Reserve Bank of India
Second Quarter Review of Monetary Policy 2011-12

By

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Governor

Introduction

From a macroeconomic perspective, the last quarter witnessed significant developments, both globally and domestically. Growth momentum in the US and the euro area economies has weakened. In the euro area, macroeconomic prospects are intimately tied in to its ability to credibly resolve its sovereign debt and financial sector problems. In turn, trade and financial linkages increase the risks of euro area instability transmitting through to emerging market economies (EMEs), which have already experienced large volatility in their financial markets, particularly their currency markets. Significantly, while the prices of many commodities declined over the quarter, crude oil prices remained relatively firm. The impact of this on commodity importing EMEs has been exacerbated by currency depreciation.

2. Amidst this turbulence and heightened uncertainty, the Indian economy is clearly seeing slowing growth. This moderation is, in part, due to the anti-inflationary stance of monetary policy, a necessary pre-condition to bring inflation down. But there are also other factors responsible for the moderation in growth, particularly for the significant slowdown in investment activity, such as policy and regulatory matters. These issues clearly have adverse implications for sustaining rapid growth.

3. Of larger concern is the fact that even with the visible moderation in growth, inflation has persisted. Reassuringly, momentum indicators are turning down, consistent with the Reserve Bank's projections that inflation rate will decline significantly in December and continue on that trajectory into 2012-13.

4. The policy stance and guidance in this Review are shaped by the need to balance concerns about persistent inflation and moderating growth. Recent policy actions have been firmly based on the proposition that sustained growth over a long period of time is compatible only with low and stable inflation. Persistently high inflation strongly influences expectations adversely and, through them, consumption and investment decisions. Changing the policy stance when inflation is still far above the tolerance level entails risks to the credibility of the Reserve Bank's commitment to low and stable inflation. However, growth risks are undoubtedly significant in the current scenario, and these need to be given due consideration.

5. 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.

6. 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 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 for Commercial Banks (Section V) and Institutional Developments (Section VI).

Part A. Monetary Policy

I. The State of the Economy

Global Economy

7. Economic activity in advanced economies weakened further during Q3 of 2011 (July-September). Escalating concerns over medium-term sovereign debt dynamics in the euro area and, in particular, substantial potential losses to banks holding this debt have impacted global financial markets enormously. The adverse feedback loops among sluggish growth, weak sovereign balance sheets, large exposures of banks to sovereign debt and political compulsions coming in the way of a credible solution have created a crisis of confidence, which is a potential threat to regional and global financial stability.

8. High prices of crude oil and other commodities, persistently high unemployment and weak housing markets continued to impact consumer confidence and private consumption. Fiscal tightening, driven by medium-term sovereign debt concerns, also contributed to the loss in the growth momentum. This is reflected in the fall in the global manufacturing purchasing managers' index (PMI) to 49.9 in September, its lowest level since June 2009.

9. The above factors also had a knock-on impact on major EMEs. According to the IMF, global growth decelerated from 4.3 per cent year-on-year (y-o-y) in Q1 of 2011 to 3.7 per cent in Q2, and further to an estimated 3.6 per cent in Q3, as growth in advanced economies fell from 2.2 per cent to 1.5 per cent and 1.3 per cent over the same period.

10. Significantly, the weaker global growth since Q2 has resulted in only a small correction in international commodity prices, particularly crude oil. Brent and Dubai Fateh prices (which comprise the Indian basket) have declined only modestly. The World Bank's September 2011 indices of energy prices were higher by 32 per cent (y-o-y) and of non-energy by 17 per cent.

11. Reflecting the above trend, headline measures of inflation remained above the comfort zones/targets in both advanced economies and EMEs. In the case of EMEs, strong domestic demand pressures added to inflationary pressures. Amongst major economies, headline consumer price inflation (y-o-y) in September 2011 was 3.9 per cent in the US, 3.0 per cent in the euro area, 5.2 per cent in the UK, 6.1 per cent in China, 7.3 per cent in Brazil and 6.2 per cent in Turkey. In response to turbulent global conditions and domestic considerations, central banks in major EMEs have displayed a variety of responses, depending on their specific macroeconomic conditions.

Domestic Economy

12. GDP growth decelerated to 7.7 per cent in Q1 (April-June) of 2011-12 from 8.8 per cent a year ago, and 7.8 per cent in Q4 of 2010-11. From the supply side, the deceleration in growth in Q1 was mainly due to slower growth in mining, manufacturing, construction and 'community, social and personal services'.

13. Rainfall during the south-west monsoon was one per cent above normal. The Reserve Bank's production weighted rainfall was also one per cent above normal. The first advance estimates for the 2011-12 *kharif* season point to record production of rice, oilseeds and cotton. However, the output of pulses may decline due to a reduction in acreage.

14. Industrial growth, as measured by the index of industrial production (IIP), decelerated to 5.6 per cent during April-August 2011 from 8.7 per cent in the corresponding period of the previous year. This was mainly on account of slowdown in capital goods, intermediate goods and consumer durables. Growth of eight core infrastructure industries during April-August 2011 also slowed down to 5.3 per cent from 6.1 per cent in the corresponding period of last year.

15. According to the Reserve Bank's order books, inventories and capacity utilisation survey (OBICUS), capacity utilisation moderated during Q1 of 2011-12 compared with the previous quarter. Business sentiment, as indicated by the business expectations index of the Reserve Bank's industrial outlook survey, declined in Q2 of 2011-12 and showed further moderation for the following quarter. PMI indices for both manufacturing and services declined during September 2011.

16. Based on an analysis of a sample of 2,426 non-financial companies, margins of corporates in Q1 of 2011-12 moderated across sectors compared with their levels in Q4 of 2010-11. A classification of companies into the use-based segments of the IIP indicated that the intermediate goods segment registered the maximum decline in margins, reflecting the impact of commodity prices. Other segments saw lower margin compression, suggesting that pricing power was reducing, *albeit* gradually. Early results for Q2 of 2011-12 (of 161 companies analysed till October 20, 2011) suggest that both sales growth and margins moderated marginally.

17. Y-o-Y headline WPI inflation has remained stubbornly high during the financial year so far, averaging 9.6 per cent. Inflation was driven by all the three major groups, *viz.*, primary articles; fuel and power; and manufactured products. As indicated in the First Quarter Review, both the level and persistence of inflation remain a cause of concern. However, there is some comfort coming from de-seasonalised sequential quarterly WPI data which suggest that inflation momentum has turned down.

18. Y-o-Y primary food inflation was 9.2 per cent in September 2011 as compared with 9.6 per cent in August. The elevated level of primary food inflation was mainly on account of increase in prices of vegetables, milk and pulses.

19. Y-o-Y fuel-group inflation increased from 12.8 per cent in August 2011 to 14.1 per cent in September mainly due to the increase in petrol prices and upward revision in electricity prices.

20. Y-o-Y non-food manufactured products inflation was 7.6 per cent in September as compared with 7.7 per cent in August; it was 7.0 per cent in April. This should be seen in comparison with the average non-food manufactured product inflation of a little over 4.0 per cent during the last six years. The current high level reflects a combination of high commodity prices and persistent pricing power as evidenced from the early corporate results of Q2 of 2011-12.

21. Y-o-Y inflation as measured by the consumer price index (CPI) for industrial workers, which had moderated during April-July 2011, rose to 9.0 per cent in August reflecting increase in food prices. The new combined (rural and urban) CPI (Base: 2010=100) rose to 113.1 in September from 111.7 in August. Inflation based on other CPIs was in the range of 9.3 to 9.4 per cent during September.

22. Y-o-Y money supply (M_3) growth moderated from 17.2 per cent at the beginning of the financial year to 16.2 per cent on October 7, 2011. This level, however, was still higher than the indicative projection of 15.5 per cent for 2011-12, essentially reflecting the growth in bank deposits as term deposit rates increased. In turn, this has resulted in moderation in currency growth.

23. Although non-food credit growth decelerated from 22.6 per cent on a y-o-y basis in April to 19.3 per cent on October 7, 2011, it was still running higher than the indicative projection of 18 per cent set out in the First Quarter Review of Monetary Policy 2011-12. Disaggregated data on a financial year basis (April-September) show that credit growth to industry decelerated to 7.5 per cent from 8.1 per cent in the previous year, with credit to infrastructure decelerating sharply. There was also deceleration in credit growth in services and personal loans. However, growth of housing loans accelerated.

24. The estimated total flow of financial resources from banks, non-banks and external sources to the commercial sector during the first half of 2011-12 was around ₹5,00,000 crore, up from ₹4,80,000 crore during the same period of last year. The deceleration in bank credit was more than offset by higher flows from non-bank and external sources, particularly foreign direct investment and external commercial borrowings, reflecting still buoyant demand for financial resources.

25. During the first half of 2011-12, the modal deposit rate of banks increased by 80 basis points (bps) to 7.45 per cent. The rise in deposit rates was relatively sharper for maturities up to one year across the banking system. During the same period, the modal Base Rate of banks increased by 125 bps to 10.75 per cent.

26. Liquidity conditions continued to remain in deficit during the current financial year (up to October 21), consistent with the anti-inflationary stance of monetary policy. The liquidity deficit in the system, as reflected by the daily borrowings under the liquidity adjustment facility (LAF) repos, averaged around

₹47,000 crore till October 21, 2011. The systemic deficit thus remained within one per cent of banks' net demand and time liabilities (NDTL), the comfort zone assessed by the Reserve Bank.

27. The Central Government's key deficit indicators widened during April-August 2011. This was due to both deceleration in tax revenues and increase in expenditure, particularly relating to fertiliser and petroleum subsidies. The fiscal deficit during April-August 2011 was 66.3 per cent of budget estimates as compared with 58.4 per cent in 2010-11, even after adjusting for higher than budgeted spectrum receipts.

28. The Central Government has announced an increase in the budgeted borrowing by about ₹53,000 crore to meet the shortfall in other financing items. Consequently, the revised gross (net) borrowings for the year work out to about ₹5,23,000 crore (₹4,06,000 crore). The Central Government raised 61 per cent of gross (₹3,20,000 crore) and 59 per cent of net market borrowings (₹2,41,000 crore) up to October 14, 2011.

29. In the money market, the overnight interest rates have remained generally close to the repo rate during 2011-12 so far. The 10-year benchmark government security yield, which remained range-bound during the first half of 2011-12, increased by 38 basis points during October 2011 (to 8.82 per cent as on October 21), reflecting in part, increased government borrowings for the second half of the year.

30. Following a period of stability in Q1 of 2011-12, equity and forex markets came under some pressure in Q2 of 2011-12 reflecting the volatility in the global financial markets. Domestic equity prices declined in recent weeks due to significant outflows by foreign institutional investors (FIIs), driven largely by global risk aversion.

31. Between March and September 2011, the 6, 30 and 36-currency trade weighted real effective exchange rates (REER) depreciated by 6.3 per cent, 2.0per cent and 4.1 per cent, respectively, primarily reflecting the nominal depreciation of rupee against the US dollar by 8.7 per cent. The rupee depreciated further against the US dollar by 2.3 per cent between end-September and October 21, 2011. It is relevant to note in this context that the Reserve Bank's exchange rate policy is not guided by a fixed or pre-announced target or band. The policy has been to retain the flexibility to intervene in the market to manage excessive volatility and disruptions to macroeconomic stability.

32. Notwithstanding slowing and uncertain global conditions, exports grew by 47 per cent during Q1 of 2011-12 reflecting diversification in products and destinations. During the same period, imports increased by 33 per cent largely reflecting higher oil prices. Consequently, the trade deficit widened to US$ 35.4 billion in Q1 of 2011-12 from US$ 32.3 billion in the corresponding period of last year. If the current trend persists, the current account deficit (CAD) as a percentage of GDP this year may be higher than it was last year.

II. Outlook and Projections

Global Outlook

Growth

33. Global growth prospects have significantly weakened over the past few months, primarily reflecting increased concerns over sovereign debt sustainability in some euro area countries. This has added to the existing vulnerabilities in the major advanced economies arising out of elevated oil and other commodity prices, high unemployment rates, depressed consumer confidence and weak housing markets. In contrast, growth has remained relatively resilient in EMEs, notwithstanding some moderation in response to monetary tightening. However, a prolonged slowdown in advanced economies would also weaken the growth prospects of EMEs. In its September 2011 World Economic Outlook (WEO), the IMF scaled down its projection for world GDP growth to 4.0 per cent for both 2011 and 2012 from its earlier (June) projections of 4.3 per cent and 4.5 per cent, respectively.

Inflation

34. Despite significant weakening of economic activity, global commodity prices have corrected only marginally. Supply limitations remain a key upside risk

to commodity prices. According to the IMF (WEO, September 2011), consumer price inflation is likely to increase from 1.6 per cent in 2010 to 2.6 per cent in 2011 in advanced economies, and from 6.1 per cent to 7.5 per cent in emerging and developing economies.

Domestic Outlook

Growth

35. In its May and July Quarterly Review Statements, the Reserve Bank projected GDP growth of 8.0 per cent for 2011-12. The mid-quarter review of September, however, pointed out that the risk to the growth projection was on the downside mainly on account of slowing down of the global economy and moderating domestic demand. Slower global growth will have an adverse impact on domestic growth, particularly on industrial production, given the rising inter-linkages of the Indian economy with the global economy. The growth in the service sector is holding up well, although some moderation is possible here too on account of inter-sectoral linkages. Based on the normal south-west monsoon and first advance estimates that suggest a record *kharif* production, agricultural prospects look good. This should provide a boost to rural demand. However, investment demand has slackened reflecting slower clearance and execution of projects, concerns about inflation and rising interest rates. On these considerations, the baseline projection of GDP growth for 2011-12is revised downwards to 7.6 per cent(Chart 1).

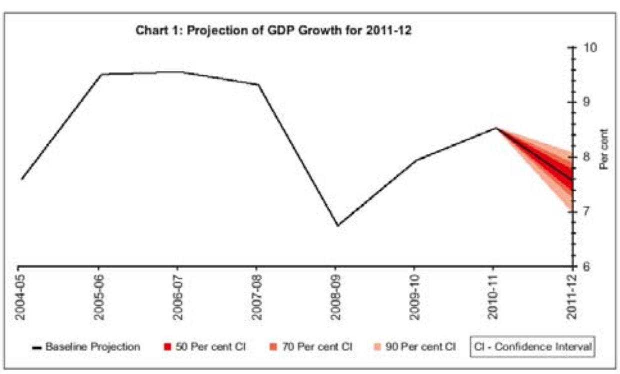


Chart 1: Projection of GDP Growth for 2011-12

Inflation

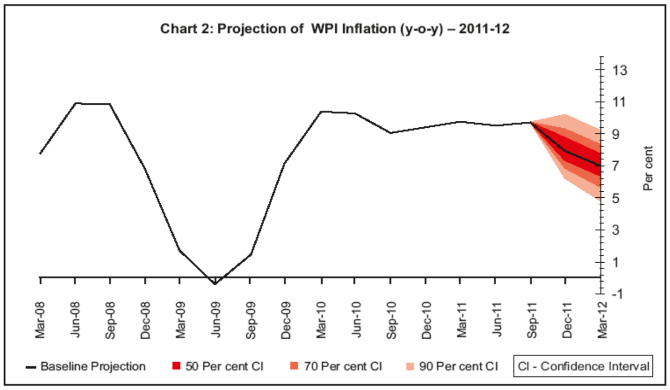
36. Going forward, the inflation path will be shaped by both demand and supply factors. First, it will depend on the extent of moderation in aggregate demand. Some signs of demand moderation are evident, although the impact is being felt more on the investment side.

37. Second, the behaviour of crude prices will be a crucial factor in shaping the outlook of domestic inflation in the near future. Despite the sluggish growth prospects of the global economy, crude prices have moderated only marginally. Also, the benefit of decline in global crude prices in the recent period so far has been more than offset by the depreciation of the rupee in nominal terms. Thus, the exchange rate will also have some impact on the behaviour of domestic petroleum prices.

38. Third, the inflation outlook will also depend on the supply response in respect of those commodities where there are structural imbalances, particularly protein items. Therefore, concerted policy focus to generate adequate supply response in respect of items such as milk, eggs, fish, meat, pulses, oilseeds, fruits and vegetables will play a major role in shaping the behaviour of food inflation in the near term.

39. Fourth, there is still an element of suppressed inflation as domestic prices of administered petroleum products do not reflect the full pass-through of global commodity prices. As the decline in crude prices has been offset by the depreciation of the rupee, under-recoveries continue to occur in respect of administered petroleum products. In addition, there are already large accumulated under-recoveries. Therefore, an increase in administered petroleum prices cannot be ruled out even in a scenario of stable or declining global crude prices. In addition, there are other items such as coal whose current prices do not reflect the underlying market conditions. Since coal is an input for electricity, coal prices, as and when raised, will also have implications for electricity tariffs.

40. Keeping in view the domestic demand-supply balance, the global trends in commodity prices and the likely demand scenario, the baseline projection for WPI inflation for March 2012 is kept unchanged at 7 per cent (Chart 2). Elevated inflationary pressures are expected to ease from December 2011, though uncertainties about sudden adverse developments remain.



41. 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

42. The current trends in money supply (M_3) and credit growth remain above the indicative trajectories of the Reserve Bank. Deposit growth has been much higher this year than that in the last year due to increase in interest rates, especially of term deposits. Credit growth showed some moderation for a time, but thereafter it accelerated again. It is expected that monetary aggregates will evolve along the projected trajectory indicated in the First Quarter Review of Monetary Policy. Accordingly, M_3 growth projection for 2011-12 has been retained at 15.5 per cent and growth of non-food credit at 18 per cent. As always, these numbers are indicative projections and not targets.

Risk Factors

43. The indicative projections of growth and inflation for 2011-12 are subject to several risks as detailed below:

i) A major downside risk to growth emanates from the global macroeconomic environment. While growth in advanced economies is already weakening, there is a risk of sharp deterioration if a credible solution to the euro area debt and financial problems is not found, in which case it will impact domestic growth through trade, finance and confidence channels.

ii) Despite recent moderation, global commodity prices remain high. However, weakening of global recovery has the potential to lead to significant softening of crude prices, which will have favourable impact for both growth and inflation.

iii) The Government has announced increased market borrowings, which can potentially crowd out more productive private sector investment. The Government has indicated that this will not impact the budgeted fiscal deficit. However, should the fiscal deficit slip from the budgeted level, it will have implications for domestic inflation. The large fiscal deficit has been an important source of demand pressure. Clearly, the impact of tightening monetary policy has been diluted by the expansionary fiscal position, which is a sub-optimal outcome.

iv) Structural imbalances in protein-rich items such as egg, fish and meat will persist. In particular, production of pulses this year is expected to be lower than last year. Consequently, food inflation is likely to remain under pressure.

III. The Policy Stance

44. The Reserve Bank began exiting from the crisis driven expansionary policy in October 2009. Since then, the Reserve Bank has cumulatively raised the cash reserve ratio (CRR) by 100 basis points, and raised the policy rate (the repo rate) 12 times by 350 basis points. The effective tightening has been of 500 basis points as liquidity in the system transited from surplus to deficit. This monetary policy response has been calibrated on the basis of India specific growth-inflation dynamics in the broader context of persistent global uncertainty.

45. Considering the persistence of inflation at a level much above the comfort zone of the Reserve Bank for almost two years, the Reserve Bank persevered with its anti-inflationary stance during the current year.

46. The monetary policy tightening effected so far has helped in containing inflation and anchoring inflation

expectations, even as both remain elevated. While the impact of past monetary actions is still unfolding, it is necessary to persist with the anti-inflationary stance. Against that background, the policy stance in this review is shaped by the following two major considerations.

47. First, both inflation and inflation expectations remain high. Inflation is broad-based and above the comfort level of the Reserve Bank. Further, these levels are expected to persist for two more months. Risks to expectations becoming unhinged in the event of a pre-mature change in the policy stance cannot be ignored. However, reassuringly, momentum indicators, particularly the de-seasonalised quarter-on-quarter headline and core inflation measures indicate moderation, consistent with the projection that inflation will begin to decline beginning December 2011.

48. Second, growth is clearly moderating on account of the cumulative impact of past monetary policy actions as well as some other factors. As inflation begins to decline, the opportunity emerges for the policy stance to give due consideration to growth risks, within the overall objective of maintaining a low and stable inflation environment.

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

- Maintain an interest rate environment to contain inflation and anchor inflation expectations.
- Stimulate investment activity to support raising the trend growth.
- Manage liquidity to ensure that it remains in moderate deficit, consistent with effective monetary transmission.

IV. Monetary Measures

50. 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:

Repo Rate

51. It has been decided to

- increase the policy repo rate under the liquidity adjustment facility (LAF) by 25 basis points from 8.25 per cent to 8.5 per cent with immediate effect.

Reverse Repo Rate

52. The reverse repo rate under the LAF, determined with a spread of 100 basis points below the repo rate, automatically adjusts to 7.5 per cent with immediate effect.

Marginal Standing Facility (MSF) Rate

53. The Marginal Standing Facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, stands recalibrated at 9.5 per cent with immediate effect.

Bank Rate

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

Cash Reserve Ratio

55. The cash reserve ratio (CRR) of scheduled banks has been retained at 6.0 per cent of their net demand and time liabilities (NDTL).

Guidance

56. The projected inflation trajectory indicates that the inflation rate will begin falling in December 2011 (January 2012 release) and then continue down a steady path to 7 per cent by March 2012. It is expected to moderate further in the first half of 2012-13. This reflects a combination of commodity price movements and the cumulative impact of monetary tightening. Further, moderating inflation rates are likely to impact expectations favourably. These expected outcomes provide some room for monetary policy to address growth risks in the short run. With this in mind, notwithstanding current rates of inflation persisting till November (December release), the likelihood of a rate action in the December mid-quarter review is relatively low. Beyond that, if the inflation trajectory conforms to projections, further rate hikes may not be warranted. However, as always, actions will depend on evolving macroeconomic conditions.

57. It must be emphasised, however, that several factors – structural imbalances in agriculture, infrastructure capacity bottlenecks, distorted

administered prices of several key commodities and the pace of fiscal consolidation – combine to keep medium-term inflation risks in the economy high. These risks can only be mitigated by concerted policy actions on several fronts. In the absence of progress on these, over the medium term, the monetary policy stance will have to take into account the risks of inflation surging in response to even a moderate growth recovery.

Expected Outcomes

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

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

ii) Reinforce the emerging trajectory of inflation, which is expected to begin to decline in December 2011.

iii) Contribute to stimulating investment activity.

Mid-Quarter Review of Monetary Policy 2011-12

59. The next mid-quarter review of Monetary Policy for 2011-12 will be announced through a press release on December 16, 2011.

Third Quarter Review of Monetary Policy 2011-12

60. The Third Quarter Review of Monetary Policy for 2011-12 is scheduled for Tuesday, January 24, 2012.

Part B. Developmental and Regulatory Policies

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

62. In an increasingly globalised world and closely integrated financial markets, shocks in any one part of the world are now quickly transmitted to the rest of the world. This was clearly evident during the global financial crisis of 2008, and now with the re-emergence of global financial risks. This inter-connectedness has reinforced the significance of financial stability for the macroeconomic stability. Financial stability has been one of the key objectives of the Reserve Bank's policy. Even as the financial system in India emerged unscathed from the global financial crisis, there was still a need to further strengthen the financial sector, drawing lessons from the global financial crisis.

63. In the banking sector, the focus of the Reserve Bank's regulatory policies in the recent period has been to strengthen capital and liquidity norms and macroprudential framework so that it remains resilient. The thrust of various regulatory measures in the financial markets is to make them more deep and liquid. The Reserve Bank has also been strengthening the regulation of systemically important non-banking financial companies.

64. The Reserve Bank has also been playing a developmental role, although the focus of developmental activity has changed from time to time. In the recent period, concerted attention has been paid to promote financial inclusion. In addition, the promotion of secure and efficient technology based services remains on the Reserve Bank's priority agenda.

I. Interest Rate Policy

Deregulation of Savings Bank Deposit Interest Rate

65. As indicated in the Second Quarter Review of November 2010, the Reserve Bank prepared a discussion paper on 'Deregulation of Savings Bank Deposit Interest Rate', which was posted on its website in April 2011, for public comments/suggestions. The discussion paper spelt out both the pros and cons of deregulating the savings bank deposit interest rate. The discussion paper evoked wide-ranging responses from a cross-section of stakeholders, ranging from the suggestion that savings bank deposit interest rate should not be deregulated at all to the suggestion that it should be deregulated completely. The Reserve Bank has examined the suggestions received and weighed the pros and cons of deregulation of the savings bank deposit interest rate. On balance, it is felt that the time is appropriate to move forward and complete the process of deregulation of rupee interest rates. Accordingly, it has been decided:

- to deregulate the savings bank deposit interest rate with immediate effect; banks are free to determine their savings bank deposit interest rate, subject to the following two conditions:
  - (i) First, each bank will have to offer a uniform interest rate on savings bank deposits up to ₹1 lakh, irrespective of the amount in the account within this limit.
  - (ii) Second, for savings bank deposits over ₹1 lakh, a bank may provide differential rates of interest, if it so chooses. However, there should not be any discrimination from customer to customer on interest rates for similar amount of deposit.

66. The operational guidelines in this regard will be issued separately.

II. Financial Markets

Financial Market Products

Interest Rate Futures

67. In pursuance of the announcement made in the Second Quarter Review of November 2010, exchange traded interest rate futures (IRFs) on 91-day Treasury Bills with cash settlement in Indian Rupees were permitted with effect from March 2011. It was indicated in the Monetary Policy Statement of May 2011 that the guidelines for 5-year and 2-year IRFs were being finalised in consultation with the

Securities and Exchange Board of India (SEBI). Accordingly, it is proposed:

- to issue the final guidelines on the cash settled 5-year and 2-year IRFs, including the final settlement price by end-December 2011.

Introduction of Credit Default Swaps

68. As announced in the Monetary Policy Statement of May 2011, the final guidelines on credit default swaps (CDSs) for corporate bonds were issued in May 2011 with the indication that they would be launched once the necessary market infrastructure was in place. Accordingly, it is proposed:

- to make the guidelines on CDS effective by end-November 2011.

Review of Short Sale in Government Securities

69. It was indicated in the Monetary Policy Statement of May 2011 that with a view to providing a fillip to the IRF market and the term repo market, the period of short sale would be extended from the earlier limit of five days to a maximum period of three months. The existing reporting mechanism for short sale is being revised. It is proposed:

- to issue guidelines on short sale in government securities by end-December 2011.

Extension of DvP III Facility to Gilt Account Holders

70. It was announced in the Monetary Policy Statement of May 2011 to extend delivery versus payment (DvP) III facility to transactions by the gilt account holders (excluding transactions between the gilt account holders of the same custodian) so that the gilt account holders get the benefit of efficient use of funds and securities. The final guidelines were issued in July 2011.

Financial Market Infrastructure

Working Group on the G-Sec and Interest Rate Derivatives Markets

71. The various reform measures initiated since the early 1990s have resulted in the development of a robust government securities market that is able to meet the funding requirement of the Central and State Governments in an efficient and transparent manner. However, there is a need to further broaden and deepen the market for government securities and the allied derivatives. Accordingly, it is proposed:

- to set up a Working Group comprising representatives from various stakeholders to examine and suggest ways for enhancing secondary market liquidity in the G-Sec and the interest rate derivatives markets.

72. Details of the Working Group will be announced separately.

Committee for Review of Procedures relating to Facilities to Individuals – Residents/NRIs and PIOs

73. It was indicated in the Monetary Policy Statement of May 2011 that a Committee (Chairperson: Smt. K. J. Udeshi) was constituted by the Reserve Bank to identify areas for streamlining and simplifying the procedure so as to remove the operational impediments, and assess the level of efficiency in the functioning of authorised persons, including the infrastructure created by them. The Committee submitted its report in August 2011. The recommendations of the Committee were examined by the Reserve Bank. Some of the recommendations of the Committee, which have already been implemented, are: (i) permission to non-resident Indians (NRIs) to be joint holders in resident bank accounts; (ii) permission to residents to be joint holders in non-resident (external) Rupee account (NRE) scheme/foreign currency (non-resident) (FCNR) account (banks) scheme; (iii) permission to residents to gift shares/debentures up to US $50,000 to non-residents; (iv) sale proceeds of foreign direct investment (FDI) allowed to be credited to NRE/FCNR (B) accounts; and (v) permission to residents to repay loans given to NRIs' close relatives, as also bear medical expenses of NRIs. Other recommendations of the Committee are under examination.

III. Financial Stability

Financial Stability and Development Council and its Sub-Committee

74. The Financial Stability and Development Council (FSDC), set up in 2010, is assisted by a Sub-Committee, chaired by Governor, Reserve Bank, and its

members include financial system regulators, the Finance Secretary and other key Ministry of Finance officials. In order to provide focused attention to the broad areas of functioning of the FSDC and its Sub-Committee, the Sub-Committee has set up two Technical Groups – a Technical Group on Financial Inclusion and Financial Literacy and an Inter-Regulatory Technical Group. The Technical Group on Financial Inclusion and Financial Literacy, headed by the Deputy Governor in charge of financial stability in the Reserve Bank, will include representatives from the regulators and from the ministries and associated departments of the Central and State Governments. The Inter-Regulatory Technical Group, chaired by the Executive Director in charge of the financial stability in the Reserve Bank, will include representatives from the four financial sector regulators, *viz.*, the Reserve Bank, the SEBI, the Insurance Regulatory and Development Authority (IRDA) and the Pension Fund Regulatory and Development Authority (PFRDA) and will discuss issues relating to systemic financial stability risks and inter-regulatory co-ordination. Both Technical Groups will provide critical inputs to the Sub-Committee. The secretariat of the Sub-Committee (Financial Stability Unit at the Reserve Bank) will act as the secretariat for these two Groups.

Financial Stability Report

75. The first Financial Stability Report (FSR) was published by the Reserve Bank in March 2010. Subsequently, it was decided that the Reserve Bank would publish FSRs twice every year in June and December. The June 2011 FSR, which included contributions from the SEBI and the IRDA, reflected the deepening of inter-regulatory collaborative process for financial stability assessment and presented a more holistic position of risks and stress in the system. In order to further enhance the coverage of the FSR so that it adequately reflects the potential systemic risks facing the whole of the economy, it has been decided that beginning from the next FSR, the draft report will be discussed in a meeting of the Sub-Committee of the FSDC. The comments/suggestions of the members would be suitably incorporated in the Report before its final release. In addition to the half-yearly FSRs, an internal review of systemic risks facing the financial system is undertaken in the interim period through Systemic Risk Monitors. Financial Market Risk Monitors are also prepared on a monthly basis for internal surveillance of various markets. The tools and techniques used to assess the stability of the financial sector are being improved over time.

Assessment of Financial Stability

76. The June 2011 FSR observed that the Indian financial system remained stable in the face of some fragilities being observed in the global macro-financial environment. The macroeconomic fundamentals for India continued to be strong, notwithstanding the prevailing inflationary pressures and concerns on the fiscal front. The banking sector was resilient, though going forward stress tests pointed to the strains in profitability and asset quality. Under severe stress tests, banks might also face liquidity constraints.

IV. Credit Delivery and Financial Inclusion

Branch Authorisation Policy -

Relaxation

77. Considering the requirement of penetration of banking in rural and semi-urban areas, domestic scheduled commercial banks [excluding regional rural banks (RRBs)] were permitted in December 2009 to open branches in Tier 3 to Tier 6 centres (with population up to 49,999 as per Census 2001) and in the rural, semi-urban and urban centres in North-Eastern States and Sikkim under general permission, subject to reporting. They were further mandated in July 2011 to allocate at least 25 per cent of the total number of branches proposed to be opened during a year in unbanked rural centres (Tier 5 and Tier 6 *i.e.*, population up to 9,999 as per Census 2001), so as to meet the targets set out for providing banking services in villages with population over 2,000 by March 2012, and thereafter progressively to all villages over a period of time. However, prior authorisation from the Reserve Bank is required for opening of branches in Tier 1 and Tier 2 centres, except in the case of North-Eastern States and Sikkim where general permission has been granted.

78. These initiatives have led to increased pace in the number of branches opened in Tier 3 to Tier 6 centres.

However, it is observed that branch expansion in Tier 2 centres has not taken place at the desired pace. To provide enhanced banking services in Tier 2 centres, it is proposed:

- to permit domestic scheduled commercial banks (other than RRBs) to open branches in Tier 2 centres (with population 50,000 to 99,999 as per Census 2001) without the need to take permission from the Reserve Bank in each case, subject to reporting.

79. The opening of branches by domestic scheduled commercial banks (other than RRBs) in Tier 1 centres (centres with population of 1,00,000 and above as per Census 2001) will continue to require prior permission of the Reserve Bank. While issuing such authorisation, the Reserve Bank will continue to factor in, among others, whether at least 25 per cent of the total number of branches to be opened during a year are proposed to be opened in unbanked rural centres.

80. Detailed guidelines in this regard will be issued separately.

Redefining the Priority Sector

81. Based on the Malegam Committee's recommendations, and as proposed in the Monetary Policy Statement of May 2011, the Reserve Bank set up a Committee (Chairman: Shri M. V. Nair) to re-examine the existing classification and suggest revised guidelines with regard to priority sector lending classification and related issues. The terms of reference of the Committee include revising the current eligibility criteria for classification of bank loans as priority sector; review of the definition of direct and indirect priority sector finance; classification of bank lending through financial intermediaries as priority sector lending; and the consideration of capping interest rate on loans under the eligible categories of the priority sector. The Committee first met on September 29, 2011 and it will submit its report within four months from that date.

Credit Flow to the Micro, Small and Medium Enterprises Sector

82. Based on the recommendations of the High Level Task Force on the micro, small and medium enterprises (MSMEs), the Reserve Bank issued guidelines in June 2010, advising scheduled commercial banks that the allocation of 60 per cent of micro and small enterprises (MSEs) advances to micro enterprises was to be achieved in stages, *viz*., 50 per cent in the year 2010-11, 55 per cent in the year 2011-12 and 60 per cent in the year 2012-13. Banks were also mandated to achieve a 10 per cent annual growth in the number of micro enterprise accounts and a 20 per cent year-on-year growth in credit to the MSE sector. The Reserve Bank has been closely monitoring the achievement of targets by banks on a half-yearly basis. The last review of the achievement of targets was done as on March 2011. It has been observed that 27 banks (10 public sector banks, 7 private sector banks and 10 foreign banks) have attained the target of 50 per cent advances to the micro enterprises, and another 27 banks (9 public sector banks, 12 private sector banks and 6 foreign banks) have attained the target of 10 per cent growth in the number of micro enterprises. Similarly, 38 banks (22 public sector banks, 11 private sector banks and 5 foreign banks) have attained the target of 20 per cent growth in credit to the MSE sector. Meetings were held with all those banks which lagged behind in achieving the targets to agree on a plan of action for meeting the targets. The frequency of monitoring has been changed from half-yearly to quarterly with effect from the quarter ended June 2011.

Rural Credit Institutions

Licensing of Co-operatives

83. In terms of the recommendations of the Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla), and as proposed in the Annual Policy Statement of April 2009, the work relating to licensing of unlicensed state and central co-operative banks in a non-disruptive manner, in consultation with National Bank for Agriculture and Rural Development (NABARD), has been initiated. Subsequent to the issuance of revised guidelines on licensing of state co-operative banks (StCBs)/district central co-operative banks (DCCBs), 10 StCBs and 169 DCCBs were licensed, bringing down the number of unlicensed StCBs from 17 to 7 and unlicensed DCCBs from 296 to 127 by end-August 31, 2011.

Revival of the Rural Co-operative Credit Structure

84. The Government of India, 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, had approved a package for revival of the short-term rural co-operative credit structure. As envisaged in the package, 25 States have entered into memorandum of understanding (MoU) with the Government of India and NABARD and 21 States have amended their respective State Co-operative Societies Acts. As on July 31, 2011, an aggregate amount of ₹9,000 crore was released by NABARD for recapitalisation of primary agricultural credit societies (PACS) in 16 States as the Government of India's share under the revival package and as part of the operationalisation of the recommendations of the Vaidyanathan Committee.

Roadmap for Provision of Banking Services in Villages with Population of over 2000

85. In pursuance of the announcement made in the Monetary Policy Statement of April 2010, a roadmap to provide banking services in every village with a population of over 2000 was finalised by the state level bankers' committees (SLBCs). In all, 74,386 villages as per 2001 Census have been identified. They have been allotted to various banks for provision of banking services by March 2012. Banking outlets have been opened in 32,144 villages across various States in the country. Of these, 809 villages are covered through branches, 30,882 villages through branchless banking, *i.e.*, business correspondents (BCs) and 453 through other modes like automated teller machines (ATMs), mobile vans, etc., constituting 43 per cent of the target. Of the total 32,144 banking outlets opened, public sector banks hold 85 per cent share, followed by RRBs with 12 per cent and private sector banks with 3 per cent.

Financial Inclusion Plan for Banks

86. It was indicated in the Monetary Policy Statement of May 2011 that all public and private sector banks had prepared and submitted board-approved three-year financial inclusion plans (FIPs), containing targets for March 2011, 2012 and 2013, to the Reserve Bank. In order to review the progress of banks in the implementation of FIPs and making way for accelerated progress in future, the Reserve Bank has been conducting annual FIP review meetings with banks. Based on discussions with banks, some action points were conveyed to them.

87. Banks were advised to ensure close and continuous monitoring of BCs. They were also advised to focus, in future, on opening of some form of low cost brick and mortar branches between the base branch and BC locations. Further, banks were required to make efforts to increase the number of transactions in no-frill accounts. There should be seamless integration of the financial inclusion server with their internal core banking solution (CBS) systems and in the case of end-to-end solution, there should be a clear demarcation of the technology related activities and BC related activities of their service providers. Banks should initiate action for registering with the Unique Identification Authority of India (UIDAI) and start opening accounts on the basis of Aadhaar information. Public sector banks should formulate FIPs for all RRBs sponsored by them and develop an effective monitoring mechanism so that targets assigned to the RRBs were also achieved meticulously.

88. The reporting format for monitoring the progress made by banks under FIPs has been segregated under qualitative and quantitative parameters. Banks have been mandated to submit quantitative reports on a monthly basis and qualitative reports on a quarterly basis in future.

Urban Co-operative Banks

Enhancement of Limit and Repayment Period of Housing Loan

89. Based on the representations received from the urban co-operative banks (UCBs) and their associations, it is felt that there is a need to increase the maximum permissible limit of individual housing loans that can be granted by the UCBs, as also to increase the maximum repayment period for such loans. It is, therefore, proposed:

- **to increase the individual housing loan limit from ₹25 lakh to ₹30 lakh for Tier I UCBs and from ₹50 lakh to ₹70 lakh for Tier II UCBs, subject to extant prudential exposure limits; and**

- **to enhance the maximum repayment period of housing loans from the present period of 15 years to 20 years.**

90. Detailed guidelines in this regard will be issued separately.

Licences for Setting up new Urban Co-operative Banks

91. As announced in the Monetary Policy Statement of April 2010, an Expert Committee (Chairman: Shri Y. H. Malegam) was constituted in October 2010 with representations from all stakeholders for studying the advisability of granting licences for setting up new UCBs. The Committee was also mandated to look into the feasibility of an umbrella organisation for the UCB sector. The major recommendations of the Committee, which submitted its report in August 2011, include (i) minimum entry point capital norms ranging between ₹50 lakh and ₹500 lakh depending upon the location and area of operation; (ii) preference to be given to existing co-operative credit societies with a sound track record for grant of licence; (iii) every new UCB to have a Board of Management (BoM) to be appointed by the Board of Directors (BoD) and a Chief Executive Officer (CEO) to be appointed by the BoM; and (iv) setting up two separate umbrella organisations, namely (a) a national level organisation, which will provide payment and settlement services and other services normally provided by central banks as also liquidity support to its member UCBs; and (b) one or more State level organisations or outside agencies to provide information technology (IT), training and other services. The report of the Committee was placed in public domain, inviting comments up to October 31, 2011. After receipt of feedback from the public, the recommendations will be examined and guidelines issued.

Customer Service

92. Recognising the need for revisiting the issue of customer service in banks, a Committee (Chairman: Shri M. Damodaran) was constituted by the Reserve Bank in May 2010. The Committee looked into the banking services rendered to retail and small customers and pensioners, structure and efficacy of the existing grievance redressal mechanism, the functioning of Banking Ombudsman Scheme, and possibility of leveraging technology for better customer service and has recommended steps for improvement. The report was published in July 2011 and placed in public domain calling for comments/suggestions from all the stakeholders.

93. A large number of comments and suggestions were received and examined with a view to translating the recommendations into executable policies. However, on account of a wide range of issues covered and certain recommendations with far-reaching implications, it would require some time to finalise the entire list of implementable recommendations. In the interregnum, 88 recommendations on which a broad consensus has emerged may be taken up for implementation initially. Further, in a recently concluded Banking Ombudsmen conference, in which the Indian Banks' Association (IBA) together with the Banking Codes and Standards Board of India (BCSBI) participated, 10 action points were identified, which are essential to protect the rights of the customers. Accordingly, it is proposed:

- to implement the recommendations of the Damodaran Committee, on which a broad consensus has emerged, as also the action points which were identified by the IBA and BCSBI in the last Banking Ombudsmen conference.

94. The matter will be pursued with the stakeholders in respect of remaining recommendations of the Damodaran Committee.

V. Regulatory and Supervisory Measures for Commercial Banks

Strengthening the Resilience of the Banking Sector

95. It was announced in the Monetary Policy Statement of May 2011 that the Reserve Bank would adhere to internationally agreed phase-in period (beginning January 1, 2013) for implementation of the Basel III framework. The Reserve Bank is finalising the draft guidelines for implementing Basel III framework for the scheduled commercial banks operating in India. It is proposed:

- to issue the draft guidelines for implementing the Basel III framework by end-December 2011.

96. While at present, at the system level, banks in India are adequately capitalised, and transition to Basel III is expected to be smooth, careful capital planning would be required by banks in view of substantially higher equity requirement in capital. The draft guidelines would form the basis for preliminary estimation of capital requirements over the implementation phase of Basel III.

Implementation of Advanced Approaches under Basel II Framework

97. Guidelines on computation of capital requirements under the standardised approach (TSA)/alternate standardised approach (ASA) for operational risk were issued in March 2010 and those for internal models approach (IMA) for market risk were issued in April 2010. Final guidelines for advanced measurement approach (AMA) for operational risk were issued in April 2011. Draft guidelines on internal rating based (IRB) approach for credit risk were issued in August 2011. Comments/suggestions received from various stakeholders are under examination. It is proposed:

- to issue the final guidelines on IRB approach for credit risk by end-December 2011.

Dynamic Provisioning

98. After the financial crisis, the inherent pro-cyclicality of regulatory capital and provisioning requirement have attracted considerable attention. Consequently, work has been taken up at international level by the Basel Committee on Banking Supervision (BCBS) to introduce countercyclical capital and provisioning buffers. Essentially, these approaches require build-up of capital and provision in good times, which can be drawn down in bad times to enable banks to absorb the losses and continue lending. While BCBS has finalised a framework for countercyclical capital buffer, the work on devising a framework for countercyclical provisioning norm is still underway. Therefore, as an interim measure, a provisioning coverage ratio (PCR) was introduced by the Reserve Bank in December 2009 as a countercyclical measure to ensure build-up of provisioning buffer when banks in general were making good profits. This measure was aimed at achieving a PCR of 70 per cent with reference to the position as on September 30, 2010. Since work is still in progress by BCBS for devising a methodology for countercyclical provisioning, the Reserve Bank has, as a further interim measure, initiated work for devising a forward looking provisioning framework reflecting the credit history of Indian banks, based on data collected from select banks and data already available with the Reserve Bank. Accordingly, it is proposed:

- to issue a discussion paper by end-March 2012, on the proposed provisioning approach for comments.

Working Group on Pricing of Loans and Advances

99. As part of financial sector reform, interest rates on loans and advances have been deregulated in a phased manner since 1997 and banks have been given freedom to fix the rates. The Base Rate system was introduced with effect from July 1, 2010, under which all categories of loans and advances are priced with reference to the Base Rate and banks are not permitted to lend below the Base Rate. Banks are required to determine interest rates on advances with reference to the Base Rate by adding a spread reflecting product specific charges together with term premium and risk premium. While the Base Rate can change depending on the cost of funds, the spread over the Base Rate should undergo change only when components of the spread undergo changes.

100. In a deregulated environment, transparency in pricing assumes greater significance in ensuring that the risk is priced adequately and borrowers are charged interest in a fair manner. It has, however, been observed that in the case of floating rate loans, there is lack of transparency in loan pricing and banks are also

mispricing risk. Instances where the spread charged to a customer has been revised upward frequently during the tenure of the floating rate loan, have also come to the notice of the Reserve Bank. These have also resulted in a situation where existing customers are at a disadvantage, as compared with new customers with the same credit rating, leading to customers complaining about discrimination. In view of the above, it is proposed:

- to set up a Working Group to look into principles governing proper, transparent and non-discriminatory pricing of credit.

Prudential Norms for Restructuring of Advances by Banks

101. An account, if restructured due to borrowers' financial difficulties, is treated as being in default and accordingly considered impaired as per international prudential and accounting norms. Accordingly, as per extant guidelines issued by the Reserve Bank, accounts classified as 'standard assets' should be immediately re-classified as 'sub-standard assets' upon restructuring. However, if the restructuring is done as per a specified framework prescribed by the Reserve Bank, certain asset classification benefits are extended. These guidelines have evolved over a period of time. The current restructuring guidelines were formulated based on the recommendations of the Special Group (Chairperson: Smt. S. Gopinath), which had representations from the IBA, among others. The restructuring guidelines, last revised in August 2008, have generally helped both the lenders and borrowers, especially during economic downturns. However, the Reserve Bank has been receiving requests from stakeholders to review the restructuring guidelines in the light of experience gained. In view of the above, it is proposed:

- to constitute a Working Group to review the existing prudential guidelines on restructuring of advances by banks/financial institutions and suggest revisions taking into account the best international practices and accounting standards.

Monitoring of Unhedged Foreign Currency Exposure of Corporates by Banks

102. Unhedged forex exposure of corporates is a source of risk to corporates and a source of credit risk to financing banks. If the unhedged position is large, it can have serious consequences for the solvency of corporates in the event of large depreciation of the home currency and can result in large credit losses to the financing banks. Considering that a significant part of corporates' foreign currency commitments tended to remain unhedged, banks were mandated in October 2001 to monitor and review on a monthly basis the unhedged portion of the foreign currency exposures of large corporates whose total foreign currency exposure was relatively large (say, above US $25 million or its equivalent). Banks were further advised in December 2003 to put in place a policy that explicitly recognised and took into account risks arising on account of unhedged foreign exchange exposures of their clients. Banks were also advised that foreign currency loans above US $10 million, or such lower limits as may be deemed appropriate *vis-a-vis* the banks' portfolios of such exposures, could be extended by banks only on the basis of a well laid out policy of their Boards with regard to hedging of such foreign currency loans. These instructions to banks were reiterated in December 2008. Further, banks were advised in December 2008 to exchange information among themselves in respect of borrowers enjoying credit facilities from more than one bank, which should, *inter alia*, cover information relating to derivative transactions and unhedged foreign currency exposures of the borrowers.

103. Recent events relating to derivative trades showed that excessive risk taking by corporates could lead to severe distress to them and large potential credit loss to their bankers in the event of sharp adverse movements in currencies. The recent episode of volatility in rupee exchange rate when the rupee depreciated by more than 10 per cent in a short period of 6 weeks has sharply underlined the importance of prudent management of foreign exchange risk. It is, therefore, proposed that:

- while extending fund based and non-fund based credit facilities to corporates, banks should rigorously evaluate the risks arising out of unhedged foreign currency exposure of the corporates and price them in the credit risk premium. Banks may also consider stipulating a limit on unhedged position of corporates on the basis of their Board's approved policy.

Licensing of New Banks in the Private Sector

104. Following the announcement made by the Hon'ble Finance Minister in the Union Budget 2010-11 and as indicated in the Monetary Policy Statement of April 2010, the Reserve Bank released a discussion paper on licensing of new banks on its website in August 2010, seeking views/comments of banks, non-banking financial companies (NBFCs), industrial houses, other institutions, and the public at large. Detailed discussions were also held with various stakeholders. All these comments were examined and the draft guidelines on licensing of new banks in the private sector were placed on the Reserve Bank's website in August 2011, inviting comments from all the stakeholders up to October 31, 2011. It was indicated in the draft guidelines that certain amendments to the Banking Regulation Act, 1949 are under consideration of the Government of India, including a few which are vital for finalisation and implementation of the policy for licensing of new banks in the private sector. Once the amendments are in place, and after examining the feedback on the draft guidelines, the final guidelines will be issued and the process of inviting applications for setting up of new banks in the private sector will be initiated.

Presence of Foreign Banks in India

105. Pursuant to the announcement in the Monetary Policy Statement of April 2010, a discussion paper on the presence of foreign banks in India was placed on the Reserve Bank's website in January 2011 soliciting views/comments from all stakeholders, including banks, non-banking financial institutions, and the public at large. Feedback/comments received from foreign banks and other stakeholders have been consolidated and are under examination. The comprehensive guidelines on the mode of presence of foreign banks in India would be formulated after factoring in the views/comments on the discussion paper received from all concerned.

Compensation Practices

106. Pursuant to the announcement made in the Monetary Policy Statement of May 2011, the Reserve Bank is in the process of issuing the final guidelines on compensation based on the Financial Stability Board (FSB) principles on sound compensation practices as well as taking into account the guidelines issued by the BCBS in May 2011 on *Range of Methodologies for Risk and Performance Alignment of Remuneration.*

Introduction of Bank Holding Company/Financial Holding Company Structure in India

107. A Working Group (Chairperson: Smt. Shyamala Gopinath) was constituted to examine the introduction of a holding company structure for banks and other financial entities together with the required legislative and regulatory framework. The Group submitted its report, and the same was placed on the Reserve Bank's website, inviting comments/feedback from all the stakeholders. Comments received are under examination.

Supervisory Policies, Procedures and Processes: Comprehensive Review

108. A High Level Steering Committee (Chairman: Dr. K. C. Chakrabarty) was set up by the Reserve Bank to review the existing supervisory processes in respect of commercial banks in India. The terms of reference of the Committee, include (i) review of the approach to supervision; (ii) review of the extant onsite supervisory examination and offsite supervisory methods; (iii) review of the adequacy of prudential supervisory guidelines and supervisory review process; (iv) examination of the extant methods for consolidated supervision; (v) recommendation of the measures for strengthening the extant cross-border supervisory cooperation processes; (vi) assessment of the adequacy of the institutional structure for carrying out supervisory function; and (vii) suggestion for a framework for feedback mechanism. A Technical Committee, comprising officers from the Reserve Bank and representatives from a few banks, has also been constituted to aid and assist the Steering Committee. The Steering Committee will submit its report by end-July 2012.

VI. Institutional Developments

Non-Banking Financial Companies

Regulatory Framework for Non-Banking Financial Company – Micro Finance Institution

109. As announced in the Monetary Policy Statement of May 2011, the broad framework of regulations recommended by the Malegam Committee, which had been constituted to study issues and concerns of the

micro finance institution (MFI) sector, was accepted by the Reserve Bank. Guidelines with regard to priority sector treatment of MFI loans were also issued to banks. It is further proposed:

- to introduce a new category of NBFCs called Non-Banking Financial Company – Micro Finance Institutions (NBFC-MFIs), the regulatory framework of which will be broadly based on the recommendations of the Malegam Committee.

110. Detailed guidelines in this regard will be issued by end-November 2011.

Overseas Investment by Core Investment Companies

111. Under the extant regulations, NBFCs desirous of investing overseas require prior approval from the Reserve Bank. These investments are allowed by the Reserve Bank subject to certain eligibility conditions, and only in the regulated financial activities. Core investment companies (CICs), however, have as their primary activity, investment in equity shares of group entities for the sake of holding stake in these companies. Such group companies may be in different sectors of the economy and not confined to the financial sector alone. As a holding company, a CIC may need to invest in non-financial entities overseas. It is, therefore, proposed:

- to issue a separate set of guidelines for overseas investment by CICs in both financial and non-financial sector companies.

112. Detailed guidelines in this regard will be issued separately.

Review of the Existing Regulatory Framework for NBFCs

113. The Reserve Bank had constituted a Working Group (Chairperson: Smt. Usha Thorat) to examine a range of emerging issues pertaining to the regulation of the NBFC sector in view of their growing importance and inter-connectedness with other segments of the financial system, which will have a bearing on financial stability. The major issues examined by the Committee were: definition and classification of NBFCs keeping in view the need for addressing regulatory gaps and regulatory arbitrage; improving standards of governance in the sector; and adopting appropriate approach to NBFC supervision. The key recommendations of the Committee, which submitted its report in August 2011, are: minimum asset size of more than ₹50 crore for registering any new NBFC; 12 per cent as Tier I capital; prescription of a liquidity ratio for NBFCs; raising of the percentage of total financial assets and income from these assets to 75 per cent each of the total assets and income respectively, from the existing stipulation of 50 per cent each for the classification of the entity as an NBFC; asset classification and provisioning norms to be made similar to banks; adopting financial conglomerate approach for larger NBFCs; and undertaking comprehensive inspection of NBFCs having assets of ₹1,000 crore and more. The report was placed on the Reserve Bank's website for comments/feedback from the public till September 30, 2011. The responses are under examination.

Payment and Settlement Systems

Working Group for Card-based Transactions

114. As indicated in the Monetary Policy Statement of May 2011, a Working Group, comprising representatives from public/private/foreign banks, card companies, National Payments Corporation of India (NPCI) and the Reserve Bank, was formed to recommend an action plan for enabling additional authentication for transactions at points of sale (PoS) using existing cards in a cost effective manner and propose a timeframe for migrating the card infrastructure to enabling issuance and acceptance of chip-based and personal identification number (PIN)-based cards. The recommendations of the Group, which submitted its report in June 2011, include (i) strengthening the technology and payment infrastructure, like implementation of unique key per terminal (UKPT) and terminal line encryption (TLE), etc., within 18-24 months; (ii) introducing an additional factor for all debit card transactions within 24 months for domestic transactions; (iii) review of the progress made in the roll out of Aadhaar after 18 months so as to examine the use of biometric finger print capture in lieu of PIN at the ATM and PoS as an additional factor of authentication; (iv) introducing europay, mastercard and visa (EMV) chip and PIN for credit cards and debit cards by 5 and 7 years, respectively, for all domestic transactions; and (v) EMV chip card and PIN to be issued in lieu of magstripe cards when at least one purchase is evidenced at an overseas location. The recommendations of the Group were

largely accepted, and suitable instructions were issued to all the stakeholders in September 2011.

Performance of National Electronic Funds Transfer System

115. All the refinements to the national electronic funds transfer (NEFT) have been well accepted by the stakeholders and the product is growing from strength to strength in terms of acceptability, reach and volumes handled. As at end-September 2011, around 79,500 branches of 103 banks participated in the NEFT system and the volume of transactions processed increased to 17.5 million. A few banks have also successfully and seamlessly brought the RRBs sponsored by them under the NEFT ambit. More RRBs are expected to join the NEFT soon.

IT Vision Document for 2011-17

116. As indicated in the Monetary Policy Statement of May 2011, the High Level Committee (Chairman: Dr. K. C. Chakrabarty), constituted by the Reserve Bank to prepare an IT vision document for the period 2011-17, made recommendations relating to both the Reserve Bank and commercial banks. Action points stemming from the IT vision document have been identified and a Standing Committee (Chairman: Shri Anand Sinha) has been formed to monitor the progress of implementation of the IT vision document. A Steering Committee (Chairman: Shri G. Padmanabhan) has been constituted to ensure the smooth implementation of the recommendations as given in the IT vision document.

Automated Data Flow from Banks

117. As indicated in the Monetary Policy Statement of May 2011, a Core Group consisting of experts from banks, the Reserve Bank, the Institute for Development and Research in Banking Technology (IDRBT) and the IBA had prepared an approach paper on automated data flow (a straight through process) from the CBS or other IT systems of commercial banks to the Reserve Bank. Following the Reserve Bank's advice to put in place, at the earliest, a system by which the Reserve Bank returns can be sourced directly from the banks' CBS and other IT systems without any manual intervention, all banks have submitted their action plans. Further, they have been submitting quarterly progress in the prescribed formats. Some of the banks have already started generating a few returns directly from their source systems. To facilitate smooth and speedy implementation, a working group with representatives from a few banks has been formed. Banks are being advised to increase the pace of bringing the returns under automated data flow and the progress in this regard is being closely monitored.

Real Time Gross Settlement System

118. As indicated in the Monetary Policy Statement of May 2011, the Working Group constituted for preparing an approach paper for implementing the next generation real time gross settlement (NG-RTGS) system, submitted the approach paper, the suggestions of which were taken as a basis for preparing the blueprint for the NG-RTGS system. The Reserve Bank is in the process of identifying the suitable solution under the guidance of a Technical Advisory Group (TAG) with members from reputed technology institutes, banks and the Reserve Bank.

Currency Management

119. One of the key recommendations of the High Level Group on Systems and Procedures for Currency Distribution (Chairperson: Smt. Usha Thorat) was that to address the tendency of under-reporting of cases of detection of counterfeit notes to the Reserve Bank/police, the requirement of filing first information report (FIR) should be done away with, where any person inadvertently in possession of counterfeit notes up to five pieces tenders the same at a bank counter. Taking into account all relevant issues and in consultation with the Government of India, the Reserve Bank instructed the banks that (i) for cases of detection of counterfeit notes up to four pieces, in a single transaction, a consolidated report should be sent to the police authorities at the end of the month; and (ii) for cases of detection of counterfeit notes of five or more pieces, in a single transaction, FIRs should be lodged with the nodal police station/police authorities as per jurisdiction. It will ensure that all cases of detection of counterfeit notes at bank branches/treasuries are promptly reported to the Reserve Bank/police authorities.

Mumbai

October 25, 2011