RBI Governor announces Mid-term Review of Monetary and Credit Policy for the year 2002-03

October 29, 2002

Highlights

- **RBI pegs GDP growth at 5.0 to 5.5 per cent despite drought conditions.**
- **Bank Rate reduced by 0.25 percentage point.**
- **CRR reduced by 0.25 percentage point.**
- **Substantial increase in flow of bank credit to industries. Upturn in industrial production and buoyancy in exports to sustain growth**
- **Money supply (M_3) contained within the projected trajectory of 14 per cent.**
- **Decline in reserve money despite large increase in foreign exchange reserves and significant primary support to government borrowing programme.**
- **Bulk of the government borrowing programme completed at lower interest cost and with longer maturity.**
- **Inflation to remain benign around 4 per cent despite drought and pressures on oil prices.**
- **Sharp reduction in interest rates on various types of government and corporate papers.**
- **Reduction in effective lending rates of banks.**
- **Reserves build up at a low effective cost without adding to external debt. The increase in reserves reflects higher remittances, quicker repatriation of export proceeds and non-debt inflows.**
- **RBI to continue the monetary policy stance for 2002-03 announced in April 2002 for the remaining half of the year.**
- **Monetary and prudential measures towards flexibility**

October 29, 2002

RBI Governor announces Mid-term Review of Monetary and Credit Policy for the year 2002-03

Dr. Bimal Jalan, Governor, in a meeting with Chief Executives of major commercial banks today presented the Mid-term Review of Monetary and Credit Policy for 2002-03. Governor after reviewing macroeconomic and monetary development indicated that RBI will continue the monetary policy stance for 2002-03 as announced in April 2002 for the remaining part of the year. He announced a series of measures for developing technological and institutional infrastructure of the financial sector and for improving the credit delivery system and highlighted the following aspects.

GDP Growth 5.0 – 5.5 per cent despite drought

Reviewing GDP growth for 2002-03, Governor said that while the CSO estimate for the first quarter of the current year is in line with the projected rate of growth of 6.0 to 6.5 per cent for the year as a whole, the rate of growth in GDP will be lower in view of the poor rainfall in some parts of the country With indications of recovery in industrial production, substantially higher growth in infrastructure industries and impressive export performance, Governor said that the overall GDP growth for the year 2002-03 is likely to be 5.0 to 5.5 per cent as against the earlier projection of 6.0 to 6.5 per cent.

Substantial flow of bank credit to industries

2. Governor mentioned that there has been an improvement in the growth of non-food bank credit this year reflecting better outlook for industrial growth. Apart from credit growth, various business expectation surveys point to a positive industrial outlook for the current year. Food credit, however, declined on account of lower procurement and higher off-take of foodgrains.

Monetary indicators on projected trajectory

3. Referring to monetary developments, Governor said that on an annual basis, growth in Money Supply (M_3) at 13.2 per cent, net of merger, was in line with the projected trajectory. The growth in deposits has also been consistent with the projections made at the beginning of the year in the annual policy Statement. Another important feature of monetary development during this year has been the reduction in reserve money despite liquidity pressure emanating from increase in RBI's foreign currency assets as also primary support to the Government's borrowing programme.

Inflation to remain benign

4. Governor mentioned that inflation in the current year is more evenly spread across major sub-groups. The annual inflation, on a point-to-point basis, was 2.8 per cent on October 12, 2002 as against 3.0 per cent a year ago. While the deficiency in rainfall caused pressure on the prices of many agricultural commodities, the domestic inflation outlook still looks comfortable and the inflation rate is likely to be around 4.0 per cent, which is in line with the expectations in the annual policy Statement of 2002-03***.***

RBI continues with the present debt management strategy

5. Elaborating on debt management strategy, Governor explained that RBI continues to combine auction issues with acceptance by private placement of dated securities consistent with market conditions. Because of the existing liquidity conditions in the market and low inflation, the Government has been able to borrow at a substantially lower cost during 2002-03. The monetary impact of private placement, however, was neutralised by conduct of outright OMO sales of government securities.

Financial Markets stable

6. Highlighting financial market developments, Governor said, financial markets in India have been generally stable, liquidity has been adequate, and the interest rate environment has also been favourable to promote investments. A steady increase in net foreign currency assets of the Reserve Bank combined with lower than anticipated level of real economic activity, created a situation of excess liquidity during most part of the current year so far. The Reserve Bank, therefore, had to actively manage liquidity not only through outright OMO sales of securities but also through its daily Liquidity Adjustment Facility (LAF).

Decline in interest rates across various segments

7. Dwelling on interest rate scenario, Governor said, reflecting easy liquidity conditions, interest rates continued to maintain their downward trend. The spread between AAA rated corporate bonds and government securities has narrowed considerably over the last six months in the wake of improved industrial outlook. The public sector banks have reduced their deposit rates. In consonance with lower cost of funds, some banks have reduced their prime lending rates (PLRs). Since banks are lending below their PLRs and also reduced their maximum spread over PLR, the effective lending rates of banks have shown some moderation. The weighted average call money rate has come down from over 13.06 per cent in August 2000 to 5.74 per cent by October 2002. The yields on government securities with 1-year and 10-year residual maturities fell from 10.82 per cent and 11.47 per cent in August 2000 to 5.92 per cent and 7.07 per cent, respectively, by October 2002.

8. Referring to the substantial reduction in interest rates achieved in the recent period, Governor expressed satisfaction and said that this is in line with the announced policy of the Reserve Bank. He added that this combined with a benign inflationary environment, is a welcome development which augurs well for industrial recovery and sustained growth in the economy.

India to perform better than other economies

9. Highlighting the developments in the world economy, Governor said that the prospects for recovery in the world economy, now appears to be somewhat slower than that anticipated earlier. However, in terms of relative performance, India and China are anticipated to perform better than the global trend.

Exchange rate policy has stood the test of time

10. Elaborating on foreign exchange management, Governor said that the recent experience has once again highlighted the need for developing countries to keep a continuous vigil on market developments and build adequate safety nets that can withstand the effects of unexpected shocks and market uncertainties. In this context, India's current exchange rate policy has stood the test of time. It has focused on the management of volatility without a fixed rate target, while the underlying demand and supply conditions are allowed to determine the exchange rate movements over a period in an orderly way. Recent international research on viable exchange rate strategies in emerging markets has also lent considerable support to the exchange rate policy followed in India.

Forex Reserves at all time high

11. Governor indicated that India's foreign exchange reserves have increased sharply from US $ 45.2 billion as on October 26, 2001 to US $ 64.0 billion by October 25, 2002, an increase of US $ 18.8 billion. The overall approach to the management of India's foreign exchange reserves in recent years has reflected the changing composition of balance of payments, and has endeavoured to reflect the "liquidity risks" associated with different types of flows and other requirements such as the size of the current account deficit; the size of short-term liabilities (including current repayment obligations on long-term loans); the possible variability in portfolio investment and other types of capital flows; the unanticipated pressures on the balance of payments arising out of external shocks; and movements in the repatriable foreign currency deposits of Non-resident Indians (NRIs).

Cost of additional reserves quite low

12. Referring to the recent debate regarding the cost and benefit of holding reserves, Governor said that sharp exchange rate movements can be highly disequilibrating and costly for the economy during periods of uncertainty or adverse expectations. The economic costs are likely to be substantially higher than the net financial cost, if any, of holding reserves. In the last few years almost the whole of addition to reserves has been made without increasing the overall level of external debt. The increase in reserves largely reflects higher remittances, quicker repatriation of export proceeds and non-debt inflows. Even after taking into account foreign currency denominated NRI flows, the financial cost of additional reserve accretion in India in the recent period is quite low and is likely to be more than off set by the return on additional reserves.

Release of counterpart domestic currency in lieu of net purchases in the foreign market

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

Export credit delivery system to be customer- friendly

14. Governor said that export performance during the current year has been encouraging and it is expected that the current account deficit for the year would be below 1.0 per cent of GDP and no significant pressures on balance of payments are expected on this account. The Reserve Bank has started making available on its website the reference rate for the euro in addition to the US dollar. Governor urged that it will be desirable if more and more of our trade to the euro area is also invoiced

in the euro. Governor emphasised that sustained efforts towards accelerating the growth of exports becomes imperative for long-term viability of the balance of payments as well as for increasing income and employment opportunities. Governor urged that banks should continue with their efforts to make the export credit delivery system customer-friendly and efficient at the branch levels, particularly, in areas with concentration of small and medium sized exporters.

Procedures/documentations minimised for individuals

15. Governor indicated that procedures for financial transactions such as remittances, investments and maintenance of bank accounts, etc., for non-residents have been simplified considerably in the recent past. The policy framework governing inward foreign direct investment (FDI) was substantially liberalised under the automatic route. Continuing with the policy of progressive liberalisation of the capital account, NRI deposit schemes were also rationalised and are now fully convertible (with the exception of NRO accounts). In order to facilitate the external commercial borrowings of corporates, the Reserve Bank allowed corporates, on a case by case basis, to credit even higher proportions of export proceeds to their EEFC accounts so that they can take advantage of lower interest rates and prepay their ECBs. Governor emphasised the need to monitor large exposures to such corporates against unhedged exposures.

Stance of Monetary Policy to continue

16. Spelling out the stance of monetary policy, Governor said, consistent with price stability, RBI will continue to ensure that all legitimate requirements for credit are adequately met. Towards this end, RBI will continue its policy of active demand management of liquidity through OMO including LAF, and using the policy instruments at its disposal as and when the situation warrants. The outlook for industrial growth and exports during the year 2002-03 remains positive. This scenario coupled with a moderate level of global inflation, the inflationary outlook on the domestic economy continues to be favourable. The Reserve Bank, therefore, proposes to continue with the overall stance of monetary policy announced in the April policy Statement for 2002-03 for the remaining half of the current year.

17. Governor recalled that the annual policy Statement of April 2002 had indicated that under normal conditions and barring emergence of any adverse and unexpected developments in the various sectors of the economy, the overall stance of monetary policy for 2002-03 will be:

- Provision of adequate liquidity to meet credit growth and support investment demand in the economy while continuing a vigil on movements in the price level.
- In line with the above, to continue the present stance on interest rates including preference for soft interest rates.
- To impart greater flexibility to the interest rate structure in the medium-term.

Elongation of maturities in Government securities at lower costs

18. Governor indicated that monetary management in the first half of 2002-03 was largely in conformity with the monetary policy stance announced in the annual policy Statement of April 2002. As spelt out in the policy Statement, RBI has been able to maintain a stable interest rate regime throughout the first half of the year with a bias towards softening of interest rates. Nearly two-thirds of the market borrowing programme of the Government could be completed at a lower cost, with longer maturities and without any adverse impact on the general interest rate structure. The maximum maturity was gradually elongated from 20 years during 1998-99 to 30 years in 2002-03. Simultaneously the weighted average maturity has increased substantially from 5.7 years in 1995-96 to 14.26 years in 2001-02. On the other hand, the average cost of issuance has come down from 13.75 per cent to 9.44 per cent over the same period. Further, certain innovations were also brought into the instruments like floating rate bonds and allowing put/call options in the government securities.

Further flexibility in interest rates

19. Referring to interest rate flexibility, Governor said that banks were urged to devise schemes for encouraging depositors to convert their existing long-term fixed rate past deposits into variable rate deposits. It is expected that such efforts would, over time, enable banks to reduce to some extent, the downward inflexibility in the interest rate structure. Governor urged banks to review the maximum spread over PLR and reduce their interest rates wherever unreasonably high so that credit could be available to the borrowers at reasonable interest rates. The measures apart from generating healthy competition among banks, are expected to improve banking facility available to depositors and make them more responsive to changes in the overall financial and inflationary environment. Governor said that the Reserve Bank will be pursuing these issues further and welcomes any suggestions in this regard.

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

21. Governor reviewed the progress made in respect of structural measures indicated for increasing the operational efficiency of monetary policy, improving the regulatory and supervisory functions of the Reserve Bank and strengthening the prudential and supervisory norms along with developing technological and institutional infrastructure of the financial sector and improving the credit delivery system. Governor also announced certain further structural and other policy measures.

Monetary Measures

(a) Bank Rate

- The Bank Rate is reduced by 0.25 percentage point from 6.50 per cent with effect from the close of business of October 29, 2002.

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

(b) Repo Rate

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

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

(c) Cash Reserve Ratio

24. As a further step in moving towards the statutory level of CRR of 3.0 per cent, Governor proposed:

- To reduce CRR from 5.0 per cent to 4.75 per cent effective from the fortnight beginning November 16, 2002. (With this reduction, CRR has been reduced by as much as 3.75 percentage points over the past two years).
- To raise the minimum daily maintenance of CRR of banks to 80 per cent of required amount with effect from fortnight beginning November 16, 2002. The minimum level of 80 per cent would be applicable for all the days in a reporting fortnight.

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

25. Governor proposed:

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

(e) Statutory Liquidity Ratio of Regional Rural Banks

26. Governor proposed:

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

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

Interest Rate Policy

(a) Interest Rate Flexibility

27. Governor said that the recent monetary policy Statements have been drawing attention to factors causing rigidities in the structure of interest rates, particularly in the lending rates of commercial banks. There has been some improvement with regard to NPAs, operating expenses and cost of funds of commercial banks. In order to further improve flexibility, banks have been given freedom to decide the period of reset on variable rate deposits.

(b) Prime Lending Rate and Spread

28. Governor explained that in the current environment of low inflation, unreasonably wide spreads could adversely affect the overall credit portfolio of banks. Furthermore, very wide spreads provide opportunities for non-transparency. In order to ensure appropriate pricing of loans, banks are encouraged to review both their PLRs and spreads and align spreads within reasonable limits around PLR subject to approval of their Boards.

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

29. Governor indicated that interest rates on deposits have been deregulated except deposits in savings bank accounts, which is currently prescribed by RBI. However, discretion was given to Regional Rural Banks (RRBs)/Local Area Banks (LABs) and co-operative banks (Urban/Central/State) to pay additional interest. In order to remove these anomalies, Governor suggested the following measures for implementation as early as possible:

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

(d) Interest Rates Export Credit in rupee terms

30. With a view to encouraging competition among banks and also to increase flow of credit to export sector, Governor proposed to liberalise interest rates on rupee export credit in two phases. Accordingly, in the first phase, it is proposed that:

- The ceiling rate of PLR plus 0.5 percentage point on pre-shipment credit beyond 180 days and up to 270 days and post-shipment credit beyond 90 days and up to 180 days will be deregulated with effect from May 1, 2003. Banks would have freedom to charge PLR or sub-PLR rates subject to approval of their Boards.

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

(e) Flexibility in the Repayment of Export Credit

31. Imparting flexibility in the repayment of export credit, Governor proposed that:

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

(f) Interest Rate on FCNR (B) Deposits

32. Governor stated that banks are free to decide FCNR (B) deposit rates denominated in Japanese Yen which may be equal to or less than LIBOR/SWAP rates of corresponding maturities till further notice. Interest rate ceiling on FCNR (B) deposits denominated in other currencies will remain unchanged at the prevailing level of LIBOR/SWAP rates of corresponding maturities minus 25 basis points.

Short-term Liquidity Assessment Model

33. Governor informed that a short-term liquidity forecasting model, developed under the guidance of eminent academic experts, is currently being used for internal evaluation and information. The generic form of the model has also been made available at the Bank's website for wider public debate.

Money Market

34. Governor indicated that a number of structural measures have been initiated to ensure balanced development of various segments of the money market as also to preserve the integrity and transparency. While implementing these measures, it is desirable to take cognisance of the progress of developments made in other markets/payments system infrastructure, e.g., the repo market, operationalisation of NDS/CCIL etc. In this context, Governor announced the following additional measures :

(a) Rationalisation of Standing Facilities

35. With the emergence of Liquidity Adjustment Facility (LAF) as the primary instrument for modulating systemic liquidity on a day to day basis, the usage of export credit refinance (ECR) facility has gone down substantially in the recent period. With a view to furthering the process of phasing out sector-specific standing facility in an environment of low CRR, Governor proposed:

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

(b) Certificates of Deposit

36. With a view to providing more flexibility for pricing of CDs and to give additional choice to both investors and issuers.

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

(c) OTC Rupee Derivatives

37. In order to enlarge the menu for managing interest rate risks for banks and other financial intermediaries as well as corporates in the rupee derivatives market, Governor proposed:

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

Government Securities Market

38. Governor said that in an effort to provide further transparency and stability in the government securities market, a number of measures have been put in place by RBI during 2002-03 so far. These measures, *inter alia,* include an announcement of a half-yearly calendar for Government of India dated securities, holding of government securities by both wholesale and retail investors in dematerialised form, arranging NDS data almost on real-time basis to the RBI website for market participants etc. RBI has also been making sustained efforts to increase the investor base of government securities market by encouraging retailing of government securities and making CSGL account holders eligible for the repo market. It is also attempting to impart greater flexibility to both issuers and investors of government securities through introducing STRIPS, floating rate bonds and bonds with call/put option. In this direction, Governor announced the following further initiatives.

(a) Trading in Stock Exchanges

39. In order to enlarge the number of participants and to provide countrywide access to government securities, it is proposed to introduce anonymous screen based order driven trading in government securities on the stock exchanges. The scheme will be placed for comments from market participants/public on the website of RBI and SEBI.

(b) Extension of Repo to CSGL Account Holders

40. Governor proposed to extend repo eligibility to select category of non-SGL account holders with adequate safeguards to ensure 'Delivery Versus Payment' and transparency.

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

41. Governor mentioned that as banks are not following an uniform accounting system for repo/reverse repo transactions, draft guidelines on 'Uniform Accounting Norm for Repo Transactions' on the lines suggested by a Sub-Group of TAC were circulated to banks and FIMMDA for their comments.

(d) Development of the Repo Market

42. In order to facilitate phasing out of non-bank participants from call/notice money market as also to impart more flexibility to the repos market, Governor proposed to permit rollover of repos using the same securities between the same counterparties. Further measures for developing repo market may be considered in consultation with experts and participants at a later stage.

(e) Collateralised Borrowing and Lending Obligation (CBLO)

43. The Reserve Bank has been promoting collateralised lending/ borrowing operations by market participants so that their reliance on call/notice money market may be reduced. In this direction, Collateralised Borrowing and Lending Obligation (CBLO), a product developed by CCIL for its members was considered. Accordingly :

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

(f) NDS Data on website

44. Governor indicated that with the operationalisation of NDS, price and trade information on government securities and related data reported on NDS is now available on the RBI website on real time basis.

Credit Delivery Mechanism

(a) Priority Sector Lending

(i) Agriculture

45. In order to improve credit delivery to the priority sector and in particular to agriculture, Governor proposed:

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

(ii) Small Business and Weaker Sections

46. In order to further increase credit flow to the small business and to weaker sections, Governor proposed:

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

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

(iii) Repairs of Damaged Houses in Rural and other Areas.

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

(b) Micro Finance

47. Governor indicated that the Reserve Bank's objective has been to accelerate the flow of bank credit to micro finance institutions while maintaining their decentralised, voluntary and non-bureaucratic character. Banks were also allowed to classify their credit under the SHG-bank linkage programme as advances to weaker sections. The SHG-bank linkage programme proved that banking for the poor was a viable proposition. Considering the fact that the recovery rate has been very high in respect of banks' advances to SHGs and the SHG bank linkage programme helps the poor, Governor proposed:

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

Urban Co-operative Banks

Proposal for an Apex Supervisory Body

48. Governor mentioned that RBI had again drawn the attention to the present system of dual/triple regulatory and supervisory control (involving Centre, Sates and RBI) and stated that it is not conducive to efficient functioning of the co-operative banks in the interest of their depositors. Accordingly, RBI mooted a proposal to set up a separate supervisory authority in the interest of the public depositors, with representatives of Centre, State and other interested elements. This important issue was examined recently by a Committee under the Chairmanship of Hon. Minister of State for Finance. The Committee while agreeing that the duality of control should be done away with, recommended that RBI should be vested with full powers for regulation and supervision of UCBs. Governor assured that while RBI will do its best in implementing the decisions of the Government in this regard, it may be kept in view that in case immediate measures are not taken to remove duality of control, it will be difficult to make the supervisory system effective.

Supervision and Monitoring

(a) Risk Based Supervision

49. Governor stressed that RBI would switch over to risk based supervision of banks by 2003 and accordingly certain change management processes were initiated by the Project Implementation Group formed for the purpose.

(b) Consolidated Accounting and Supervision

50. Governor mentioned that in order to provide enabling provisions to facilitate consolidated accounting and quantitative methods under Indian conditions, a working arrangement with other regulators viz. SEBI and IRDA, for sharing of information by way of Memorandum of Understanding (MOU) is being explored.

Prudential Measures

51. Governor said that prudential regulation and supervision have formed a critical component of the financial sector reform process since the beginning and these norms have been progressively tightened over the years in line with international best practices.

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

52. With a view to moving towards international best practices and to ensure greater transparency, commercial banks were advised to adopt 90 days norm for recognition of loan impairment from the year ending March 31, 2004. In order to

have a consistent and uniform approach towards all segments of the banking system, Governor proposed:

- To extend the 90 days norm to the SCBs and DCCBs from the year ending March 31, 2006. To facilitate smooth transition, banks are advised to move over to charging interest on monthly rests effective April 1, 2004.

(b) New Capital Accord

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

54. Governor informed that India is also participating in the Quantitative Impact Study (QIS 3) being conducted by the Basel Committee to assess the impact of the New Accord and RBI has constituted a group of seven banks (three public sector banks, two new private banks and two old private banks) that have begun participating in the exercise.

(c) Banks' Entry into Insurance Business Referral Arrangement

55. Governor said that under the referral arrangement, banks provide physical infrastructure within their select branch premises to insurance companies for selling their insurance products to the banks' customers with adequate disclosure and transparency, and in turn earn referral fees on the basis of premia collected. Accordingly, a few banks have been permitted to enter into referral arrangements with insurance companies subject to certain conditions to protect the interests of their customers.

(d) Technical Committee on Market Integrity

56. Governor mentioned that the Report of an internal technical Group which assessed India's position vis-à-vis international standards on 'market integrity' has been placed on the RBI Website for wider dissemination.

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

57. Governor advised banks to put in place a sound Know Your Customer policy, adopt anti-money laundering measures comprising systems and procedures for customer identification while opening accounts, institute internal control and audit mechanism, and lay down risk management and monitoring procedures.

(f) Offshore Banking Units in Special Economic Zones

58. Governor said that RBI has formulated a scheme of Off-shore Banking Units in Special Economic Zones as branches of banks operating in India and obtained the approval of the Government.

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

59. Governor informed that draft prudential guidelines on management of non-SLR investment portfolio have been referred to the RBI-SEBI Technical Committee to take a view on disclosure and regulation of private placement.

(h) Country Risk Management

60. Governor said that draft guidelines on country risk management together with a 'Note for Discussion' were forwarded to banks and were also placed on RBI website seeking comments/views thereon.

(i) Investment Fluctuation Reserve

61. Governor recalled that with a view to building up of adequate reserves to guard against any possible reversal of interest rate environment in future, banks were advised to build up Investment Fluctuation Reserve (IFR). As per the extant guidelines, banks are required to build up IFR of a minimum 5 per cent within a period of 5 years. The IFR as at end March 2002 constituted 0.91 per cent of the relevant category of investment.

Review of Various Working Groups by the Reserve Bank

62. Governor indicated that as a part of the consultative process in initiating financial sector reforms, RBI has constituted a number of Working Groups on various policy issues, with members drawn from banks, market participants and experts in the relevant areas. Working Groups were also set up for suggesting road maps for implementation of international best systems and practices in the financial sector with particular reference to the banking sector. The reports of the Working Groups were examined internally and were also put on RBI website where necessary for wider dissemination and comments. The progress of the Working Groups was reviewed in Annex I.

Technology Upgradation

63. Governor said that an important objective of the programme for technology upgradation in our financial sector is to link various payment and settlement systems into an efficient and integrated system. The roadmap for development is provided in the 'Payment System Vision Document'. In this direction, Governor reviewed further steps taken by RBI in this regard and reviewed the progress in Annex II.

Legal Reforms

64. Governor said that RBI has proposed for consideration of the Government, various amendments to the existing Acts in order to provide more flexibility in day-to-day operations. He further mentioned that some of the proposals are at various levels of consideration of the Government and gave a detail account in Annex III.

Alpana Killawala
General Manager

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