and the volume of transactions processed increased with a record volume of 8.3 million transactions in March 2010.

Directions to Intermediaries and Payment Aggregators

123. The use of electronic/online modes of payments for purchase of goods and services and also for making payments for other utilities is increasingly gaining popularity in the country. The increase in the electronic/online mode of payment involves the use of intermediaries such as aggregators and payment gateway service providers. In order to ensure the safety of such transactions, detailed guidelines were issued in November 2009.

Mobile Banking in India

124. The use of mobile phone channels for initiation and execution of banking transactions has been gaining significance the world over. The significance of this channel has been recognised by the Reserve Bank. Accordingly, regulatory guidelines for enabling mobile banking were notified in October 2008. The transaction limits were further relaxed in December 2009. Banks were also permitted to enable small value transactions up to Rs.1,000 without end-to-end encryption. Currently, this channel is used to settle on an average 1.9 lakh transactions of average value 12 crore in a month.

125. To further encourage the development of other mobile-based products, non-bank entities were also permitted in August 2009 to issue mobile-based, semi-closed prepaid payment instruments, up to Rs.5,000. Non-bank entities can issue such instruments for facilitating payment for goods/services and m-commerce transactions.

126. The Reserve Bank believes that given the penetration levels of mobile telephony in India, this could become an important medium for achieving financial inclusion in the country. However, this calls for focused efforts by the banks to partner with mobile service providers. Co-operation rather than competition between these two important stakeholders is the critical need of the hour. Recently, an Inter-Ministerial Group constituted by the Government of India, has made important recommendations for financial inclusion through a bank-led model using the infrastructure already set up by mobile service providers. The Reserve Bank is examining the recommendations of the Group.

Automated Data Flow from Banks

127. As the policy and decision-making processes are becoming more information intensive, it is imperative to ensure quality of data and their timely submission. With a view to ensuring accuracy and integrity of data flow from the banking system to the Reserve Bank, a Core Group consisting of experts from banks, the Reserve Bank, IDRBT and the IBA has been constituted for preparing an Approach Paper on Automated Data Flow (a straight-through-process) from the core banking solution (CBS) or other IT systems of

commercial banks to the Reserve Bank. It is expected that the Approach Paper would be ready for circulation among banks by end-August 2010.

RTGS Upgradation

128. The current RTGS system has been in operation for nearly six years and there is a need to initiate steps for replacing it with a new system having improved functionalities in view of advancement in technology. Accordingly, a Working Group comprising representatives from the Reserve Bank and major commercial banks has been constituted for preparing the basic approach towards a next generation RTGS system, both from the business and IT perspective.

Second Quarter Review

129. The next review of the Developmental and Regulatory Policies will be undertaken as part of the Second Quarter Review of Monetary Policy on November 2, 2010.

Mumbai

April 20, 2010