RESERVE BANK OF INDIA

Second Quarter Review of Monetary Policy 2012-13

(Including Review of Developmental and Regulatory Policies)

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ABBREVIATIONS

AEs	-	Advanced Economies
ANBC	-	Adjusted Net Bank Credit
ATM	-	Automated Teller Machine
BCBS	-	Basel Committee on Banking Supervision
BOS	-	Banking Ombudsman Scheme
BRICS	-	Brazil, Russia, India, China and South Africa
CAMELS	-	Capital Adequacy, Asset Quality, Management, Earning, Liquidity, and System and Control
CCP	-	Central Counterparty
CE	-	Credit Equivalent
CEO	-	Chief Executive Officer
CI	-	Confidence Interval
CICs	-	Credit Information Companies
CMDs	-	Chairman and Managing Directors
CPI	-	Consumer Price Index
CRAR	-	Capital to Risk-Weighted Assets Ratio
CRR	-	Cash Reserve Ratio
CTS	-	Cheque Truncation System
DCCB	-	District Central Co-operative Bank
ECB	-	European Central Bank/External Commercial Borrowing
EDEs	-	Emerging and Developing Economies
FCs	-	Financial Conglomerates
FDI	-	Foreign Direct Investment
FEMA	-	Foreign Exchange and Management Act
FII	-	Foreign Institutional Investors
FQR	-	First Quarter Review
FRA	-	Forward Rate Agreement
FSB	-	Financial Stability Board

FSDC	-	Financial Stability and Development Council
FSR	-	Financial Stability Report
GDP	-	Gross Domestic Product
GFD	-	Gross Fiscal Deficit
G-secs	-	Government Securities
H	-	Half Year
HFCs	-	Housing Finance Companies
HLSC	-	High Level Steering Committee
HTM	-	Held to Maturity
IBA	-	Indian Banks' Association
IFSC	-	Indian Financial System Code
IIP	-	Index of Industrial Production
IMF	-	International Monetary Fund
IOS	-	Industrial Outlook Survey
IRFs	-	Interest Rate Futures
IRS	-	Interest Rate Swaps
IT	-	Information Technology
ITEs	-	Intra-Group Transactions and Exposures
KYC	-	Know Your Customer
LAB	-	Local Area Bank
LAF	-	Liquidity Adjustment Facility
LPA	-	Long Period Average
M_3	-	Broad Money
MDR	-	Merchant Discount Rate
MIS	-	Management Information System
MITCs	-	Most Important Terms and Conditions
MQR	-	Mid-Quarter Review
MSEs	-	Micro and Small Enterprises
MSF	-	Marginal Standing Facility
MSMEs	-	Micro, Small and Medium Enterprises
MSMED	-	Micro, Small and Medium Enterprises Development

MT	-	Million Tonnes
NABARD	-	National Bank for Agriculture and Rural Development
NBFCs	-	Non-Banking Financial Companies
NDTL	-	Net Demand and Time Liabilities
NEFT	-	National Electronic Funds Transfer
NPAs	-	Non-Performing Assets
NPCI	-	National Payments Corporation of India
OBE	-	Off-Balance Sheet Exposure
OBICUS	-	Order Books, Inventories and Capacity Utilisation Survey
OTC	-	Over-the-Counter
PMI	-	Purchasing Managers' Index
PML	-	Prevention of Money Laundering
POS	-	Point-of-Sale
Q	-	Quarterly
RBS	-	Risk Based Supervision
RD	-	Revenue Deficit
RRB	-	Regional Rural Bank
SIFI	-	Systemically Important Financial Institution
SLBC	-	State Level Bankers' Committee
SLR	-	Statutory Liquidity Ratio
SQR	-	Second Quarter Review
StCB	-	State Co-operative Bank
STCCS	-	Short-Term Co-operative Credit Structure
T-Bill	-	Treasury Bill
UCB	-	Urban Co-operative Bank
UID	-	Unique Identification Number
UK	-	United Kingdom
US	-	United States of America
WEO	-	World Economic Outlook
WPI	-	Wholesale Price Index
Y-o-Y	-	Year-on-Year

Reserve Bank of India
Second Quarter Review of Monetary Policy 2012-13

By
Dr. D. Subbarao

Introduction

Over the last quarter, policymakers around the world have confronted increasingly difficult challenges. Globally, even as the growth momentum has slowed, governments have had to manage the balance between fiscal consolidation and growth stimulus amidst visible signs that the two objectives are in conflict with each other. As the advanced economies (AEs) deal with these tensions and global demand conditions weaken, emerging and developing economies (EDEs) are also slowing down.

2. Liquidity infusions by central banks in AEs during the quarter have contributed to some stability in global financial markets. These measures cannot, however, substitute for robust structural solutions that can return the AEs to the path of recovery. At this stage, growth risks have risen and could well overwhelm the positive effects of enhanced liquidity. Moreover, with commodity prices still at elevated levels, notwithstanding some muted softening recently, risks of liquidity-driven price increases remain significant. Even as this process moves forward, the months ahead will be a period of heightened uncertainty for the global economy.

3. Amidst this global slowdown and uncertainty, the Indian economy remains sluggish, held down by stalled investment, weakening consumption and declining exports. However, recent policy initiatives undertaken by the Government have begun to dispel pervasive negative sentiments. As the measures already announced are implemented and further reforms are initiated, they should help improve the investment climate further.

4. Meanwhile, the persistence of inflationary pressures even as growth has moderated, remains a key challenge. In this respect, India is an exception to the global trend, which underscores the role of domestic structural factors. Of particular concern is the stickiness of core inflation, mainly on account of supply constraints and the cost-push of rupee depreciation. Consequently, managing inflation and inflation expectations must remain the primary focus of monetary policy. A central premise of monetary policy is that low and stable inflation and well-anchored inflation expectations contribute to a conducive investment climate and consumer confidence, which is key to sustained growth on a higher trajectory in the medium-term.

5. Accordingly, over the past few quarters, monetary policy had to focus on inflation, even as growth risks have increased. As recent policy initiatives by the Government start yielding results in terms of revitalising activity, they will open up space for monetary policy to work in concert to stimulate growth. However, in doing so, it is important not to lose sight of the primary objective of managing inflation and inflation expectations.

6. This policy review is set in the context of the above global and domestic concerns. It should be read and understood together with the detailed review in *Macroeconomic and Monetary Developments* released yesterday by the Reserve Bank.

7. The 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 in six sections: Interest Rate Policy (Section I); Financial Markets (Section II); Financial Stability (Section III); Credit Delivery and Financial Inclusion (Section IV); Regulatory and Supervisory Measures (Section V); and Institutional Developments (Section VI).

Part A. Monetary Policy

I. The State of the Economy

Global Economy

8. Notwithstanding modest improvement in growth performance in parts of the world in Q3 of 2012, the global economy remains sluggish. In the US, growth in Q3 picked up relative to the earlier quarter. In the UK, after three consecutive quarters of contraction, growth turned positive in Q3. The euro area continued to experience contraction in output in Q2, and recessionary headwinds have persisted in Q3. Growth decelerated significantly in Japan. High unemployment relative to trend persisted in all major AEs, although in September the US unemployment rate declined to below 8 per cent for the first time in four years. As regards the other BRICS – Brazil, Russia, China and South Africa – they have also slowed in the first half of 2012, with China decelerating further in Q3. Reinforcing this perspective, the average level of the global composite PMI for Q3 remained nearly unchanged from the three year low in the previous quarter.

9. In September, additional quantitative easing measures were announced by the US Fed, the European Central Bank and the Bank of Japan to which financial markets responded

positively as reflected in the prices of risky assets and narrowing of spreads. According to the October 2012 Global Financial Stability Report of the IMF, however, risks to financial stability have increased since April as confidence in the global financial system remains fragile, notwithstanding greater monetary accommodation by central banks.

Domestic Economy

10. The loss of growth momentum that started in 2011-12 has extended into 2012-13 though the pace of deceleration moderated in Q1. Nevertheless, growth remains below trend and persisting weakness in investment activity has clouded the outlook.

11. After decelerating over four successive quarters from 9.2 per cent y-o-y in Q4 of 2010-11 to 5.3 per cent in Q4 of 2011-12, GDP growth was marginally higher at 5.5 per cent in Q1 of 2012-13. The slight improvement in GDP growth in Q1 of 2012-13 was mainly driven by growth in construction, and supported by better than expected growth in agriculture.

12. On the expenditure side, the growth of gross fixed capital formation decelerated from 14.7 per cent in Q1 of 2011-12 to 0.7 per cent in Q1 of 2012-13. The slowdown in growth of private consumption expenditure witnessed during Q4 of 2011-12 continued through Q1 of 2012-13. External demand conditions and crude oil prices have also remained unfavourable, adversely impacting net exports.

13. After declining for two consecutive months, the index of industrial production (IIP) posted a modest growth of 2.7 per cent in August. The upturn was visible in mining and manufacturing sectors. However, over the period April-August, industrial activity was lacklustre at 0.4 per cent as against 5.6 per cent during the corresponding period last year. Most significantly, reflecting the retrenchment of investment demand, capital goods production declined by 13.8 per cent during April-August.

14. The seasonally adjusted manufacturing PMI in September was unchanged relative to its August level, but was below its level in June. The headline services business activity index, seasonally adjusted, was marginally higher in September than in August.

15. Notwithstanding apprehensions earlier in the season, rainfall deficiency during the south-west monsoon was 8 per cent of the long period average (LPA). However, the uneven temporal and spatial distribution of the monsoon this year is expected to adversely impact the *Kharif* output. According to the first advance estimates, production of *Kharif* foodgrains at 117.2 million tonnes (MT) in 2012-13 will be lower by 9.8 per cent than the record output in the previous year.

16. According to the Reserve Bank's order books, inventories and capacity utilisation survey (OBICUS), capacity utilisation of the manufacturing sector in Q1 of 2012-13

declined from the preceding quarter and a year ago. For Q2, business confidence, as measured by the business expectations index of the Reserve Bank's industrial outlook survey (IOS), dipped relative to the previous quarter.

17. Headline WPI inflation remained sticky at above 7.5 per cent on a y-o-y basis through the first half of 2012-13. Furthermore, in September there was a pick-up in the momentum of headline inflation, driven by the increase in fuel prices and elevated price levels of non-food manufactured products. While this is in part attributable to some suppressed inflation in the form of earlier under-pricing being corrected, even after this, the momentum remains firm.

18. Even while y-o-y inflation of WPI primary food articles moderated since July due to the softening of prices of vegetables, prices of cereal and protein-based items such as pulses, eggs, fish and meat edged up. WPI food products inflation increased in September, mainly due to the firming up of the prices of sugar, edible oils and grain mill products.

19. Fuel group inflation registered a significant rise in September, primarily due to the WPI reflecting the sharp increase in prices of electricity effected from June, the partial impact of the increase in prices of diesel in mid-September and significant increase in non-administered fuel prices on account of rising global crude prices.

20. Non-food manufactured products inflation was persistent at 5.6 per cent through July-September and continued to exhibit upside pressures from firm prices of metal products and other inputs and intermediates, especially goods with high import content due to the rupee depreciation. The momentum indicator of non-food manufactured products inflation (seasonally adjusted 3-month moving average annualised inflation rate) also remained high.

21. The new combined (rural and urban) CPI (Base: 2010=100) inflation remained elevated, reflecting the build-up of food price pressures. CPI inflation excluding food and fuel groups ebbed slightly during June-September, from double digits earlier. Inflation based on the CPI for industrial workers recorded an upturn, primarily due to higher food inflation. The y-o-y increase in rural wages, though showing some moderation, has remained high.

22. Reflecting some softening in inflation from the high levels observed in the last two years, urban households' inflation expectations showed a marginal decline in Q2 of 2012-13, though they remained in double digits.

23. The Reserve Bank's quarterly house price index suggests that house price inflation remained firm in Q1 of 2012-13. Notwithstanding the increase in house prices, the volume of housing transactions grew y-o-y at a faster pace than in the preceding quarter.

24. An analysis of corporate performance in Q1 of 2012-13, based on a common sample of 2,308 non-government non-financial companies, indicates that y-o-y sales growth decelerated sequentially over the last three quarters, but remained positive after adjusting for inflation. Earnings, however, contracted sharply due to higher increase in expenditure

relative to sales, indicating a decline in pricing power. The early results for Q2 of 2012-13 indicate that the drop in sales growth and earnings may be bottoming out.

25. Money supply (M_3) moderated y-o-y to 13.3 per cent on October 5, 2012, lower than the indicative projection of 15 per cent set out in the Monetary Policy Statement 2012-13. This essentially reflected the deceleration of growth in aggregate deposits. Non-food credit growth at 15.4 per cent y-o-y was below the indicative projection of 17 per cent, reflecting the growth slowdown. Disaggregated data show that barring agriculture, credit growth decelerated on a y-o-y basis across all the major sectors, particularly infrastructure.

26. The estimated total flow of financial resources from banks, non-banks and external sources to the commercial sector at around ₹4,700 billion in 2012-13 (up to October 5, 2012) was lower than ₹5,000 billion during the corresponding period of last year. Apart from the decline in the flow of resources from banks, the flow from external sources declined on account of lower external commercial borrowings (ECBs) and foreign direct investment (FDI) into India.

27. Following the cut in the policy repo rate in April and the cash reserve ratio (CRR) in September, several commercial banks reduced their deposit and lending rates. During H1 of 2012-13, the modal deposit rates of scheduled commercial banks declined by 13 bps across all maturities and the modal base rate of banks also declined by 25 bps.

28. Liquidity conditions, as reflected in the average net borrowing under the LAF at ₹486 billion during July-September remained within the comfort zone of (+/-) one per cent of NDTL. However, liquidity conditions tightened in October, mainly on account of the build-up in the Centre's cash balances and the seasonal increase in currency demand, taking the average LAF borrowing to ₹871 billion during October 15-25, well above the band of (+/-) one per cent of NDTL.

29. During April-August, the Centre's fiscal deficit was nearly two-thirds of the budget estimate for the year as a whole. In view of evolving patterns of revenues and non-plan expenditure, the revenue deficit (RD) and the gross fiscal deficit (GFD) for 2012-13 are expected to be higher than budgeted.

30. During Q2 of 2012-13, yields on government securities (G-secs) eased and have remained range-bound in October. Equity markets also improved in Q2 of 2012-13 on account of revival in sentiment and the turnaround in foreign institutional investor (FII) inflows.

31. The adverse external environment and, in particular, the slump in world trade took its toll on export performance. Exports declined in September for the fifth month in succession. However, with imports also declining, the trade deficit in H1 of 2012-13 remained broadly at the same level as a year ago. In terms of external financing, net inflows

on account of FDI and ECBs were sizably lower than in the first half of the preceding year, but the shortfall was largely offset by a surge in non-resident deposits and a turnaround in FII flows in Q2. Reflecting these developments, the nominal exchange rate of the rupee *vis-a-vis* the US dollar moved within a relatively narrow range during Q2 compared with its behaviour in Q1. Overall, in H1 of 2012-13, the rupee depreciated in nominal terms by 7.8 per cent. In real terms, it depreciated by 5.4 per cent. The impact of real depreciation on net exports is being offset by global demand conditions.

II. Outlook and Projections

Global Outlook

Growth

32. Global growth prospects have deteriorated further and downside risks have increased, even as monetary policy in AEs remains supportive. Much depends on concrete policy actions in the euro area to ease the sovereign debt stress, balance growth-friendly structural reforms with fiscal consolidation, and carry forward integration at the area level, particularly in banking and fiscal domains. In the US, determined political resolve to agree on a credible medium-term fiscal consolidation strategy is critical to averting the fiscal cliff and to avoid once again encountering the debt ceiling deadline. In the absence of these efforts, the outlook for AEs appears bleak, with the risks of a prolonged downturn more real than before. Spillovers from AEs present a serious downside risk to the prospects for EDEs, notwithstanding their relatively stronger fundamentals and absence of financial strains.

33. In its October 2012 World Economic Outlook (WEO), the IMF scaled down its projection of world GDP growth for 2012 to 3.3 per cent from its July projections of 3.5 per cent, and for 2013 to 3.6 per cent from its earlier projection of 3.9 per cent. Since September 2011, the IMF has been scaling down its projection of global growth for 2012, evidencing persistent and more than anticipated weakness in the global economy.

Inflation

34. According to the IMF (WEO, October 2012), consumer price inflation is likely to decline from 1.9 per cent in 2012 to 1.6 per cent in 2013 in AEs, and from 6.1 per cent to 5.8 per cent in EDEs. As a result of weakening of global economic activity, headline and core inflation are expected to ease. However, risks to this outlook remain as global commodity prices, particularly of crude oil, have corrected only marginally. Further accommodation in monetary policy in major AEs is likely to work in conjunction with supply constraints to keep commodity prices elevated and volatile.

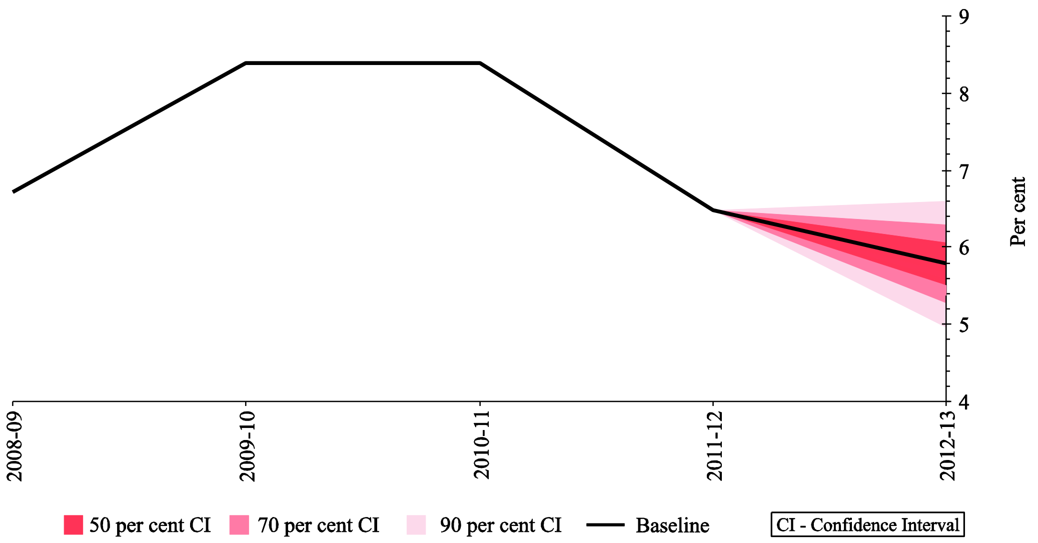
Domestic Outlook

Growth

35. In its April 2012 Policy, the Reserve Bank projected GDP growth for 2012-13 at 7.3 per cent. In the First Quarter Review (FQR) of July, this was revised downwards to 6.5 per cent on an assessment that risks to domestic growth from the global slowdown, weak industrial activity and slower growth of services had materialised. By the time of the Mid-Quarter Review (MQR) of September, growth risks had heightened on account of worsening global macroeconomic conditions, decline in domestic industrial activity and service sector growth falling below trend.

36. Since then, global risks have increased further and domestic risks have become accentuated by halted investment demand, moderation in consumption spending and continuing erosion in export competitiveness accompanied by weakening business and consumer confidence. Although industrial output picked up marginally in August and the services PMI showed a modest improvement in September, the outlook remains uncertain. Notwithstanding the improvement in rainfall in the months of August and September, the first advance estimates of the 2012 *kharif* production are somewhat less buoyant in comparison to the previous year. Accordingly, even while prospects for agriculture appear resilient, the overall outlook for economic activity remains subdued. On these considerations, the baseline projection of GDP growth for 2012-13 is revised downwards to 5.8 per cent (Chart 1).

Chart 1: Projection of GDP Growth (y-o-y) for 2012-13

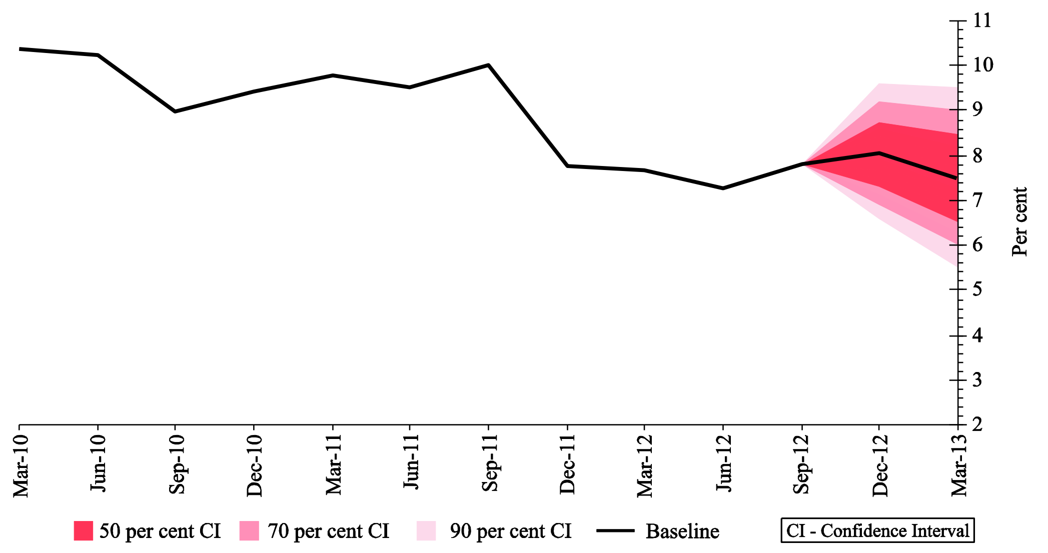


Inflation

37. Looking ahead, the path of inflation will be shaped by two sets of counteracting forces. On the downside, slower growth and excess capacity in some sectors will help moderate core inflation. Stable, or in the best case scenario, declining commodity prices will reinforce this tendency. An appreciating rupee will also help to contain inflationary pressures by bringing down the rupee cost of imports, especially of commodities. On the upside, persistent supply constraints may be aggravated as demand revives, resulting in price pressures. Rupee depreciation, which may result from global financial instability, will add to imported inflation. An important driver of inflation is the upsurge in both rural and urban wages, which is exerting cost-push pressures. Finally, as under-pricing in several products is corrected as part of the fiscal consolidation process, suppressed inflation is being brought into the open. As necessary a step as this is, it will result in higher inflation readings.

38. Taking into consideration the above factors, the baseline projection for headline WPI inflation for March 2013 is raised to 7.5 per cent from 7.0 per cent indicated in July (Chart 2). Importantly, it is expected to rise somewhat in Q3 before beginning to ease in Q4.

Chart 2: Projection of WPI Inflation (y-o-y) for 2012-13



39. Although inflation has remained persistently high over the past two years, it is important to note that during the 2000s, it averaged around 5.5 per cent, both in terms of WPI and CPI, down from its earlier trend rate of about 7.5 per cent. Given this record, 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 is 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

40. Money supply (M_3), deposit and credit growth have so far trailed below the indicative trajectories of the Reserve Bank indicated in the April Policy and reiterated in the July Review. Deposit growth has decelerated with the moderation in interest rates, especially term deposits. Credit growth has ebbed with the slowdown in investment demand, especially with regard to infrastructure, and lower absorption of credit by industry, in general. Keeping in view the developments during the year so far and the usual year-end pick-up, the trajectories of the monetary aggregates for 2012-13 are projected at 14.0 per cent for M_3, 15.0 per cent for deposit growth and 16.0 per cent for growth of non-food credit. As always, these numbers are indicative projections and not targets.

41. The wedge between deposit growth and credit growth, in conjunction with the build-up of the Centre's cash balances from mid-September and the drainage of liquidity on account of festival-related step-up in currency demand, have kept the system level liquidity deficit high, with adverse implications for the flow of credit to productive sectors and for the overall growth of the economy going forward.

Risk Factors

42. The projections of growth and inflation for the remaining part of 2012-13 are subject to several risks as detailed below:

i) Downside risks to growth emanating from the global macroeconomic environment are now adjudged to be more elevated than at the time of the FQR of July and the MQR of September. Weak growth momentum and policy uncertainties are impacting the macroeconomic outlook of EDEs. Spillovers to the Indian economy through trade, finance and confidence channels could increase. Domestically, a revival in investment activity, which is key to stimulating growth, depends on a number of factors. In particular, recent policy announcements by the Government, which have positively impacted sentiment, need to be translated into effective action to convert sentiment into concrete investment decisions.

ii) On the inflation front, despite recent moderation, global commodity prices remain high. While oil prices appear to have stabilised, balancing between weak demand prospects and abundant liquidity, upside risks from persistently high liquidity and geopolitical developments remain. Further, domestic prices of administered petroleum products do not reflect the full pass-through of global commodity prices, and under-recoveries persist. While corrections are welcome from the viewpoint of overall macroeconomic stability, their second-round effects on inflation will have to be guarded against. As regards food prices, drought conditions in important foodgrain producing areas of the world are likely to impart an upside and persistent bias to international food prices with adverse implications for all countries that have relatively high weights for food in their inflation indicators. The behaviour of food inflation will also depend on the supply response in respect of those commodities characterised by structural imbalances, particularly protein items. Finally, the persistent increase in rural and urban wages, unaccompanied by commensurate productivity increases, is also a source of inflationary pressures.

iii) The large twin deficits, *i.e.,* the current account deficit and the fiscal deficit continue to pose significant risks to both growth and macroeconomic stability. A large current account deficit poses challenges for financing it in the current global environment. In a situation of volatile capital flows, the deficit could exacerbate downward pressures on the rupee. A persistently large fiscal deficit reduces the space for a revival in private spending, particularly investment spending, without quickly re-kindling inflationary pressures.

iv) Liquidity pressures pose risks to credit availability for productive purposes and could affect overall investment and growth prospects adversely. On the other hand, excess liquidity could aggravate inflation risks.

III. The Policy Stance

43. In response to rising inflation pressures in the period January 2010 - October 2011, the Reserve Bank started monetary tightening. This helped in moderating inflation from its peak of 10.9 per cent in April 2010 to an average level of 7.5 per cent over the period January-August 2012. Over this period, however, growth slowed down and is currently below trend. This slowdown is due to a host of factors, including monetary tightening.

44. Since April 2012, the monetary policy stance has sought to balance the growth–inflation dynamic through calibrated easing. The transmission of these policy impulses through the economy is underway, and in conjunction with the fiscal and other measures recently announced, should work towards arresting the loss of growth momentum over the next few months. As inflation eases further, there will be an opportunity for monetary policy to act in conjunction with fiscal and other measures to mitigate the growth risks and take the economy to a sustained higher growth trajectory.

45. It is important, however, to note that inflation turned up again in September. To some extent, this reflected the partial pass-through of revisions of diesel and electricity prices which, notwithstanding their contribution to inflation, were absolutely necessary. Besides, underlying inflationary pressures reflected in non-food manufactured products inflation has remained stubbornly above comfort levels. Accordingly, it is critical that even as the

monetary policy stance shifts further towards addressing growth risks, the objective of containing inflation and anchoring inflation expectations is not de-emphasised.

46. Against this backdrop, the stance of monetary policy is intended to:

- manage liquidity to ensure adequate flow of credit to the productive sectors of the economy;
- reinforce the positive impact of government policy actions on growth as inflation risks moderate; and
- maintain an interest rate environment to contain inflation and anchor inflation expectations.

IV. Monetary Measures

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

Cash Reserve Ratio

48. It has been decided to:

- reduce the cash reserve ratio (CRR) of scheduled banks by 25 basis points from 4.5 per cent to 4.25 per cent of their net demand and time liabilities (NDTL) effective the fortnight beginning November 3, 2012.

49. As as result of this reduction in the CRR, around ₹175 billion of primary liquidity will be injected into the banking system.

Repo Rate

50. The policy repo rate under the liquidity adjustment facility (LAF) has been retained at 8.0 per cent.

Reverse Repo Rate

51. The reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, stands at 7.0 per cent.

Marginal Standing Facility (MSF) Rate

52. The Marginal Standing Facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, stands at 9.0 per cent.

Bank Rate

53. The Bank Rate stands at 9.0 per cent.

Guidance

54. The reduction in the CRR is intended to pre-empt a prospective tightening of liquidity conditions, thereby keeping liquidity comfortable to support growth. It anticipates the projected inflation trajectory which indicates a rise in inflation before easing in the last quarter. While risks to this trajectory remain, the baseline scenario suggests a reasonable likelihood of further policy easing in the fourth quarter of 2012-13. The above policy guidance will, however, be conditioned by the evolving growth-inflation dynamic.

Expected Outcomes

55. These actions and the guidance that is given are expected to:

i. enable liquidity conditions to facilitate a turnaround in credit growth to productive sectors so as to support growth;

ii. reinforce the growth stimulus of the policy actions announced by the Government as inflation risks moderate; and

iii. anchor medium-term inflation expectations on the basis of a credible commitment to low and stable inflation.

Mid-Quarter Review of Monetary Policy 2012-13

56. The next Mid-Quarter Review of Monetary Policy for 2012-13 will be announced through a press release on Tuesday, December 18, 2012.

Third Quarter Review of Monetary Policy 2012-13

57. The Third Quarter Review of Monetary Policy for 2012-13 is scheduled for Tuesday, January 29, 2013.

Part B. Developmental and Regulatory Policies

58. This part of the Statement reviews the progress on various developmental and regulatory policy measures announced by the Reserve Bank in recent policy statements and also sets out new measures.

59. Since the Monetary Policy Statement of April 2012, risks to global financial stability have increased, despite some improvement in markets associated with exceptional liquidity operations. In advanced economies, significant fiscal challenges could morph into broader macro-financial concerns. For emerging and developing economies (EDEs), financial stability risks are embedded in potential spillovers, apart from those associated with domestic challenges of managing slowdown in growth, while countering lingering inflationary pressures in some. These unsettled conditions have nevertheless spurred movements towards globalised regulatory reforms intended to make financial systems safer, less complex and more transparent, and financial institutions less leveraged, better capitalised and thus able to effectively manage various risks. Many of these reforms are at various stages of implementation.

60. In India, in the face of a challenging global environment and a difficult growth-inflation dynamic, developmental and regulatory policies have focused on building a sound, efficient and vibrant financial system that ensures the effective provision of financial services to the widest sections of society. Financial sector reforms have moved in step with evolving international best practices, but with a country-specific orientation. Accordingly, financial market development, credit quality, credit delivery, customer service and financial inclusion within a participative and consultative approach with involvement of all stakeholders have been pursued.

61. This review of Developmental and Regulatory Policies for SQR of Monetary Policy 2012-13 focuses on certain key areas while assessing the progress made on the measures instituted in recent policy statements: reviewing interest rate policies and products; carrying forward financial market development and strengthening the market infrastructure, including payment and settlement systems; further improving credit delivery and financial inclusion; expanding customer service initiatives; upgrading the regulatory and supervisory framework in terms of progress towards Basel III, risk based supervision (RBS), non-performing assets (NPAs) management/restructuring and resolution frameworks; and strengthening currency management.

I. Interest Rate Policy

Fixed Interest Rate Products

62. In the Monetary Policy Statement of April 2012, it was noted that while interest rates on deposits are predominantly fixed, most of the retail loan products, especially home loans, are sanctioned on a floating interest rate basis, thereby exposing the borrowers to the uncertainties of interest rate movements and associated interest rate risk. In order to examine the issue, a Committee (Chairman: Shri K.K.Vohra) comprising external as well as internal experts has been set up to assess the feasibility of introduction of long-term fixed interest rate loan products by banks.

- The draft report of the Committee will be put out on the Reserve Bank's website by mid-November 2012 inviting views/suggestions from the public/stakeholders.

II. Financial Markets

Development of Trade Repository for OTC Derivatives

63. Pursuant to the announcement made in the Monetary Policy Statement of April 2010, the reporting platform for over-the-counter (OTC) inter-bank foreign exchange forwards, swaps and options was launched in July 2012. It has been decided to extend this arrangement, in phases, in terms of a well-defined roadmap, so as to cover:

- trades in foreign currency-rupee forwards and options, foreign currency-foreign currency forwards and options between banks and their clients under a suitable protocol to ensure confidentiality of client trades reported by banks to the repository.
- currency swaps, interest rate swaps (IRS)/forward rate agreements (FRAs)/caps/floors/collars in foreign currency and client trades in rupee IRS.

Working Group on G-secs and Interest Rate Derivatives Markets

64. As announced in the Monetary Policy Statement of April 2012, the report of the Working Group (Chairman: Shri R. Gandhi) was put out on the Reserve Bank's website for feedback from market participants. Based on the feedback received, the Group finalised its report on August 10, 2012. The Working Group has recommended measures to promote liquidity in the secondary market, to improve retail participation in the G-secs market, and to develop the market for interest rate derivatives. Its recommendations include consolidation

of outstanding G-secs, gradually bringing down the upper limit on the Held to Maturity (HTM) portfolio, steps to promote the term repo market, centralised market makers for retail participants in G-secs in the long-run, and permitting cash-settled 10-year Interest Rate Futures (IRFs), subject to appropriate regulations. Some recommendations like truncating the time-window for bidding in the primary auction, and re-issuances of existing securities in State Development Loans have been implemented. Following the Group's recommendations, it has been decided to:

- change the settlement cycle of the primary auction in Treasury Bills (T-Bills) from T+2 to T+1.
- undertake reissuance/introduce fungibility of T-Bills/Cash Management Bills with identical maturity dates.
- standardise IRS contracts to facilitate centralised clearing and settlement of these contracts.

65. Operational guidelines in this regard are being issued separately.

66. The remaining recommendations are being examined by the Reserve Bank in consultation with stakeholders.

Financial Market Infrastructure

Working Group on Export Reporting and Follow-up

67. Under the Foreign Exchange Management Act (FEMA) 1999, it is obligatory on the part of exporters to realise and repatriate the full value of exports to India, and monitoring and follow-up in this regard is done by Reserve Bank through the Authorised Dealer banks. It has been observed that there has been an increase in the number of unmatched export transactions between customs and bank reporting which, in turn, attenuates export realisation follow-up. Accordingly, a Working Group (Chairperson: Smt. Rashmi Fauzdar) was constituted to identify gaps/lacunae in the current export reporting and follow-up procedure and to recommend suitable re-engineering of the system. The Group submitted its report on September 27, 2012, recommending implementation of an IT - based solution using a secured website of the Reserve Bank to update the export database on a real time basis to facilitate quicker follow-up/data generation/policy formulation. It has been decided:

- to put in place the envisaged architecture by September 2013.

III. Financial Stability

Assessment of Financial Stability

68. The fifth Financial Stability Report (FSR) of June 2012 observed that the domestic financial system remained robust, notwithstanding an increase in risks to stability. The Reserve Bank's Second Systemic Survey Review reflected concerns about evolving global risks. On the domestic front, lower growth, elevated inflation and high fiscal and current account deficits were identified as posing risks to financial stability. Despite rising NPAs in the banking sector, simulations of shocks under different scenarios for banks as at end-June 2012 showed that the system-level CRAR remained above the required minimum of 9 per cent. Banks also remained resilient to credit, market, and liquidity risks. However, distress dependencies between banks have risen, warranting closer monitoring. The Financial Stability Report reflects the collective assessment of the Sub-Committee of the Financial Stability and Development Council (FSDC) on potential risks to financial stability.

Financial Stability and Development Council (FSDC) and its Sub-Committees

69. The Sub-Committee of the FSDC is assisted by two Technical Groups, *viz.*, the Technical Group on Financial Inclusion and Financial Literacy and the Inter-Regulatory Technical Group. In addition, the Sub-Committee approved the creation of an Inter-Regulatory Forum under the Chairmanship of the Deputy Governor in charge of banking supervision in the Reserve Bank with Executive Director level membership from other regulatory/supervisory agencies to institutionalise the framework for supervision of financial conglomerates (FCs) and for monitoring and management of systemic risks emanating from their activities. This Inter-Regulatory Forum would have responsibility for framing policies for FCs such as identification, group-wide risk management, and corporate governance as well as for conducting high-level supervision. The Forum would also seek to strengthen the supervisory co-ordination/cooperation mechanism amongst domestic supervisors for effective supervision.

IV. Credit Delivery and Financial Inclusion

Roadmap for Provision of Banking Services in Unbanked Villages

70. The Monetary Policy Statement of April 2012 mandated State Level Bankers' Committees (SLBCs) to prepare a roadmap covering all unbanked villages of population less than 2,000 and to notionally allot these villages to banks for providing banking services in a time-bound manner. Accordingly, detailed guidelines were issued to SLBC convenor banks on June 19, 2012. Furthermore, banks were advised to furnish details of allocation of villages to respective regional offices of the Reserve Bank by end-August 2012. Quarterly statements on district-wise and bank-wise progress in opening banking outlets are required to be submitted from the quarter ending September 2012 by the 10th of the following month to the Reserve Bank.

Constitution of Financial Inclusion Advisory Committee

71. Moving towards universal financial inclusion has been a national commitment as well as a policy priority for the Reserve Bank. In order to spearhead efforts towards greater financial inclusion, the Reserve Bank constituted a Financial Inclusion Advisory Committee (Chairman:
Dr. K.C. Chakrabarty). The collective expertise and experience of the members will be leveraged to explore viable and sustainable banking services delivery models focusing on accessible and affordable financial services, developing products and processes for rural as well as urban consumers presently outside the banking network and suggesting the appropriate regulatory framework to ensure that financial inclusion and financial stability move in tandem. The first meeting of the Committee will be held in December 2012.

Redefining the Priority Sector

72. As indicated in the SQR of October 2011, the Reserve Bank constituted a Committee (Chairman:
Shri M. V. Nair) to re-examine existing classifications and suggest revised guidelines with regard to priority sector lending. The Committee submitted its report in February 2012. Based on the discussion with various stakeholders and in the light of the comments/suggestions received, guidelines on priority sector lending were revised on July 20, 2012. The overall target under the priority sector for domestic scheduled commercial banks has been left unchanged at 40 per cent of the Adjusted Net Bank Credit (ANBC) or

Credit Equivalent (CE) amount of Off-Balance Sheet Exposure (OBE), whichever is higher, as on March 31 of the previous year. Targets under both direct and indirect agriculture have also been kept unchanged at 13.5 percent and 4.5 percent, respectively. Foreign banks with 20 or more branches have been brought at par with the domestic commercial banks in terms of the target/sub-targets under priority sector lending. The target under the priority sector for foreign banks with less than 20 branches has been set at 32 per cent of ANBC or CE of OBE, whichever is higher, as on March 31 of the previous year, without any sub-target.

73. To address concerns raised by banks on the revised priority sector guidelines, discussions were held with the Chairman and Managing Directors (CMDs)/Chief Executive Officers (CEOs) and with operational heads of priority sector departments of select banks.

74. Foreign banks have to prepare roadmaps for meeting the targets over a period of five years and their performance *vis-à-vis* targets will be reviewed periodically.

75. Based on the feedback received, it has been decided that:

- loans up to ₹20 million to partnership firms, cooperatives and corporates directly engaged in agriculture and allied activities under partnership, rural cooperative and corporate categories will also be classified as direct finance to agriculture.
- bank loans to Housing Finance Companies (HFCs) for on-lending for housing up to ₹1 million per borrower, may be included under the priority sector, provided the interest rate charged to the ultimate borrower by the HFC does not exceed two percentage points above the lowest interest rate of the lending bank for housing loans.

76. Guidelines on additions/amendments have since been issued.

Urban Cooperative Banks (UCBs) -
Repo in Corporate Bonds

77. In the SQR of October 2009, the Reserve Bank had announced the introduction of repo in corporate bonds and issued the 'Repo in Corporate Debt Securities (Reserve Bank) Directions, 2010' in January 2010. On the basis of requests received from Federations/Associations of UCBs, it has been decided:

- to include scheduled UCBs with strong financials and sound risk management practices as eligible participants to undertake repo transactions in corporate bonds.

78. Detailed guidelines are being issued separately.

Licences for New Urban Cooperative Banks

79. Based on comments/feedback received from the public on the recommendations of the Expert Committee (Chairman: Shri Y. H. Malegam), it has been decided to initiate steps for setting up of new UCBs after issues relating to governance arrangements are resolved with the Government.

Licensing of Cooperatives

80. The Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) had recommended that rural cooperative banks which failed to obtain a license by end-March 2012 should not be allowed to operate. The Reserve Bank, along with the National Bank for Agriculture and Rural Development (NABARD), implemented a roadmap for issuing licenses to unlicensed state cooperative banks (StCBs) and district central cooperative banks (DCCBs) in a non-disruptive manner to ensure the completion of licensing work by end-March 2012.After considering the NABARD's recommendations for issuance of licenses, one out of 31 StCBs and 42 out of 371 DCCBs were unable to meet the licensing criteria by end-March 2012.

81. Subsequently, the StCB and 16 of the 42 DCCBs were recommended by the NABARD for issuance of licences, since these banks attained the licensing norms following release of funds by the State Governments. The remaining 26 DCCBs which have not met the licensing criteria within the extended period, *i.e.,* before September 30, 2012 continue to be under directions. Task Forces set up by the Reserve Bank in these States for the purpose have observed that these DCCBs are unviable in their present form and their continued existence cannot be sustained. Various alternatives are being analysed to ensure that the cooperative structure in these States does not get adversely affected.

Streamlining Short-Term Cooperative Credit Structure

82. In order to examine issues of structural constraints and to explore strengthening of the rural cooperative credit architecture with appropriate institutions and instruments to fulfil credit needs, it was proposed to constitute a Working Group to review the Short-Term Cooperative Credit Structure **(**STCCS). Accordingly, the Reserve Bank constituted an Expert Committee (Chairman: Dr. Prakash Bakshi) to undertake an in-depth analysis of the STCCS and examine various alternatives with a view to reducing the cost of credit and the feasibility of setting up of a two-tier STCCS as against the existing three-tier structure. The report of the Committee is expected by end-December 2012.

Defining Sick, Micro and Small Enterprises (MSEs)

83. In recognition of the problem being faced by the Micro and Small Enterprises (MSEs) Sector, particularly with respect to rehabilitation of potentially viable sick units, the Reserve Bank had constituted a Working Group (Chairman: Dr. K. C. Chakrabarty), which recommended a change in the definition of sickness and in the procedure for assessing the viability of sick MSE units. It was decided that the Ministry of Micro, Small and Medium Enterprises (MSME), Government of India, would constitute a Committee to examine the proposal. Following the submission of the report by this Committee, it is proposed:

- to modify the existing definition of sickness of micro and small enterprises (as defined in the MSMED Act, 2006) and lay down a procedure for assessing the viability of sick units in the sector.

84. Detailed guidelines in this regard are being issued separately.

Customer Service

Committee on Customer Service in Banks

85. Of the recommendations of the Committee on Customer Service in Banks (Chairman: Shri M. Damodaran) constituted by the Reserve Bank, 152 have been implemented, including 142 in respect of which the Indian Banks' Association (IBA) issued guidelines to banks. They include spelling out Most Important Terms and Conditions (MITCs) for products and services that are of critical importance to consumers; strict adherence by banks to the time schedule prescribed under extant regulatory guidelines for disposing of loan applications; and issue of ATM cards only at the option of the customers on written request. Ten recommendations implemented by issue of regulatory guidelines include instructions to banks on abolition of foreclosure charges on floating rate home loans; introduction of Basic Savings Account; Unique Identification Number (UID) as Know Your Customer (KYC) for opening of No Frills Account; and differential merchant discount/fee for debit cards.

Banking Ombudsman Scheme (BOS) 2006

86. Drawing on the recommendations of the Committee on Customer Service in Banks and the suggestions given by the Rajya Sabha Committee on Subordinate Legislation in their 183rd report, a Working Group (Chairperson: Smt. Suma Varma) has been constituted in the Reserve Bank to review, update, and revise the BOS, 2006 in the light of the

recommendations and suggestions. The Working Group is expected to submit its report by end-December 2012.

V. Regulatory and Supervisory Measures

Basel III Disclosure Requirements on Regulatory Capital Composition

87. As announced in the Monetary Policy Statement of April 2012, the Reserve Bank issued guidelines on implementation of Basel III Capital Regulations on May 2, 2012 to all scheduled commercial banks (excluding LABs and RRBs). The Basel Committee on Banking Supervision (BCBS) has finalised proposals on disclosure requirements in respect of the composition of regulatory capital, aimed at improving transparency of regulatory capital reporting as well as market discipline. As these disclosures have to be given effect by national authorities by June 30, 2013, it has been decided:

- to issue draft guidelines on composition of capital disclosure requirements by end-December 2012.

Banks' Exposures to Central Counterparties (CCP)

88. The BCBS has also issued an interim framework for determining capital requirements for bank exposures to CCPs. This framework is being introduced as an amendment to the existing Basel II capital adequacy framework and is intended to create incentives to increase the use of CCPs. These standards will come into effect on January 1, 2013. Accordingly, it has been decided:

- to issue draft guidelines on capital requirements for bank exposures to central counterparties, based on the interim framework of the BCBS, by mid-November 2012.

Core Principles for Effective Banking Supervision

89. The Basel Committee has issued a revised version of the Core Principles in September 2012 to reflect the lessons learned during the recent global financial crisis. In this context, it is proposed:

- to carry out a self-assessment of the existing regulatory and supervisory practices based on the revised Core Principles and to initiate steps to further strengthen the regulatory and supervisory mechanism.

Review of the Prudential Guidelines on Restructuring of Advances by Banks/Financial Institutions

90. As indicated in the Monetary Policy Statement of April 2012, a Working Group (Chairman: Shri B. Mahapatra) reviewed the existing prudential guidelines on restructuring of advances by banks/financial institutions. The report of the Working Group was submitted in July and was placed on the website of the Reserve Bank inviting comments from the stakeholders.

91. The recommendations of the Working Group as also the comments/suggestions received in this regard are under examination and draft guidelines will be issued by end-January 2013. As an immediate measure, it has been decided to:

- increase the provision for restructured standard accounts from the existing 2.0 per cent to 2.75 per cent.

92. Detailed guidelines in this regard are being issued separately.

Non-Performing Assets (NPAs) and Restructuring of Advances

93. NPAs and restructured loans of banks have been increasing significantly. A major reason for deterioration in the asset quality of banks is the lack of effective information sharing among them, despite specific instructions issued in September and December 2008 regarding sharing of information on credit, derivatives and unhedged foreign currency exposure. It is, therefore, advised that:

- banks should strictly adhere to the instructions regarding sharing of information relating to credit, derivatives and unhedged foreign currency exposures among themselves and put in place an effective mechanism for information sharing by end-December 2012;
- any sanction of fresh loans/*ad hoc* loans/renewal of loans to new/existing borrowers with effect from January 1, 2013 should be done only after obtaining/sharing necessary information; and
- non-adherence to these instructions would be viewed seriously by the Reserve Bank and banks would be liable to action, including imposition of penalty, wherever considered appropriate.

94. Detailed guidelines in this regard are being issued separately.

Monitoring of Unhedged Foreign Currency Exposure

95. Unhedged forex exposure of corporates is a source of risk to them as well as to the financing banks and the financial system. Large unhedged forex exposures have resulted in accounts becoming NPAs in some cases. Banks were, therefore, advised in February 2012 that they should rigorously evaluate the risks arising out of unhedged foreign currency exposure of the corporates and price them in the credit risk premium while extending fund-based and non fund-based credit facilities. Further, banks were also advised to consider stipulating a limit on unhedged position of corporates on the basis of banks' Board-approved policy. Despite these instructions, these risks are not being evaluated rigorously and built into pricing of credit. It is, therefore, expected that:

- banks should, in accordance with the guidelines of February 2012, put in place a proper mechanism to rigorously evaluate the risks arising out of unhedged foreign currency exposure of corporates and price them in the credit risk premium, and also consider stipulating a limit on the unhedged position of corporates on the basis of banks' Board-approved policy. Banks should furnish compliance/action taken reports to the Reserve Bank before end-December 2012 after obtaining the approval of their Board of Directors.

96. Detailed guidelines in this regard are being issued separately.

Dissemination of Credit Information

97. Credit Information Companies (CICs) are an important part of the financial sector infrastructure. The success of the credit information collection and dissemination system depends on the quality and timeliness of data supplied by credit institutions to the CICs, and also extensive use of data available with CICs by credit institutions for taking decisions on loan applications. Consequent to operationalisation of the CICs (Regulation) Act, 2005 with effect from December 14, 2006 four CICs are currently operating in India.

98. It has been observed that the number of credit information reports accessed by credit institutions at the time of sanctioning loans is considerably less than the number of credit applications considered by them. This shows that credit institutions may not be furnishing accurate and timely credit data to the CICs in some cases and also are not relying as much on available credit information at the time of taking credit decisions as they should, even after taking into account the fact that records pertaining to first-time borrowers may not be available in the system. It is, therefore, expected that:

- credit institutions should furnish timely and accurate credit information on their borrowers and make extensive use of available credit information as a part of their credit appraisal process.

99. Detailed guidelines in this regard are being issued separately.

Strengthening Regulatory Framework: Resolution Regime for Financial Institutions

100. The subprime crisis brought to the fore the importance of a cross-border resolution regime to deal with the Systemically Important Financial Institutions (SIFIs) which may come under stress and require resolution. In October 2011, the Financial Stability Board (FSB) proposed a set of twelve core elements, *viz.,* the "Key Attributes", as essential components for effective resolution of SIFIs. As decided by the Sub-Committee of the FSDC, a Working Group on a comprehensive resolution regime for all types of financial institutions in India has been set up with Shri Anand Sinha, Deputy Governor, Reserve Bank as the Chairman and Secretary, Department of Economic Affairs, Ministry of Finance, Government of India, as Co-Chairman.

Review of KYC Instructions

101. The Reserve Bank has received complaints pertaining to KYC norms relating to areas such as documentary proof of identity/address, need for introduction for opening of bank accounts, and periodicity for review of KYC documents. In view of these developments, it is proposed:

- to review the existing KYC norms for simplifying them within the provisions of Prevention of Money Laundering Act/Rules (PML Act/Rules) and international standards.

Bank Finance for the Purchase of Gold and Advances against Gold

102. In terms of extant guidelines, no advances should be granted by banks against gold bullion to dealers/traders in gold if, in their assessment, such advances are likely to be utilised for purposes of financing gold purchase at auctions and/or speculative holding of stocks and bullion. In this context, the significant rise in imports of gold in recent years is a cause for concern as direct bank financing for purchase of gold in any form *viz.,* bullion/primary gold/jewellery/gold coin could lead to fuelling of demand for gold for speculative purposes. The Monetary Policy Statement of April 2012 announced the constitution of a Working Group (Convenor: Shri K.U.B. Rao) to study issues relating to gold imports and gold loans by Non-Banking Financial Companies (NBFCs) in India. The

Working Group submitted its draft report in August 2012. Pending a decision on its recommendations, it is proposed to advise banks that:

- other than working capital finance, banks are not permitted to finance purchase of gold in any form.

103. Detailed guidelines in this regard are being issued separately.

Branch Authorisation Policy

Opening Administrative/Controlling Offices in Tier 1 Centres

104. Currently, domestic scheduled commercial banks (excluding RRBs) are permitted to open branches, including Regional Offices and Zonal Offices in Tier 2 to Tier 6 centres (with population up to 99,999 as per Census 2001) and in rural, semi-urban and urban centres in the North-Eastern States and Sikkim without the requirement of taking permission from the Reserve Bank in each case, subject to reporting. With a view to further increasing operational flexibility of banks, it is proposed:

- to permit domestic scheduled commercial banks (other than RRBs) to open offices performing purely administrative and controlling functions (Regional Offices and Zonal Offices) in Tier 1 centres, subject to reporting.

105. Detailed guidelines in this regard are being issued separately.

Issue of Co-branded Rupee Denominated Pre-paid/Debit Cards

106. In order to obviate the need for banks to approach the Reserve Bank for every co-branding arrangement, it is proposed:

- to accord general permission to banks for issue of co-branded debit and rupee denominated pre-paid instruments, subject to certain conditions.

107. Detailed guidelines in this regard are being issued separately.

Working Group on Pricing of Credit

108. As proposed in the SQR of October 2011, a Working Group on pricing of credit was constituted (Chairman: Shri Anand Sinha) to look into the principles governing proper, transparent and non-discriminatory pricing of credit. The report of the Working Group is expected by end-December 2012.

Supervisory Policies, Procedures and Processes

109. The High Level Steering Committee (HLSC) (Chairman: Dr. K. C. Chakrabarty) set up by the Reserve Bank to review the existing supervisory policies, procedures and processes for commercial banks in India submitted its report on June 11, 2012. The HLSC

has recommended a shift in the supervisory approach from a transaction-testing based CAMELS framework to a risk based approach for early identification of risks and for enabling appropriate supervisory intervention in a timely manner. A phased approach for transition to risk based supervision (RBS) is being adopted. While 50 per cent of banks are to be covered under RBS from the next supervisory cycle beginning April 2013, the remaining banks would be covered subsequently. In line with the Committee's recommendations, banks have been advised to assess their risk management architecture, culture, practices and related processes against the essential requirements identified as prerequisites for introduction of RBS. Banks should also assess and upgrade their human resources capacity for handling risk management systems, processes and MIS to facilitate the switch over to RBS.

Definition of Infrastructure Lending

110. Banks' lending to the infrastructure sector has grown significantly. As a multiplicity of definitions among various regulators gives rise to confusion and difficulties, the Government of India has notified a master list of infrastructure sectors/sub-sectors in March 2012. Accordingly, it is proposed:

- to harmonise the definition of infrastructure for the purpose of banks' lending with the master list notified by the Government of India.

111. Detailed guidelines in this regard are being issued separately.

Intra-Group Transactions and Exposures

112. On August 14, 2012 the Reserve Bank issued draft guidelines on management of Intra-Group Transactions and Exposures (ITEs) applicable to scheduled commercial banks. The draft guidelines contain both quantitative limits for the financial ITEs and prudential measures for non-financial ITEs to ensure that banks engage in ITEs in a safe and sound manner in order to contain concentration and contagion risk arising therefrom. These measures require banks to maintain arms-length relationships in their dealings with group entities, meet minimum requirements with respect to group risk management and group-wide oversight and adhere to prudential limits on ITEs. Comments/feedback on the draft guidelines have been sought. It is proposed:

- to issue final guidelines on management of ITEs by end-January 2013.

Internal Working Group on Rationalisation of Calendar of Reviews

113. Commercial banks are required to periodically place reviews on different areas of banks' operations before their Board of Directors/Management Committee/Audit Committee of the Board. These reviews are put up as per the calendar prescribed by the Reserve Bank. This calendar is reviewed by the Reserve Bank from time to time to keep it relevant to the latest developments. Accordingly, a Working Group on Rationalisation of

Calendar of Reviews (Chairman: Shri Deepak Singhal) has been constituted to examine and review the contents of current prescriptions in this regard. The Group is required to submit its report by end-December 2012.

VI. Institutional Developments

Non-Banking Financial Companies

Overseas Investment by Core Investment Companies

114. Following the announcement in the Monetary Policy Statement of April 2012, draft guidelines for overseas investment by Core Investment Companies were placed on the Reserve Bank's website in May 2012. Comments received from the public are under examination and it is proposed:

- to issue the final guidelines by end-November 2012.

Regulatory Framework for NBFCs

115. The report of the Working Group on NBFCs (Chairperson: Smt. Usha Thorat) was placed on the Reserve Bank's website in August 2011. Based on the feedback received and further discussions held with various representatives of the sector, it has been decided:

- to place draft guidelines for NBFCs on the website for comments by end-November 2012.

Registration of NBFC-Factors

116. Following the notification by the Central Government of the Factoring Regulation Act, 2011, the Reserve Bank has put in place a detailed regulatory framework for NBFC-Factors on July 23, 2012. NBFC-Factors shall have a minimum Net Owned Fund of ₹50 million for registration; factoring activity should constitute at least 75 percent of total assets; and income derived from factoring business should not be less than 75 percent of gross income. NBFC-Factors intending to deal in forex through export/import factoring will need an authorisation under FEMA, 1999 from the Reserve Bank.

Automated Data Flow from Banks

117. As stated in the Monetary Policy Statement of April 2012, banks are required to implement suitable solutions to generate all their returns to be submitted to the Reserve Bank from their source systems without any manual intervention. The process is expected to be completed by end March 2013. The Reserve Bank is closely monitoring the progress of implementation. It is reiterated that banks put in place the appropriate systems to meet the objective stated within the stipulated timeline.

Payment Systems in India: Vision 2012-15

118. The roadmap for effecting further improvements in the payments system in the country over the next three years was laid out in the document entitled “Payment Systems in India: Vision 2012-15”, released on October 1, 2012 after extensive public consultations. The Vision statement articulates the key goals to be achieved. The overall policy stance is oriented towards promoting a less cash society and, in doing so, aims to reach out beyond the currently served target groups, thereby facilitating greater financial inclusion in the country. As a first step, the Merchant Discount Rate (MDR) was reduced for debit cards to encourage all categories and types of merchants to deploy the card acceptance infrastructure and also facilitate acceptance of small value transactions.

Disincentivising Issuance and Usage of Cheques

119. Given the still high use of cheques, any strategy to discourage the use of cheques by individuals as well as institutional users has to have a multi-pronged approach encompassing cost and time considerations, incentives for use of electronic modes of transactions and disincentives for the use of paper-based instruments. Accordingly, it has been decided to prepare a Discussion Paper on the subject by end-December 2012 and place it in the public domain for comments.

Electronic Payments: National Electronic Funds Transfer (NEFT)

120. The NEFT system, introduced in 2005, is now a retail electronic payment product of system-wide importance. Banks were recently advised to proactively assist customers in correctly filling in the required details (such as Indian financial system code (IFSC) of destination bank branch) in the NEFT application form to ensure hassle- and error-free remittances. As an additional measure aimed at improving the efficiency of the system and enhancing customer service, it has been decided to introduce with effect from November 19, 2012 an additional batch at 8.00 am in the NEFT system. This is intended to meet the growing demand and increasing volume of NEFT transactions, and to decongest the build-up of transactions in the first batch on all days including Saturdays.

Alternate Payments: Committee for Implementation of GIRO Based Payment System

121. Implementation of an electronic GIRO system in India, *viz.,* a payment instruction from one bank account to another bank account which is initiated by the payer and not the payee, has been identified as one of the key tasks in Payment Systems in India: Vision 2012-15. Accordingly, it is proposed to set up a Committee (Chairman: Shri G. Padmanabhan) to finalise the modalities of GIRO payments - both electronic-and cheque-based.

Uniform Routing Code and Account Number Structure

122. In India, different payment systems use different codes for identifying the bank/branches for routing transactions. A Technical Committee (Chairman: Shri Vijay Chugh) comprising various stakeholders has been constituted to examine the feasibility of a uniform routing code and uniform account number across banks. The Committee will submit its report by end-December 2012.

Using Aadhaar for Authentication for Securing Card Present Transactions

123. One of the recommendations of the Working Group formed for securing card present transactions (Chairperson: Ms. Gowri Mukherjee) was that banks could consider the Aadhaar biometric authentication along with the MagStripe as an additional factor of authentication for card present transactions at ATMs and POS terminals. In order to take this process forward, a pilot project using Aadhaar as an additional factor of authentication for card present transactions has been scheduled to be held in Delhi from November 15, 2012. Based on the outcome of the pilot project, further steps would be taken by the Reserve Bank.

Cheque Truncation System (CTS)

124. Cheque Truncation System (CTS) is an important efficiency enhancement initiative undertaken by the Reserve Bank in paper clearing, as cheques are still an important mode of payment in the country. The pan-India roll-out of CTS is envisaged to be completed by end-December 2013. This is as per the roadmap drawn-up by the National Payments Corporation of India (NPCI), which has been entrusted with the task.

Currency Management

Distribution Channels of Bank Notes and Coins

125. Pursuant to the announcements made in the Annual Monetary Policy Statement of April 2012, the CMDs of banks were sensitised to their role in currency management. They have been advised to identify four-five branches at each of the centres where the Reserve Bank's Issue offices are located. These branches would provide exchange facilities for soiled/mutilated notes as also issue coins to the general public through their dedicated counters/coin vending machines. These identified branches have to be advised to the Reserve Bank by end-October 2012. In addition, banks may also take necessary steps to streamline their systems to provide smooth and unhindered exchange facilities at other currency chests and branches across the country.

Detection and Reporting Mechanism of Counterfeit Banknotes

126. In May 2012, banks were advised to re-align their cash management to ensure that cash receipts in denominations of ₹100 and above are not put into re-circulation without being machine-processed for authenticity. Banks have the option of either providing machines to their branches or ensuring that branches which do not have the machines are supplied only machine-processed notes for distribution among the public.

127. It is observed, however, that reporting of detection of counterfeit notes has not improved on the expected lines. It needs to be emphasised that although 90 per cent of the currency chests are with the public sector banks, they account for reporting a mere 10 per cent of counterfeit notes, while private sector banks with less than 10 per cent of currency chests are reporting 90 per cent of such cases. A review on the status of implementation of the Reserve Bank's instructions issued in May 2012 will be made in the first week of November 2012. It is reiterated that wherever counterfeit notes are detected but not impounded and reported, it will be construed as wilful involvement of the bank concerned in circulating counterfeit notes and may attract penal measures.

High Level Committee on Demand for Coins

128. The High Level Committee constituted by the Government of India (Chairman: Dr. K. C. Chakrabarty) to examine the growing demand for coins submitted its report on August 14, 2012. Some of the major recommendations include the need for the Reserve Bank to focus exclusively on management and planning of the currency system, while the responsibility for distribution of coins and notes among individuals and institutions should be entirely with banks, subject to compliance with Sections 38 and 39 of Reserve Bank of India Act, 1934. The Committee has also recommended that if the last mile connectivity for distributing coins/small notes has to be achieved, there is a need to introduce alternative avenues for distribution of small notes and coins on behalf of banks. Banks may, therefore, be encouraged to explore the possibility of introducing the franchisee model.

129. Furthermore, each bank may be allotted certain areas (districts/States) on the lines of the Lead Bank Scheme/Service Area Approach for priority sector lending for ensuring that the area is supplied with coins and clean notes in coordination with other currency chests and small coin depots in that area. Additional storage points or underground silos can be created in the space available in mints which can be used as counter- cyclical buffers - they will store/absorb coins during surplus years and release them during shortages.