Press Release

RBI Governor announces Monetary and Credit Policy for the year 2003-04

Highlights

- **GDP Growth in 2003-04, assuming satisfactory spatial distribution of monsoon, projected at about 6.0 per cent.**
- **Bank Rate reduced by 0.25 percentage point.**
- **CRR reduced by 0.25 percentage point.**
- **Inflationary situation on an average basis remained low except in the fourth quarter during 2002-03 despite drought. Inflation is expected to be in the range of 5.0 to 5.5 per cent during 2003-04.**
- **Lower increase in reserve money despite sharp increase in RBI's foreign currency assets.**
- **Money Supply (M_3) remained within projected trajectory during 2002-03 and projected at 14.0 per cent for 2003-04.**
- **Sustained increase in credit flow during 2002-03; non-food credit to increase by 15.5 to 16.0 per cent during 2003-04.**
- **Sharp reduction in interest rates of banks and in government and corporate papers.**
- **Government borrowing programme completed at lower interest cost with longer maturity. Interest rates on corporate paper are all time low.**
- **Reserves build up at a low effective cost without adding to external debt.**
- **Low interest rates and strong forex position prompts prepayment of external debt.**
- **RBI to provide adequate liquidity to meet credit growth and support investment demand.**
- **Preference for a soft and flexible interest rate environment to continue.**
- **Export credit refinance facility to continue.**
- **Interest rate on back-stop facility reduced.**
- **Transparent system to determine prime lending rate (PLR) of banks.**
- **Uniformity in maturity structure of repatriable foreign currency as well as rupee NRI deposits.**
- **Overseas investments liberalised and flexibility allowed to overseas investors for flow of FDI.**
- **Further measure to improve credit delivery mechanism to priority sector.**
- **Changes in prudential measures for UCBs in line with JPC recommendations.**

Dr.Bimal Jalan, Governor, in a meeting with Chief Executives of major commercial banks today presented the Monetary and Credit Policy for 2003-04. Governor's Statement covered a review of macroeconomic and monetary developments and stance of monetary policy with analytical and operational issues concerning monetary policy, interest rate, exchange rate and reserves management. He announced certain further measures for strengthening the financial system, improving the credit delivery mechanism and developing technological and institutional infrastructure and highlighted the following aspects.

GDP Growth 4.4 per cent during 2002-03

Reviewing GDP growth for 2002-03, Governor said that the advance estimates released by the CSO in January 2003 has placed the GDP growth at 4.4 per cent, which reflects an estimated decline in the output from agriculture and allied activities of as much as 3.1 per cent. The overall growth performance of the industrial sector as per CSO advance estimates at 5.8 per cent is, however, much higher than that of 3.2 per cent in the previous year. The services sector is estimated to grow by 7.1 per cent as against 6.5 per cent in the earlier year.

Point to point inflation rate at 6.2 per cent at end March 2003

The annual rate of inflation as measured by variations in the Wholesale Price Index (WPI), on a point-to-point basis, remained below 4.0 per cent up to mid-January 2003 and thereafter rose to 6.2 per cent by March 2003. The annual rate of inflation on an average basis in 2002-03 was, however, lower than last year: 3.3 per cent as against 3.6 per cent a year ago.

Food Stocks helped in moderating prices of food items

Governor said that while there was a decline in food credit reflecting subdued procurement and higher off-take, the large buffer stock with the Government acted as a deterrent to price increases of food items as also the general price level in the wake of severe drought conditions witnessed during the year.

Monetary indicators on projected trajectory in 2002-03

Referring to monetary developments, Governor said that on an annual basis the growth in money supply (M_3), net of mergers, at 12.1 per cent was within the projected trajectory. The growth in aggregate deposits of scheduled commercial banks at 12.2 per cent net of mergers (16.1 per cent with mergers), was consistent with the projections made at the beginning of the year. An important feature of monetary developments during 2002-03, Governor said, was lower increase in reserve money despite sharp increase in RBI's foreign currency assets and substantial primary support, to the Government's borrowing programme.

Substantial increase in credit flow

Governor stated that there was a sustained increase in credit flow to the commercial sector during 2002-03 reflecting industrial recovery. Non-food credit of scheduled commercial banks (SCBs) registered a higher growth of 26.2 per cent. Net of mergers, it rose by 17.8 per cent as against an increase of 13.6 per cent in the previous year. Governor pointed out that the incremental non-food credit-deposit ratio during 2002-03 at 79 per cent is the highest recorded over the last five years.

Cost of Government borrowings falls sharply in 2002-03

Governor said that during 2002-03, net market borrowings of the Central Government at Rs.1,04,188 crore (gross Rs.1,51,126 crore) was higher than the budget estimate by Rs.8,259 crore and lower than the revised estimate by Rs.8,747 crore. The weighted average cost of government borrowings through dated securities at 7.34 per cent during 2002-03 was lower by 210 basis points than that of 9.44 per cent in the previous year. Governor, however, cautioned that while in the current year unfavourable effects of large fiscal deficit on the interest rate scenario have not been evident, in the medium-term perspective, it is necessary to aim at fiscal consolidation and substantially lower fiscal deficits to facilitate efficient monetary and debt management operations.

Decline in interest rates across various segments

Dwelling on interest rate scenario, Governor said that as the inflationary situation remained benign for most part of the year, it was feasible to maintain a soft interest rate environment despite high level of government borrowings. Governor mentioned that an interesting development during the year has been that the interest rates in money market instruments converged to a narrow band of 5.5 to 6.0 per cent reflecting easy liquidity conditions. There was also a distinct downward drift in secondary market yields on government securities across the maturity spectrum during the year. Interestingly, yields on non-government bonds witnessed a sharper reduction than yields on government securities during 2002-03, and yields on such bonds are now closer to sovereign bonds than was the case earlier.

The public sector banks have reduced their term deposit rates, with such reduction being more pronounced for longer term deposits. As a result, there has been a flattening of the term structure of deposit rates. In consonance with lower cost of funds, banks have reduced their prime lending rates.

RBI's Bank Rate has been reduced in stages from 8.0 per cent in July 2000 to 6.25 per cent by October 2002, which is the lowest rate since May 1973. Similarly, the repo rate has been moderated from 8.0 per cent in March 1999 to 5.0 per cent by March 2003. Simultaneously, the weighted average call money rate has come down from over 13.06 per cent in August 2000 to 5.86 per cent by March 2003.

Though the overall monetary conditions are at present comfortable in the light of moderate inflation, easy liquidity and soft interest rate environment, Governor said that the Reserve Bank will continue to keep a close watch on the domestic and external situation to conduct its monetary management.

Interest rate risk

Referring to the two-way movement in interest rate during 2002-03, Governor emphasised that banks should take immediate measures to build up investment fluctuation reserve in a smooth and phased manner for better risk management.

Global economic prospects remain uncertain

Highlighting the developments in the world economy, Governor said that the IMF has projected world economy to grow by 3.2 per cent during 2003 as against 3.0 per cent in the previous year. The uncertainty regarding the economic outlook, however, remains high due to the ongoing geopolitical developments. Macroeconomic policies will have to continue to focus on strengthening the fundamentals of the economy, financial stabilisation and promoting good corporate governance to aid the long-run welfare gains.

Forex reserves at all time high

Governor said that India's foreign exchange reserves increased by as much as US $ 21.3 billion from US $ 54.1 billion in end-March 2002 to US $ 75.4 billion by end-March 2003. At the same time Government of India has pre-paid US $ 2.97 billion of high cost external debt. Corporates bodies have also repaid ECBs to the tune of US $ 595 million. The increase in reserve is the highest increase recorded in a single year and has occurred despite substantial increase in the international oil prices and several other unfavourable developments, like lower international capital flows to developing countries during the period. Drawing attention to a recent RBI study, Governor said that almost the entire addition to reserves, in the last few years, has been made without increasing the overall level of external debt. The cost of accretion to reserves has also not been found to be significant, as most of the increase is due to non-debt inflows.

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. The policy for reserve management is thus judiciously built upon a host of identifiable factors and other contingencies. Such factors, *inter alia*, include: 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). 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 (where interest rates are linked to LIBOR), the financial cost of additional reserve accretion in India in the recent period is quite low, and is likely to be more than offset by the return on additional reserves.

Exchange rate policy stood the test of time

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 the importance of building adequate safety nets that can withstand the effects of unexpected shocks and market uncertainties. In this context, India's current exchange rate policy seems to have stood the test of time. It has focused on the management of volatility without a fixed rate target and the underlying demand and supply conditions are allowed to determine the exchange rate movements over a period in an orderly way. Governor expressed satisfaction that recent international research on viable exchange rate strategies in emerging markets has also lent considerable support to the exchange rate policy followed by India. Governor assured that the Reserve Bank will continue to follow the approach of watchfulness, caution and flexibility by closely monitoring the developments in the financial markets at home and abroad.

Release of counterpart domestic currency resources against forex inflows

Governor explained 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. 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.

Movement of forward market premia

Governor referred to the recent media and expert comments by market participants relating to the movement of forward market premia. The premia have shown a considerable downward movement in the recent weeks. Thus, as of April 25, 2003, the forward premia on 6-month US dollar was only 2.1 per cent (annualised rate) as compared with 5.9 per cent a year ago and 3.4 per cent at the beginning of January 2003. Governor said that the sharp downward movement in forward premia has occurred because, at present, there seems to be a rush to sell dollars in the forward market by exporters and other entities in anticipation of further appreciation of the rupee *vis-à-vis* US dollars. In response to this expectation, there is also a rush to "borrow" dollars (for repayments later) and convert these into rupees now. This has resulted in corporates and other market participants having larger "unhedged" exposures on their future dollar obligations. While RBI will continue to operate in the spot and forward markets as per its foreign exchange management policies, Governor said, RBI is not in favour of increasing the unhedged borrowings by corporates, and short term forex liabilities of banks in order to meet the demand for "borrowed" dollars that is arising from expectations regarding future movements in dollar-rupee exchange rate. To put to rest market speculations about RBI's stance in this regard, Governor clarified that:

- At present, there is in fact an excess supply of US dollars in both the spot and forward markets to meet all genuine transactions and investment demand by corporates, banks and others. There is no shortage of foreign currency availability in the market.

- One-way expectations of exchange rate or premia may not always be fulfilled. Present unhedged exposures seem to be on account of expectations on unconstrained appreciation of rupee. Movements in respect of exchange rates may not, however, be unidirectional. This can be seen from the movement of the Euro against the US dollar from 0.9606 to 1.1087 between September 17, 2002 and March 11, 2003, from 1.1087 to 1.0501 between March 11 and March 21, 2003 and from 1.0501 to 1.0997 between March 21 and April 25, 2003. Similar movements have also been observed in the case of pound sterling/US dollar rates.

- For these reasons, it is of utmost importance, particularly in relatively thin developing country markets, that foreign currency exposures by corporates and others are largely hedged or covered against anticipated foreign currency earnings. It may be recalled that a part of the problem that many emerging economies have faced in the past has been due to excessive unhedged foreign currency exposures in a country during periods when movement in exchange rate was absent (due to fixed exchange rate policy) or currency was appreciating.

Export credit delivery system to be customer friendly

Governor said that the performance of India's exports during 2002-03 (upto December 2002) has been encouraging despite the continued global slowdown. Governor urged that exports being the most important sector of the economy, banks should continue to pursue customer-friendly export credit delivery system. Governor mentioned that going by current indications, India would be showing a current account surplus during 2002-03 for the second year in succession.

Liberalisation of capital flow and simplification of procedure/ documentation

Governor recalled the recent important measures taken by RBI relating to current and capital accounts with a view to further liberalising the movement of cross-border capital flows, especially in the areas of outward foreign direct investment, inward direct and portfolio investment, non-resident deposits and external commercial borrowings. Governor said that prepayment of ECBs under automatic route is now allowed out of local resources/market purchases without any limit. In this context, Governor emphasised the need for monitoring large unhedged exposure of corporates.

Challenges for liquidity management

Governor said that the sharp accretion to foreign currency assets of RBI posed some challenges for liquidity management during the year. The monetary impact of such large inflows had to be neutralised by conduct of substantial outright OMO sales. Despite the intervention of RBI through sterilisation, the interest rate did not firm up as adequate liquidity could be maintained in the system through judicious LAF operations of RBI.

The Reserve Bank has reduced the Bank Rate, repo rate under LAF and augmented the lendable resources of the banking system by reducing the CRR. As inflation remained benign for most part of the year, despite the impact of drought and higher oil prices, there was general reduction in market interest rates. Considerable uncertainties still remain on the inflation front due to current geopolitical uncertainties. While there is no room for complacency on this account, for the present, Governor said it is proposed to continue with the policy of maintaining adequate liquidity in the system and a soft interest rate environment. In case demand pressures emerge and the inflationary situation worsens, which hopefully will not be the case, the present monetary policy stance may have to be reviewed.

GDP and Monetary Projections for 2003-04

As regards projection for GDP, Governor said that the overall growth rate for the year 2003-04 largely hinges on sustained upturn in the industrial and services sectors and recovery in agricultural output. Assuming satisfactory spatial distribution of monsoon, and if rainfall is around 96 per cent of the long term average, Governor expected recovery in agricultural out put. With this, growth rate of real GDP in 2003-04 could be placed at 6.0 per cent for the purpose of monetary policy formulation.

On inflation outlook, Governor said that the increase in inflation in the last quarter of 2002-03 was dominated by certain commodities such as edible oils, oil cakes and mineral oils. Based on present assessment of relevant factors, Governor indicated that the inflation rate in 2003-04 may be placed in the range of 5.0 to 5.5 per cent. While prices of edible oils increased sharply partly because of drought, domestic mineral oil prices increased substantially in the wake of the sharp rise in international oil prices. The prices of these items are, as of now, expected to decline during the course of the year. It is important to initiate measures which, through a strong “pass through” effect, will help to soften the prices of commodities which showed unusual rise last year. Timely domestic action would help in further reducing the projected rate of inflation, which would be highly desirable for monetary and financial management.

Consistent with the projected GDP growth and inflation, Governor placed the projected expansion in broad money (M_3) for 2003-04 at 14.0 per cent. The non-food bank credit adjusted for investments in commercial paper, shares/debentures/bonds of PSUs and private corporate sector is projected to increase by 15.5-16.0 per cent, which, will facilitate the sustenance of growth in industrial activity during 2003-04.

An issue of policy interest for financial management by banks and other market participants is whether, after a sharp decline in the past 2-3 years, interest rates have bottomed out. As is well known, the outcome for interest rates heavily depends on the outlook for inflation, growth prospects and investment demand and it is not possible to predict short run movement in interest rates, either up or down, without taking cognizance of possible movements in all other macroeconomic variables. These variables are also subject to unanticipated changes because of unforeseen domestic or external developments.

Governor said that given normal conditions and overall stability in macroeconomic environment, in view of several structural constraints, it is likely that the present nominal and real interest rates are now relatively low and may not have significant potential for further sizeable downward movement in India.

Stance of Monetary Policy for 2003-04

Spelling out the stance of monetary policy, Governor said that as per present assessment, and barring the emergence of adverse and unexpected developments in the various sectors of the economy, the overall stance of monetary policy for 2003-04 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 with the present stance of preference for a soft and flexible interest rate environment within the framework of macroeconomic stability.

Monetary Measures

(a) Bank Rate

- It is proposed to reduce the Bank Rate by 0.25 percentage point from 6.25 per cent to 6.0 per cent with effect from the close of business today (April 29, 2003).

Commenting on the Bank Rate reduction, Governor said that the Bank Rate has been reduced from 11.0 per cent to 6.0 per cent, i.e. by 500 basis points in the last five years. This is the sharpest reduction in the Bank Rate since independence. Unless the domestic and international circumstances change, Governor stated, the policy bias in regard to the Bank Rate is to keep it stable until the mid-term Review of October 2003.

(b) Cash Reserve Ratio

As a further step in moving towards the medium-term objective of reducing cash reserve ratio (CRR) of banks to the statutory minimum level of 3.0 per cent, Governor proposed to:

- Reduce CRR further from 4.75 per cent to 4.50 per cent effective fortnight beginning June 14, 2003.

Governor mentioned that with this reduction, CRR would have been reduced by 4.0 percentage points in the last three years.

(c) Payment of Interest on eligible CRR Balances on Monthly Basis

Governor informed that as indicated in the mid-term Review of October 2002, interest on eligible CRR balances maintained by banks with RBI would be paid on monthly basis from April 2003.

(d) Export Credit Refinance Facility

Governor announced that in response to the suggestion received from the exporting community, in the present uncertain geopolitical environment, it has been decided:

- To continue extending refinance facility to eligible export credit remaining outstanding under post-shipment credit beyond 90 days and up to 180 days.

This measure will be reviewed again in October 2003.

(e) Back-stop Facility

Governor indicated that in order to increase the efficacy of liquidity adjustment facility (LAF) operations, it is desirable to rationalise the multiplicity of rates at which liquidity is absorbed/injected. Accordingly, Governor proposed that:

- The "back-stop" interest rate will be at the reverse repo cut-off rate at which funds were injected earlier during the day in the regular LAF auctions;

- Where no reverse repo bid is accepted as part of LAF auction, the "back-stop" interest rate will generally be 2.0 percentage points over the repo cut-off rate of the day under LAF;

- On the days when no bids for repo or reverse repo auctions are received/accepted, the "back-stop" interest rate will be decided by RBI, on an ad hoc basis.

With the above changes, Governor said it is expected that the "back-stop" interest rate will be lower by 1.0 percentage point over the present "back-stop" rate. This should benefit banks (as well as borrowers) using this facility.

Interest Rate Policy

(a) Prime Lending Rate and Spreads

In order to enhance transparency in banks' pricing of their loan products as also to ensure that the PLR truly reflects the actual costs, Governor advised banks to consider the following suggestions for determination of their prime lending rates:

- Banks should take into account their (i) actual cost of funds, (ii) operating expenses and (iii) a minimum margin to cover regulatory requirement of provisioning/capital charge and profit margin, while arriving at the benchmark PLR. Banks should announce a benchmark PLR with the approval of their Boards.

- As is already the case, the benchmark PLR would continue to be the ceiling rate for credit limit up to Rs.2 lakh.

- Since all other lending rates can be determined with reference to the benchmark PLR arrived at as above by taking into account term premia and/or risk premia, the system of tenor-linked PLR deserves to be discontinued. These premia can be factored in the spread over or below the PLR. The effective date for discontinuation of the tenor-linked PLR will be further discussed with banks and a decision will be announced separately in due course.

Governor further advised that in the interest of customer protection and to have greater degree of transparency in regard to actual interest rates charged to borrowers, banks are urged to continue to provide information on maximum and minimum interest rates charged together with the benchmark PLR. The system of determination of benchmark PLR by banks and the actual prevailing spreads around the benchmark PLR would be reviewed in September 2003.

(b) Non-Resident External (NRE) Deposits

In order to provide uniformity in the maturity structure to all types of repatriable deposits whether they are in foreign currency or in rupees, Governor proposed that:

- The maturity period of fresh NRE deposits, with immediate effect, will be 1 to 3 years in line with FCNR(B) scheme. This will also apply to NRE deposits renewed after their present maturity period.

Credit Delivery Mechanism

(a) Priority Sector Lending

(i) Liberalisation of credit for drip irrigation/sprinkler irrigation system/agricultural machinery

Governor said that the present limit on advances granted to dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, located in rural/semi-urban areas were Rs.20 lakh under priority sector lending for agriculture. As the scheme has been of benefit to the farming community, Governor proposed the following further liberalisation:

- Dealers in drip irrigation/sprinkler irrigation system/agricultural machinery, irrespective of their location, would be eligible for such advances, under priority sector lending for agriculture.

(ii) Housing loans

In view of increasing demand for housing in rural and semi-urban areas, and to improve financing to housing sector in these areas, Governor proposed that:

- Banks, with the approval of their Boards, will be free to extend direct finance to housing sector upto Rs.10 lakh in rural and semi-urban areas as part of priority sector lending.

(b) Relief for Drought affected Farmers

Governor said that in order to further mitigate the hardship of farmers in drought-affected states, the Government had decided, as a one-time measure, to waive completely, the first year's deferred interest liability on *Kharif* loans in those states. This instalment of deferred interest, which is to be waived by banks would be reimbursed by the Government. No interest would be charged on the deferred interest, and the balance of the deferred interest would be recovered in reasonable instalments.

(c) Relaxation on Infrastructure Financing

Governor said that certain relaxations relating to regulatory and prudential aspects have already been given to banks to boost credit flow to this sector. These include: enhancing the scope of definition of infrastructure lending, relaxing the prudential single borrower exposure limit to 20 per cent of capital fund, assigning a concessional risk weight of 50 per cent on investment in securitised paper pertaining to an infrastructure facility, etc.

(d) Micro-finance

In order to put in place a more vibrant micro-finance delivery environment, Governor said RBI had a wide-ranging interface with a cross-section of micro-finance providers. Pursuant to these interactions, four informal Groups have been set up by RBI to look into issues relating to (i) structure and sustainability; (ii) funding; (iii) regulations; and (iv) capacity building for micro-finance delivery.

Money Market

(a) Moving towards Pure Inter-bank Call/Notice Money Market

Governor recalled that in the annual policy Statement of April 2001, the intention to move towards a pure inter-bank call/notice money market by gradually phasing out non-bank participation was highlighted. In view of subsequent encouraging developments, Governor proposed that:

- Stage II of the transition to a pure inter-bank call/notice money market will be effective from the fortnight beginning June 14, 2003, wherein non-bank participants would be allowed to lend, on average in a reporting fortnight, up to 75 per cent of their average daily lending in call/notice money market during 2000-01.

Governor, however, mentioned that in case a particular non-bank institution has difficulty in developing proper alternative avenues for investment of excess liquidity, RBI may consider providing temporary permission to lend a higher amount in call/notice money market for a specific period on a case by case basis.

(b) Reporting of Call/Notice Money Market Transactions on NDS Platform

Governor proposed that:

- From the fortnight beginning May 3, 2003, it would be mandatory for all Negotiated Dealing System (NDS) members to report all their call/notice money market deals on NDS. Deals done outside NDS should be reported within 15 minutes on NDS, irrespective of the size of the deal or whether the counterparty is a member of the NDS or not.

- Full compliance with the reporting requirement to NDS will be reviewed in September 2003. In case there is repeated non-reporting of deals by an NDS member, it will be considered whether non-reported deals by that member should be treated as invalid with effect from a future date.

(c) Introduction of New OTC Rupee Derivatives

Based on the recommendation of the Working Group on Rupee Derivatives Governor proposed that to begin with:

- Less complex over-the-counter (OTC) interest rate rupee options should be permitted in the first phase which include vanilla caps, floors and collars, European Swaptions, call and put options on fixed income instruments/ benchmark rates and unleveraged structured swaps based on overnight indexed swaps (OIS) and forward rate agreements (FRAs) where the risk profile of such structure is similar to that of the building blocks.
- Scheduled commercial banks, financial institutions and PDs should be allowed to both buy and sell options; corporates may sell options initially without being the net receivers of premium.

Detailed guidelines with respect to the operationalising the above proposals would be issued in consultation with market participants.

(d) Commercial Paper

In order to provide further flexibility to both issuers and investors, Governor proposed that:

- Non-bank entities including corporates may provide unconditional and irrevocable guarantee for credit enhancement for CP issue as long as (i) the issuer fulfils the eligibility criteria prescribed for issuance of CP, (ii) the guarantor has as at least one notch higher credit rating than the issuer by an approved credit rating agency, (iii) the offer document for CP should properly disclose : the net worth of the guarantor company; the names of the companies to which the guarantor has issued similar guarantees; the extent of the guarantees offered by the guarantor company, and the conditions under which the guarantee will be invoked.

- Banks are allowed to invest in CP guaranteed by non-bank entities provided their exposure remains within the regulatory ceiling as prescribed by RBI for unsecured exposures.

Governor indicated that detailed guidelines on procedures and documentation in this regard will be issued by FIMMDA.

Foreign Exchange Market

(a) Overseas Investment by Mutual Funds – General Permission

At present, mutual funds are allowed to invest in ADRs/GDRs of Indian companies and rated foreign debt instruments/equity within an overall cap of US $ 1.0 billion with the permission of SEBI and RBI. In order to simplify the procedure and to facilitate expeditious processing of investment proposals Governor proposed:

- To accord general permission to mutual funds for their overseas investments within the cap, once SEBI's approval has been obtained. This general permission will be available until further notice.

(b) Investment by Indian Corporates/Individuals in Rated Bonds/Fixed Income Securities

At present Indian corporates and resident individuals are permitted to invest in equities of listed companies abroad subject to certain conditions. Governor proposed to extend this facility to debt instruments also. Accordingly:

- Indian corporates and resident individuals will also be permitted to invest in rated bonds/fixed income securities of listed eligible companies abroad subject to certain conditions.

(c) Forward Cover for Inflows under Foreign Direct Investments

General permission has been accorded to banks to offer forward contracts to overseas investors to hedge their Foreign Direct Investment (FDI) to the extent of investments made in India. However, such FDI inflows are not permitted to be sold forward to banks. In order to provide greater flexibility to the overseas investors and encourage flow of FDI, Governor proposed:

- To allow overseas investors making long term investments to hedge their forex exposures in India, pending investment, by entering into forward sale contracts with banks in India.

(d) Forward Cover for Forex Exposures where Settlement is in Rupees

At present resident entities are not allowed to book forward cover in case of transactions denominated in foreign currency but settled in rupees. Keeping in view the exposures of such entities to exchange rate risk, Governor proposed:

- To permit entities which have transactions denominated in foreign currency but settled in rupees to book forward contracts. Such contracts should be held till maturity and cash settlement would be made on the maturity date.

(e) Cross Currency Forward Cover for FCNR Deposits

At present, non-resident Indians (NRIs) and Overseas Corporate Bodies (OCBs) can enter into forward contracts with rupee as one of the currency to hedge the balances held in FCNR(B) or

NRE Accounts. However, cross currency covers are not permitted for such deposits. In order to facilitate better risk hedging by NRIs and OCBs, Governor proposed:

- To allow NRIs/OCBs to book cross currency forward contracts to hedge the balances held in their FCNR(B) accounts. However, contracts once cancelled cannot be rebooked.

(f) Forex Clearing

Governor informed that the live operations for the clearing and settlement of spot and forward dollar-rupee transactions has commenced from November 12, 2002 by CCIL. This new facility for clearing and settling dollar rupee transactions in India is likely to provide substantial cost and time benefits to banks.

Government Securities Market

Reviewing the developments in the government securities market, Governor said that the Reserve Bank has taken a number of initiatives in the recent past in developing and deepening the government securities market. Further, NDS has been made operational for enabling on-line trading settlement and dissemination of trade information on a near real-time basis. The supervision of PDs was strengthened with prescription of certain minimum disclosure norms and extending repo eligibility to CSGL/gilt account holders.

Urban Co-operative banks

Relexations in respect of gold loans, deposits with other UCBs and size of unsecured advances

In pursuance to the recommendations made by the Committee, set up by the Government (Chairman: Hon' Shri Anant Geete) the following measures are proposed in consultation with the Government of India.

(a) 90 days Norm for Recognition of Loan Impairment – Exemptions

- To exempt gold loans and small loans both up to Rs.1 lakh from the 90 days norm for recognition of loan impairment. These loans would continue to be governed by 180 days norm for classification as NPA.

(b) Facility for Placement of Deposits with other Scheduled UCBs

- To permit UCBs to place deposits with strong scheduled UCBs (other than banks classified as weak or sick) with certain conditions. Detailed guidelines in this regard are being issued separately.

(c) Enhancement of Limit in the Ceiling on Unsecured Advances

In order to provide greater flexibility, it is proposed to revise the ceiling on the unsecured advances by scheduled UCBs to Rs.2 lakh. Upward revision has also been made in the ceiling on unsecured advances in respect of non-scheduled UCBs depending on their size. The enhanced ceiling would not, however, be applicable to weak/sick UCBs.

(d) Timely Compliance with Inspection Reports

The Joint Parliamentary Committee which enquired into the stock market scam and matters relating thereto, recommended that:

"RBI must introduce a system whereby the irregularities pointed out in the annual inspection reports are removed by the banks and compliance report is submitted within a period of six months from the date of inspection".

- In line with the above recommendation of the JPC, it has been decided that UCBs would be given maximum period of six months from the date of the inspection report to remove the irregularities pointed out in the inspection report in <u>all</u> respects, failing which RBI will invoke the penal provisions.

(e) Mandatory Concurrent Audit

The Joint Parliamentary Committee further recommended that:

"As an apex body, though it is not possible for RBI to monitor each and every transaction, it is essential that concurrent audit is conducted in the banks on a regular basis. The RBI may consider making this mandatory".

- In line with the above recommendation of the JPC, all UCBs are advised to introduce concurrent audit with immediate effect.

(f) Loans and Advances by UCBs to their Directors

Governor said that in regard to loans or advances or other financial accommodation by UCBs to their directors, the Joint Parliamentary Committee has recommended that:

"In order to prevent irregularities of the type surfaced in the case of some of the cooperative banks which were examined by the Committee, they are of the view that full ban on granting of loans and advances to the directors and their relatives, or the concerns in which they are interested needs to be imposed. Appropriate legal procedures may be initiated to ensure that there is no conflict of interest in the grant of loans and advances to the directors and their relatives and the concerns in which they are interested".

- In line with the above recommendation of the JPC, UCBs, with immediate effect, should not grant loans and advances (both secured and unsecured) to directors, their relatives and firms/concerns/ companies in which they are interested.

Governor, however, clarified that existing advances extended prior to April 29, 2003, may be allowed to continue up to the date when they are due. These advances should not be renewed or extended further.

Supervision and Monitoring

Progress made in respect of certain announcements made in the mid-term Review of October 2002 is reviewed below.

(a) Risk Based Supervision

Governor said that certain management processes were initiated by RBI for switching over to Risk Based Supervision (RBS) of banks during 2003. It is proposed to implement RBS of a few select banks on pilot basis during April-June 2003. Based on the experience gained, the RBS would be extended to all banks in a phased manner.

(b) Prompt Corrective Action

Governor said that an internal Group was set up to study the impact of the Prompt Corrective Action (PCA) framework on select weak banks. The scheme of PCA has been put in place initially for a period of one year and would be reviewed in December 2003. Banks have been advised to place the scheme before their Boards and take necessary steps in advance in order to ensure that as far as possible, they do not come within the scope of PCA framework.

(c) Consolidated Accounting and Supervision

Governor said that the final guidelines on consolidated accounting and supervision have been issued and banks were advised to ensure strict compliance commencing from the year ended March 31, 2003. The guidelines would be reviewed after one year from the date of implementation.

(d) Macro-prudential Indicators

Governor informed that the salient features of the macro-prudential indicators (MPIs) were enhanced and the review of the same for March 2002 was published in the Report on Trend and Progress of Banking in India 2001-02.

(e) Other Supervisory Initiatives

Governor highlighted other supervisory initiatives as under:

(i) The Reserve Bank has issued, in December 2002, a guidance note on Risk-Based Internal Audit System to banks. Banks are advised to place the same before their Boards for initiating necessary steps for transition to the system in a phased manner.

(ii) Detailed guidelines for preventing slippage of NPA accounts from sub-standard to doubtful/loss category were issued to banks suggesting, *inter alia*, that banks can introduce a new asset category of “Special Mention Accounts” in between “standard” and “sub-standard” accounts for their own internal monitoring and follow-up.

(iii) A comprehensive check-list for conducting computer audit recommended by the Committee on Computer Audit was circulated to banks and FIs. In addition, an Information System Audit Cell has been formed in RBI to scrutinise Annual Financial Inspection reports for initiating corrective action, if any, at the early stage. The Cell has also been entrusted with the work of updating the check-list with latest developments, revision of guidance notes for banks on risks and controls in a computer and communication systems, and updating the Manual for inspection of banks in computerised environment on an ongoing basis.

Prudential Measures

(a) Investment Fluctuation Reserve

As suggested by banks, and to give further relaxation in building IFR, Governor proposed that:

- While IFR would continue to be treated as Tier II capital, it would not be subject to the ceiling of 1.25 per cent of the total risk-weighted assets. However, for the purpose of compliance with the capital adequacy norms Tier II capital including IFR, would be considered up to a maximum of 100 per cent of total Tier I capital.

(b) Branch Licensing

In order to encourage more efficient banking services all over the country, Governor proposed that:

- RBI will consider favourably any proposal for transfer of branches in rural and semi-urban centres from one commercial bank to another by mutual agreement. Banks will be expected to ensure that such mutually agreed transfers do not adversely affect the available banking services in that area.

(c) Provisioning in respect of NPAs which would be sold to Securitisation/Asset Reconstruction Companies

Governor mentioned that the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, allows securitisation/ reconstruction company created under the Act, to purchase non-performing assets (NPAs) from banks. In order to facilitate sale of NPAs to securitisation/reconstruction companies, guidelines to banks and FIs have been issued. Governor advised banks to build up provisions, significantly above the minimum regulatory requirements, for their NPAs particularly for those assets which they propose to sell to securitisation companies/ reconstruction companies.

Technology Upgradation

Governor said that the Reserve Bank has assigned priority to the upgradation of technological infrastructure in the financial system. In this direction, the Payments System Vision Document giving the nature and direction of reforms needed to achieve the vision was set out. Substantial progress has been made since then for developing a modern, efficient, integrated and secure payment and settlement system for the financial services sectors.

Developments in Currency Management System

Governor said that over the years, growth in volume of currency has increased and posed serious problems in regard to the currency management function of RBI in the areas of supply of notes, quality of notes and withdrawal of notes from circulation. As part of the customer service, banks have been advised to open certain chest branches on Sundays for providing note exchange facility and distribution of coins. A Currency Link was set up at RBI website which covers various aspects related to Indian currency and coinage, images and security features of contemporary bank notes in Mahatma Gandhi series, frequently asked questions (FAQs) and press releases on currency issues. Governor advised banks to give wide publicity to the initiatives in the area of currency management for convenience of the public as also provision of good quality bank notes.

Legal Reforms

Governor mentioned that in the recent past, changes in the financial markets and advancement in information and technology have necessitated changes in legal structure. Accordingly, various proposals have been submitted to the Government for making the legal system more efficient to encounter the emerging scenario.

Mid-term Review

Governor concluded that a review of monetary and credit developments in the first half of the current year will be undertaken in October 2003.

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General Manager

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