Press Release

May 18, 2004

RBI Governor announces Annual Policy Statement for 2004-05

Highlights

Statement broadly follows the pattern already set in the previous years.

Domestic Developments

- **GDP growth for 2004-05 projected at 6.5-7.0 per cent.**
- **Assuming no significant supply shocks and appropriate management of liquidity, the inflation rate projected for policy purposes at around 5.0 per cent during 2004-05.**
- **Growth in reserve money and Money supply (M_3) were higher during 2003-04 reflecting capital inflows; the expansionary impact of foreign currency assets, however, was neutralised to a large extent by substantial open market operation (OMO) including sustained repo operations under LAF.**
- **Sustained pick-up in non-food credit since September; total flow of resources to the commercial sector was higher than last year.**
- **Government market borrowing programme in 2003-04 completed at a much lower cost; while noting reduction in fiscal deficit, need to step up capital expenditure stressed.**
- **Further reduction in interest rates in money and government securities markets observed in 2003-04.**
- **Public sector banks have reduced their BPLR in the range of 25-100 basis points.**
- **RBI to continue with its policy of active liquidity management; Market Stabilisation Scheme (MSS), is an additional tool.**

External Developments

- **Global economic recovery has broadened and strengthened faster than expected despite some uncertainties.**
- **The exchange rate of the rupee appreciated *vis-à-vis* US dollar but depreciated against the Euro, Pound sterling and Japanese yen in 2003-04.**
- **India's foreign exchange reserves increased by US $ 37.6 billion during fiscal 2003-04 and are at US $ 118.6 billion by May 7, 2004.**
- **India's exports in US dollar terms increased by 17.1 per cent while imports by 25.3 per cent; the current account expected to register surplus during 2003-04 for the third year in succession.**

- **Exchange rate management, as in the past, based on flexibility, without a fixed or pre-announced target, but with ability to intervene.**

- **The most distinguishing feature of the external sector during 2003-04 relates to the large capital flows with its inevitable implications for the conduct of domestic monetary policy and exchange rate management.**

Overall Assessment

- **Despite uncertainties, India's position among the top performers globally in terms of GDP growth is expected to continue during 2004-05.**

- **As regards prices, despite overhang of problems on account of oil prices and large domestic liquidity, price situation unlikely to cause concern to macro stability during 2004-05.**

- **Need to overcome the bottlenecks in flow of bank credit to agriculture and small & medium enterprises emphasised.**

- **Restructuring of rural banking sector stressed for enhancing the quality, purposiveness and reach of banking in India.**

- **Whereas the Reserve Bank will continue to provide a policy environment that avoids excessive and destabilizing volatility as a public good, market participants were urged to take into account the portfolio risks arising from any unexpected developments and provide adequately for them.**

- **The outlook for the external sector accords comfort to the conduct of public policies.**

Stance of Monetary Policy

- **Monetary management during 2003-04 broadly in conformity with the stance of the policy set out for the year.**

- **Projected expansion of money supply (M_3) at 14.0 per cent with credit growth by 16.0-16.5 per cent during 2004-05.**

- **Noticeable uncertainties including geopolitical risks impacting on international oil economy reckoned while designing the stance of monetary policy. As such, the inflationary situation needs to be watched closely and there could be no room for complacency on this count.**

- **The overall stance of monetary policy for 2004-05 will be: (i) provision of adequate liquidity to meet credit growth and support investment and export demand while keeping a very close watch on the movements in the price level. (ii) Consistent with the above, while continuing with *status quo*, RBI to pursue an interest rate environment that is conducive to maintaining momentum of growth and, macroeconomic and price stability.**

Measures

- **Bank Rate kept stable at 6.0 per cent.**

- **Repo Rate unchanged at 4.5 per cent.**

- **Revised LAF scheme operationalised.**

- **The entire export credit refinance was made available at reverse repo rate.**

- **Almost all banks have adopted the new system of BPLR and the rates are lower from their earlier PLRs.**

- **Banks are encouraged to align the pricing of credit to assessment of credit risk to improve credit delivery and credit culture.**

- **RBI accepted some recommendations of the interim Report of Vyas Committee for implementation, e.g., loans for storage facilities under priority sector, securitised agricultural loans as priority sector lending, waiving margin/security requirements for certain agricultural loans up to a limit, NPA norms for crops loans aligned to crop seasons.**
- **Development of mechanism for debt restructuring for medium enterprises on the lines of corporate debt restructuring.**
- **Definition of infrastrucutre lending broadened.**
- **Working Group constituted on Credit Enhancement by State Governments for financing infrastructure.**
- **A Gold Card Scheme for creditworthy exporters drawn up.**
- **Various restructuring options being considered by the Government and other stakeholders for rationalising the structure of RRBs - Vyas Committee is also looking into restructuring of RRBs.**
- **Limit on the lending of non-bank participants in the call/notice money market reduced to 45 percent effective June 26, 2004.**
- **Automated value-free transfer of securities proposed between market participants and the CCIL under CBLO.**
- **RBI constituted Working Group to review the performance of negotiated dealing system (NDS).**
- **Clearing of OTC derivatives through CCIL being considered.**
- **CCIL to work out arrangement for settlement of trades in non-SLR debt instruments for NDS members.**
- **Discussion paper on Capital Indexed Bonds being put in public domain.**
- **The ECB limit already enhanced to US $ 500 million under the automatic route for investment in the real sector.**
- **Resident individuals already permitted to remit freely up to US $ 25,000 per calendar year.**
- **Indian corporates and partnership firms allowed to invest overseas upto 100 per cent of their net worth.**
- **Banks allowed to raise long-term bonds to finance infrastructure.**
- **The extant limit on unsecured exposures for banks withdrawn.**
- **Exposures on all public financial institutions (PFIs) to attract a risk weight of 100 per cent.**
- **Banks required to maintain capital charge for market risk in a phased manner.**
- **Banks to draw a road map for migration to Basel II.**
- **Banks to make higher provisioning according to the age of NPAs.**
- **Banks/ FIs to provide credit information to CIBIL.**
- **Banks to fully adhere to the KYC policy for opening new accounts.**
- **Report of the Working Group on Financial Conglomerates is being put in public domain.**

- **Risk based supervision extended to more banks.**
- **Fresh licences to UCBs only after a comprehensive policy.**
- **Report of the Working Group on Development Finance Institutions is being put in public domain.**
- **Technical Group to evaluate the regulatory and supervisory systems deployed by refinancing institutions (RFIs).**
- **Waiver of service charges on banks for electronic funds transfer and electronic clearing services.**
- **RBI sets up a Board for Payment and Settlement Systems.**
- **RBI expects most commercial banks to join the RTGS system by June 2004.**
- **A Working Group on Electronic Funds Transfer for Capital Market constituted.**
- **Single window services for all transactions in RBI cash department.**
- **Operationalisation of On-line Tax Accounting System by June 2004.**
- **Standing Committee on Procedures and Performance Audit on Public Services has submitted four Reports, being put in the public domain.**
- **The recommendations of the Advisory/Technical Groups on International Financial Standards and Codes are being pursued.**

Press Release

May 18, 2004

RBI Governor announces Annual Policy Statement for the year 2004-05

Dr. Y.Venugopal Reddy, Governor, in a meeting with Chief Executives of major commercial banks today presented the annual policy Statement for 2004-05. At the outset, Governor mentioned that the Statement follows the pattern already set in the previous years. Broadly, the Statement covered a review of macroeconomic and monetary developments with several analytical and structural issues concerning financial sector and monetary policy. It delineated and elaborated on various areas in which RBI has been taking measures from time to time and provided a focus on broad policies that are intended to be pursued for the year 2004-05, while retaining the flexibility to take specific measures promptly and effectively as the evolving circumstances warrant. He announced a number of measures for strengthening the financial system, improving the credit delivery mechanism and indicated measures addressing institutional improvements to support growth consistent with stability in a medium-term perspective. He also underscored the need to deepen the consultative process to achieve further social good.

Domestic Developments

GDP Growth in 2003-04

Reviewing GDP growth for 2003-04, Governor said that the advance estimate released by the CSO in February 2004 has placed the GDP growth much higher at 8.1 per cent as against 4.0 per cent in the previous year reflecting, *inter alia*, a rebound in agricultural production.

Inflation Rate

The annual inflation rate as measured by variations in the wholesale price index (WPI), on a point-to-point basis, declined from 6.5 per cent at end-March 2003 to 4.5 per cent by end-March 2004. The annual rate of inflation during 2003-04, on an average basis, was, however, higher at 5.4 per cent as compared with 3.4 per cent in the previous year. The point-to-point inflation declined to 4.2 per cent as on May 1, 2004 as compared with 6.9 per cent a year ago. On an average basis, it was 5.2 per cent as compared with 3.9 per cent.

Monetary Indicators

Referring to monetary developments, Governor said that money supply (M_3) increased by 16.4 per cent during 2003-04 as compared with 12.8 per cent in the previous year, net of mergers. The growth in aggregate deposits of scheduled commercial banks at 17.3 per cent was higher than that of 13.4 per cent in the previous year, adjusted for mergers. The increase in reserve money during 2003-04 at 18.3 per cent was higher than that of 9.2 per cent in the previous year essentially because RBI's foreign currency assets increased by Rs.1,41,428 crore on top of an increase of Rs.82,089 crore in the previous year. The expansionary impact of foreign currency assets was neutralised to a large extent by substantial OMO including sustained repo operations under LAF. As per the latest data, year-on-year increase in reserve money was 13.3 per cent, as on May 7, 2004 as compared with 8.9 per cent a year ago.

Credit Flows

Non-food credit increased by 17.6 per cent during 2003-04 led by the housing and retail sectors as compared with an increase of 18.6 per cent, net of mergers, in the previous year. According to the latest data, the year-on-year increase in non-food bank credit was 20.5 per cent by end-April 2004 as compared with 16.4 per cent a year ago.

Government Borrowings

Governor stated that the Central Government revised the net market borrowings downwards in the Interim Budget to Rs.82,982 crore as against the originally budgeted net borrowings of Rs.1,07,194 crore. During 2003-04, the combined net market borrowings of the Centre and States were Rs.1,35,192 crore (gross Rs.1,98,157 crore). The weighted average cost of Central Government borrowings through dated securities declined from 7.34 per cent in 2002-03 to 5.71 per cent during 2003-04. The weighted average maturity of dated securities issued during 2003-04 at 14.94 years was higher as compared with 13.83 years in the previous year. During 2003-04, the state governments' net market borrowings at

Rs.46,376 crore were significantly higher than in the previous year (Rs.30,933 crore) mainly on account of Rs.26,623 crore towards the debt swap scheme mutually agreed between the Central Government and state governments towards repayment of high cost debt of the States to the Centre.

Banks' Investments

Governor observed that the banking system already holds government securities to the extent of 41.5 per cent of its net demand and time liabilities which entail significant interest rate risk as the yields on government securities are already at their historically low levels. It is, therefore, essential to pursue fiscal consolidation, promptly and with resolve, from a medium-term perspective.

Interest Rates

(i) Money market and government securities yields

Governor observed that interest rates have softened further in the system. The weighted average call money rate declined from 5.86 per cent in March 2003 to 4.37 per cent in March 2004 and further to 4.28 per cent by mid-May 2004. Similarly, the cut-off yields on 91-day and 364-day Treasury Bills also declined from 5.89 per cent each in March 2003 to 4.42 per cent and 4.45 per cent, respectively, as on May 12, 2004. The yields on government securities with 1-year residual maturity declined by 96 basis points from 5.50 per cent to 4.54 per cent over the period. The yields on 5-year and 10-year residual maturities declined from 5.92 and 6.21 per cent in March 2003 to 4.87 and 5.20 per cent, respectively, by mid-May 2004. The term deposit rates of public sector banks for maturities up to 1-year moved down from a range of 4.00-6.00 per cent in March 2003 to 3.75-5.25 per cent by April 2004. Overall, Governor noted that there has been a considerable flattening of the term structure of deposit rates.

(ii) Lending rates

Governor stated that almost all commercial banks have announced their BPLR in place of the earlier system of tenor-linked PLR. Public sector banks have reduced their rates by 25 to 100 basis points while announcing their BPLR. The range of BPLR for public sector banks is lower at 10.25-11.5 per cent. The compression in the range of PLRs of foreign and private sector banks is more evident.

As at end-March 2004, public sector banks' median (representative) lending rate for demand and term loans (at which maximum business is contracted), in the range of 11.0-12.75 per cent and 11.0-13.25 per cent, respectively, exhibited some moderation as compared with their corresponding levels of 11.5-14.0 per cent and 12.0-14.0 per cent, respectively, in March 2003.

Interest Rate Risk

Tracing the movement in interest rates during 2003-04, Governor exhorted bankers to take steps to build up investment fluctuation reserves (IFR) in a smooth and phased manner for better risk management.

Progress in the Banking Sector

Considerable progress has been made in developing the Indian banking sector into a vibrant, sound and well-functioning system. The Reserve Bank's persistent efforts towards strengthening of regulatory and supervisory norms to induce greater accountability and market discipline amongst the participants, adoption of international benchmarks as appropriate to Indian conditions, improvement in management practices and corporate governance, and upgradation of the technological infrastructure have enabled the banking system to emerge as a stronger, efficient and resilient system to meet global competition. While certain changes in the legal infrastructure are yet to be effected, the developments so far have brought the Indian financial system closer to global standards.

Monetary Management

Referring to the dynamics of monetary management in an increasingly open economy which was clearly evident during 2003-04, Governor said that even when the domestic interest rates remained consistent with domestic inflation, it engendered large capital flows in the wake of expectations over promising economic gains. Substantial liberalisation of capital and current account transactions further reinforced capital inflows, he added. However, he assured bankers that in order to ensure that appropriate liquidity is maintained in the system, RBI will continue with its policy of active management of liquidity through OMO including LAF, and using other policy instruments. The operationalisation of Market Stabilisation Scheme (MSS) has given an additional instrument for liquidity and monetary management.

External Developments

Global Economic Prospects Improved

Governor said that according to the latest update on world economy in April 2004 by the IMF, the world output growth for 2004 was placed higher at 4.6 per cent and at 4.4 per cent for 2005. He noted that the global economic recovery has broadened and strengthened faster than expected last November. He also noted that, in recent years, emerging markets have been major drivers of growth. However, he cautioned that several uncertainties still persist, which include firmness in global oil prices, volatility among major currencies and cyclical factors arising out of a pick-up in economic activity.

Global Developments – Major concerns

Drawing the attention of bankers to the possible global implications of interest rate uncertainties, the volatility among major currencies and their impact on capital flows and on the financial sector, Governor said these issues would remain the major concern for the emerging economies.

Forex Market Remains Stable

Governor noted that during 2003-04, the Indian foreign exchange market witnessed orderly conditions despite payments of US $ 5.2 billion in October 2003 on account of redemption of Resurgent India Bonds. The exchange rate of the rupee at Rs.47.50 per US dollar in March 2003 appreciated by 9.5 per cent to Rs.43.39 per US dollar by March 2004, but depreciated by 3.1 per cent against the Euro, 5.9 per cent against Pound sterling and 4.4 per cent against Japanese yen during the period.

Reserves Increase

Governor said RBI's policy to build a higher level of foreign exchange reserves takes into account anticipated current account deficits and "liquidity at risk" arising from unanticipated capital movements and added that India's foreign exchange reserves increased by US $ 37.6 billion from US $ 75.4 billion at end-March 2003 to US $ 113.0 billion by end-March 2004 and further to US $ 118.6 billion by May 7, 2004. Governor emphasised that exchange rate management was based on flexibility without a fixed target or a pre-announced target or a band with ability to intervene.

Exports and Imports

During 2003-04, India's exports in US dollar terms increased by 17.1 per cent as compared with 20.3 per cent in the previous year. Imports showed a higher increase of 25.3 per cent as compared with 17.0 per cent in the previous year.

Current Account Surplus

The current account of the balance of payments, which had remained in surplus consecutively in the previous two years, showed a surplus of US $ 3.2 billion during April-December 2003. The net accretion to foreign exchange reserves, including valuation changes, amounted to US $ 26.4 billion during April-December 2003. Going by current indications, India would register a current account surplus during 2003-04 for the third year in succession.

The most distinguishing feature of the external sector during 2003-04 relates to the large capital flows with its inevitable implications for the conduct of domestic monetary policy and exchange rate management. Delving at length on the various modes of policy intervention (categorised as market based vs non-market based), their *pros and cons*, Governor said that the primary objective of the monetary authorities in this context is to offset the impact of such foreign exchange market intervention, partly or wholly, so as to retain the intent of monetary policy. The degree of impact of such flows on domestic monetary policy, however, depends largely on the kind of exchange rate regime that the authorities follow. While in practice, the central banks do intervene in the forex markets in all countries, in emerging markets, a more intensive approach to intervention may be warranted in the context of large inflows. He also added that the key issue before the monetary authority is to determine whether the capital inflows are of a permanent and sustainable nature or whether such inflows are temporary and subject to reversal. In practice, however, such determination is difficult to achieve.

Stating that while OMO involving sale of securities as the commonly used instrument of sterilisation, he cited the availability of several other instruments to offset the impact of capital inflows on domestic money supply. Among the other important policy responses that can be used to manage large capital inflows are trade liberalisation, investment promotion, liberalisation of the capital account, management of external debt, management of non-debt flows, taxation of inflows and use of foreign exchange reserves.

Governor said that the recent movement of the exchange rate of the rupee has drawn attention to the external competitiveness of the economy and hence, a reference to the real effective exchange rate (REER) is appropriate and added that REER may not be relevant for day-to-day operations of RBI, but it cannot be ignored when considered in the medium to longer-term.

Overall Assessment

From an overall policy perspective and a qualitative assessment of major developments during the fiscal year 2003-04, Governor observed that assuming normal monsoon conditions, in spite of several uncertainties especially in the global economy, and unless there are totally unanticipated shocks, there are reasons to expect that in terms of growth in GDP in 2004-05, India will continue to be among the top performers globally.

On the price situation, Governor observed that there is an overhang of problems on account of oil prices and large domestic liquidity. However, in view of India's proven resilience to shocks, reasonable levels of food stocks coupled with prospects for a good monsoon, and the comfortable foreign exchange reserves, the price situation during 2004-05 is unlikely to cause concern to macro stability; but both on welfare considerations and impact on inflationary expectations, a very close watch is needed on the implications of global and other developments for India.

With regard to credit, Governor mentioned that there is a need for significant efforts to overcome the bottlenecks in flow of bank credit to agriculture and small & medium enterprises. Also, a step-up in investment activity in infrastructure would augment the prospects for credit off-take for productive sectors. He also indicated that the restructuring of Development Finance Institutions is under way and the contemplated restructuring of rural banking sector should help the process of enhancing the quality, purposiveness and reach of banking in India.

With regard to the global financial markets, Governor observed that the major issue that has now arisen for 2004-05 relates to the continuing macroeconomic imbalances in the United States, and their possible consequences on the rest of the world in addition to geopolitical uncertainties. These concerns include the impact on asset prices that could emerge internationally from any tightening of monetary policy that may take place in the coming months and on commodity prices, particularly oil. While the Reserve Bank will continue to provide a policy environment that avoids excessive and destabilising volatility as a public good, market participants are expected to take into account the portfolio risks arising from any unexpected developments and provide adequately for them. Further, the external sector has strengthened over the years. The outlook for the external sector accords comfort to the conduct of public policies.

Stance of Monetary Policy for 2004-05

Governor said that monetary management during 2003-04 was conducted broadly in conformity with the stance of the policy set out for the year and observed that the overall assessment of the developments during 2003-04 and the outlook for 2004-05, on a qualitative basis, provide grounds for optimism. He said that the stance of monetary policy will depend on several factors, and among them are: (a) prospects for the real sector, especially growth in GDP; (b) inflationary expectations; and (c) global developments. As regards GDP growth, he said that India may continue to be among top performers globally. For the purpose of monetary policy formulation, real GDP growth for 2004-05 may be placed in the range of 6.5 to 7.0 per cent, assuming sustained growth in the industrial sector, normal monsoon and good performance of exports. The realisation of such a rate of growth would signify a structural acceleration in growth rate of the economy. On the price situation, he observed that in view of the current trends, assuming no significant supply shocks and appropriate management of liquidity, the inflation rate in 2004-05, on a point-to-point basis, may be placed at around 5.0 per cent.

As regards the global developments, Governor said that the recovery appears more sustainable now and there is greater resilience in emerging economies. However, he noted that there are noticeable uncertainties and risks that should be reckoned with while designing the stance of monetary policy. In particular, the policy should take cognisance of the prospect that a significant trade deficit would continue with accelerated exports as well as imports, while recognising that its impact on the current account will, as in the past, be compensated by the remittances. The policy should also be prepared for the persistence of large capital flows.

Consistent with the real growth of GDP and inflation, the projected expansion of money supply (M_3) and aggregate deposits of scheduled commercial banks for 2004-05 are placed at 14.0 per cent and 14.5 per cent, respectively. Taking into account the market borrowings programmes of the Centre and State Governments, RBI expects to conduct debt management without serious pressure on overall liquidity and interest rates within the monetary projections for 2004-05.

In sum, the Governor observed that according to the present assessment, barring the emergence of any adverse and unexpected developments in the various sectors of the economy and assuming that the underlying inflationary situation does not turn adverse, the overall stance of monetary policy for 2004-05 will be:

- Provision of adequate liquidity to meet credit growth and support investment and export demand in the economy while keeping a very close watch on the movements in the price level.

- Consistent with the above, while continuing with the *status quo*, to pursue an interest rate environment that is conducive to maintaining the momentum of growth and, macroeconomic and price stability.

Financial Sector Reforms and Monetary Policy Measures

Governor pointed out that the financial sector now operates in a more competitive environment than before and intermediates relatively large volumes of international financial flows. Consequently, he said that the monetary policy formulation has become complex and, in particular, has to be alert to a possible build-up of financial imbalances and thus needs to explore ways and means of containing such shocks.

Reiterating the need for maintaining a conducive credit culture, Governor said that as financial institutions expand and grow more complex, it is also necessary to ensure that the quality of service to customers, especially the common person, is focused on and improved.

In order to ensure timely and effective implementation of the measures, RBI has been adopting a consultative approach before introducing policy measures so that the benefits of financial efficiency and stability percolates to the common person and the services of the Indian financial system can be benchmarked against international best standards in a transparent manner.

(a) Bank Rate - Kept stable at 6.0 per cent.

(b) Repo Rate – Kept unchanged at 4.5 per cent.

(c) Liquidity Adjustment Facility – Revised Scheme

Taking into account the recommendations of the Internal Group on LAF and the suggestions from the market participants and experts, the revised LAF scheme was operationalised effective March 29, 2004 through, *inter alia*, (i) 7-day fixed rate repo conducted daily and (ii) overnight fixed rate reverse repo conducted daily, on weekdays.

Considering the prevailing situation, the rate for the 7-day repo was retained by RBI at 4.50 per cent per annum. The reverse repo rate continues to be linked to the repo rate though at a lower spread of 150 basis points and was reduced to 6.00 per cent per annum with effect from March 29, 2004. Simultaneously, in order to rationalise the existing structure of provision of liquidity facility from RBI, the entire amount of export credit refinance to banks and liquidity support to primary dealers was made available at a single rate, at the reverse repo rate.

The Internal Group had proposed introduction of a standing deposit facility to provide more flexibility to RBI's repo facility as also to impart a floor to the movement of call money rates. The Reserve Bank agrees with the proposal, but this has to await amendment to the relevant provisions of the RBI Act, 1934.

Interest Rate Policy

Prime lending rate and spread

Referring to the advice by the Indian Banks' Association (IBA), Governor said that almost all commercial banks have adopted the new system of BPLR and the rates are lower in the range of 25-200 basis points from their earlier PLRs.

Governor observed that while there is intense competition among banks to lend to large top-rated borrowers, other borrowers with long standing relationship with banks and good credit record do not get the benefit of lower rates. Governor advised banks to take steps for putting in place comprehensive and rigorous risk assessment of borrowers using the database available with them, as also other internal and external factors so that the pricing of credit is related to risk more appropriately.

Credit Delivery Mechanism

(a) Priority sector lending

Referring to the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof. V.S. Vyas) constituted by RBI, Governor said that the Committee has submitted its interim Report and some of the recommendations made therein have been accepted by RBI for implementation.

(i) Loans for storage facilities

In order to further enhance credit flow to build up storage facilities, Governor proposed that:

- Loans to storage units, including cold storage units which are designed to store agricultural produce/products, irrespective of their location, would be treated as indirect agricultural finance under priority sector.

(ii) Investment by banks in securitised assets

With increasing emphasis on securitisation of agricultural loans, Governor proposed that:

- Investment by banks in securitised assets representing direct (indirect) lending to agriculture would be treated as their direct (indirect) lending to agriculture under priority sector, provided the securitised loans are originated by banks and financial institutions.

(iii) Agricultural loans - Waiver of margin/security requirements

Keeping in view the importance of flow of credit to agriculture, in particular to the smaller borrowers who may not have the necessary assets as collateral, Governor proposed that:

- Banks may waive margin/security requirements for agricultural loans up to Rs.50,000 and in the case of agri-business and agri-clinics for loans up to Rs.5 lakh.

(iv) NPA Norms in Agricultural Finance

In order to align the repayment dates with harvesting of crops, Governor proposed that:

- A loan granted for short duration crops will be treated as an NPA if the instalment of the principal or interest thereon remains unpaid for two crop seasons beyond the due date.

- A loan granted for long duration crops will be treated as an NPA if the instalment of the principal or interest thereon remains unpaid for one crop season beyond the due date.

- All the above prescriptions of crop loans would also be applicable, *mutatis mutandis*, to agricultural term loans.

(b) Micro-finance

In view of the need to protect the interests of depositors and on the basis of the recommendations of the Vyas Committee's Interim Report, Governor proposed that:

- Micro-finance institutions would not be permitted to accept public deposits unless they comply with the extant regulatory framework of the Reserve Bank.

(c) Kisan credit card scheme

A survey for assessing the impact of the Kisan Credit Card scheme was entrusted to National Council of Applied Economic Research. Governor stated that the Report is expected shortly.

(d) Policy framework for small and medium enterprises

The Working Group on Flow of Credit to SSI Sector (Chairman: Dr.A.S. Ganguly) has submitted its Report. Governor proposed that:

- In order to enable the banks to determine appropriate pricing of loans to small and medium enterprises, development of a system of proper credit records is useful. For this purpose, Credit Information Bureau of India Ltd. (CIBIL) would work out a mechanism, in consultation with RBI, SIDBI and IBA. Further, a mechanism for debt restructuring on the lines of the Corporate Debt Restructuring (CDR) is proposed to be developed for medium enterprises. A special Group would be constituted by RBI to suggest appropriate operational guidelines in this regard.

(e) Widening the scope of infrastructure lending

Keeping in view the critical importance of the infrastructure sector, Governor proposed:

- To expand the scope of definition of infrastructure lending to include the following projects/sectors: (i) construction relating to projects involving agro-processing and supply of inputs to agriculture; (ii) construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality; and (iii) construction of educational institutions and hospitals.

(f) Working Group on credit enhancement by state governments

Keeping in view the importance of infrastructure financing at the State level, Governor announced that a Working Group on Credit Enhancement by State Governments for financing infrastructure has been constituted with members drawn from the Government, state governments, select banks, FIs and RBI.

(g) Gold Card Scheme for exporters

Governor said that a Gold Card Scheme for creditworthy exporters with good track record for availability of export credit on best terms has been drawn up in consultation with select banks and exporters.

(h) Restructuring of regional rural banks

Governor said that with a view to rationalising the structure of RRBs and to move towards greater viability, various restructuring options are under consideration of the Government and other stake-holders. The Vyas Committee is also looking into the aspect of restructuring of RRBs and would explore various options for making appropriate recommendations to the Government.

(i) Restructuring of co-operative banks

Governor said that a scheme to revitalise the co-operative credit structure was announced by the Government. The Government has proposed that this scheme would be initiated as soon as the revised regulatory framework has been put in place.

Money Market

(a) Moving towards pure inter-bank call/notice money market

In view of further market developments as also to move towards a pure inter-bank call/notice money market, Governor proposed that:

- With effect from the fortnight beginning June 26, 2004, non-bank participants would be allowed to lend, on average in a reporting fortnight, up to 45 per cent of their average daily lending in call/notice money market during 2000-01.

(b) Collateralised borrowing and lending obligation (CBLO)

Governor announced that with a view to encouraging further development of the CBLO segment, it is proposed to:

- Facilitate automated value-free transfer of securities between market participants and the CCIL.

Government Securities Market

(a) Review of the negotiated dealing system

Keeping in view the encouraging developments in NDS and based on the experience gained over time, RBI has constituted a Working Group (Chairman: Dr.R.H.Patil) to review the performance of NDS in the context of its operational efficiency.

(b) Clearing of OTC interest rate derivatives by CCIL

Governor informed that in order to strengthen the OTC derivatives market and to mitigate the risks involved, a clearing arrangement through CCIL is being considered.

(c) Trade in non-SLR securities - Settlement and information

Governor said that CCIL is working out an arrangement for settlement on non-guaranteed basis and dissemination of information relating to trades in listed as well as unlisted non-SLR debt instruments by NDS members.

(d) Capital Indexed Bonds

Governor said that a discussion paper on Capital Indexed Bonds (CIB), detailing the product features of a modified CIB, is being put in the public domain.

(e) Market Stabilisation Scheme

Governor said that a Memorandum of Understanding (MoU) detailing the rationale and operational modalities of the Market Stabilisation Scheme (MSS) was signed between the Government of India and RBI on March 25, 2004. The intention of MSS is essentially to differentiate the liquidity absorption of a more enduring nature by way of sterilisation from the day-to-day normal liquidity management operations. In order to provide transparency and stability to the financial markets, to begin with, an indicative schedule for issuance of Treasury Bills/dated securities for Rs.35,500 crore under MSS for the quarter April-June 2004 was released on March 25, 2004. Treasury Bills and dated securities with a face value of Rs.27,000 crore were issued under the MSS up to May 14, 2004, out of which dated securities amounted to Rs.15,000 crore.

Foreign Exchange Market

(a) Housing loan in rupees to NRIs/PIO

As a further measure of liberalisation, Governor proposed:

- To allow the borrower's close relatives in India to repay the instalment of housing loans in rupees availed by NRIs/PIO, interest and other charges, if any, directly to the concerned authorised dealers/housing finance institutions.

(b) External commercial borrowings - Relaxation

Governor said that, on a review, the ECB limit has been enhanced to US $ 500 million under the automatic route with minimum average maturity of 5 years. End use for ECBs was enlarged to include overseas direct investment in Joint Ventures/Wholly Owned Subsidiaries in order to facilitate corporates to become global players. Further, banks and financial institutions that had participated in the textile or steel sector restructuring packages as approved by the Government were permitted under the approval route, to avail ECB.

(c) Remittance scheme for resident individuals – Liberalisation

Governor stated that, resident individuals are now permitted to remit freely up to US $ 25,000 per calendar year, for any current or capital account transaction or a combination of these.

(d) Overseas investment

In order to enhance the strategic presence of Indian corporates overseas, Indian corporates and partnership firms have been allowed to invest overseas upto 100 per cent of their net worth.

(e) Internal Group on external liabilities of banks

Governor announced that an Internal Group on External Liabilities of Scheduled Commercial Banks, constituted by RBI, submitted its Report in April 2004 which is being put in the public domain. On the basis of the recommendations of the Group, he said, RBI has implemented the following measures:

(i) The interest rates on NRE term deposits for one to three years were reduced to LIBOR/SWAP rates for US dollar of corresponding maturity effective April 17, 2004.

(ii) The ceiling on interest rate on NRE savings deposits was fixed at six-month US dollar LIBOR/SWAP rate; and no lien on these accounts, direct or indirect, would be permitted.

(iii) Entities other than authorised dealers or authorised banks were disallowed, effective April 24, 2004, from accepting fresh deposits from non-resident Indians, received either through fresh inward remittances or by debit to their NRE/FCNR(B) accounts.

Prudential Measures

In the areas of regulation and supervision, Governor stated that RBI is committed to continuing the reform process by adopting international best practices tempered with sufficient flexibility on account of the differences in the country's institutional framework and capacity, so as to minimise the burden on banks and financial institutions. In this direction, Governor proposed the following further measures:

(a) Long term bonds for infrastructure financing

In order to boost infrastructure lending, Governor proposed:

- To allow banks to raise long-term bonds with a minimum maturity of 5 years to the extent of their exposure of residual maturity of more than 5 years to the infrastructure sector.

(b) Withdrawal of limits on unsecured exposures

In order to extend further flexibility to banks on their loan policies, Governor proposed:

- To withdraw the extant limit on unsecured exposures to enable banks' Boards to fix their own policy on unsecured exposures.

- Banks would be required to make an additional provision of 10 per cent, i.e., a total provision of 20 per cent of the total outstanding advances in the substandard category to cover expected loss on unsecured exposures.

- Provision at the level of 100 per cent for unsecured exposures in doubtful and loss categories will continue as hitherto.

(c) Prudential credit exposure limits

In the light of the liberalised access of borrowers to ECBs and their ability to raise resources through capital/debt market, it has been decided to discontinue with the practice of giving case by case approval. Accordingly, Governor proposed that:

- Banks may, in exceptional circumstances, with the approval of their Boards, consider enhancement of the exposure to the borrower up to a maximum of further 5 per cent of capital funds, subject to the borrower consenting to the banks making appropriate disclosures in their Annual Reports. The additional allowance of 5 and 10 per cent of capital funds for single and group borrowers, respectively, for the infrastructure exposure would continue.

- Exposures of banks that are fully guaranteed by the Government of India would be exempt from the purview of credit exposure norms.

- Banks would phase out the excess exposures beyond the prescribed limits either by increasing capital funds or reducing exposures by March 31, 2005.

(d) Risk weight for exposure to public financial institutions

Governor proposed that:

- With effect from April 1, 2005, exposures on all PFIs will attract a risk weight of 100 per cent.

(e) Capital charge for market risk

With a view to ensuring smooth transition to the norms under Basel II, Governor proposed to phase the implementation of capital charge for market risk over a two-year period as under:

- Banks would be required to maintain capital charge for market risk in respect of their trading book exposures (including derivatives) by March 31, 2005.

- Banks would be required to maintain capital charge for market risk in respect of the securities included under available for sale (AFS) category by March 31, 2006.

(f) Preparation for implementing the New Capital Accord (Basel II)

As a well-established risk management system is a pre-requisite for implementation of advanced approaches under Basel II, Governor proposed that:

- Banks should examine in-depth the options available under Basel II and draw a road map by end-December 2004 for migration to Basel II and review the progress made thereof at quarterly intervals. The Reserve Bank will closely monitor the progress made by banks in this direction.

(g) Country risk management

Governor proposed:

- To extend the guidelines to countries where a bank has an exposure of 1.0 per cent or more of its assets with effect from the year ending March 31, 2005.

(h) Provisioning requirement for NPAs

With the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 and the chances/extent of recovery of an asset reducing over a period of time, it is essential that banks expedite recovery of NPAs. Accordingly, Governor proposed:

- To introduce graded higher provisioning requirement according to the age of NPAs, which are included under 'doubtful for more than three years' category, with effect from March 31, 2005.

(i) Wilful defaulters - Clarification on process

Representations have been received that the redressal of grievance after classification of borrowal accounts as 'wilful defaulters' is not fair in view of the damage that cannot be easily reversed. Governor clarified that the classification of borrowal accounts and the redressal mechanism are two distinct processes, comprising (i) identification of defaults as wilful with clear-cut reasons; and (ii) providing an opportunity to the borrower to make a representation before being classified as a wilful defaulter.

(j) Dissemination of credit information – Role of CIBIL

Governor stated that the Reserve Bank accords highest priority to the development of an efficient credit information system and would be closely monitoring the progress in this regard. With a view to developing a sound financial system, it is proposed that:

- The Boards of banks/FIs should review the measures taken for furnishing credit information in respect of all borrowers to CIBIL and report compliance to RBI.

- Credit Information Bureaus, like credit rating agencies, are critical for the operation of the financial system and, in many ways, have a privileged relationship with the regulator. As such, it is desirable that the objective should be to move towards a sufficiently diversified ownership with no single entity owning more than 10 per cent of the paid-up capital in the first stage, and 5 per cent later.

(k) Progress in debt recovery tribunals

Governor stated that on the basis of an internal review on the functioning of Debt Recovery Tribunals and in order to consider further improvements in this regard, RBI has requested the Government to set up a Working Group.

(l) KYC and privacy of customer relationship

In the context of Know Your Customer (KYC) principle, Governor advised that:

- Banks may fully adhere to the KYC policy adopted by their Boards for opening new accounts; they may limit its application to the existing accounts in such cases where the summation of the credit/debit transactions is more than Rs.10 lakh or where the banks suspect any unusual transaction.

- Banks may conduct KYC in all accounts belonging to trusts, intermediaries or where the accounts are operated through a mandate or power of attorney. The KYC procedure may be applied diligently to suit local conditions and should be completed by December 2004.

Banks have been advised that information collected by them for KYC purposes on a confidential basis should not be used for any other purpose such as cross-selling of products.

(m) Banks' investment in non-SLR securities

Governor said that with effect from January 1, 2005, only banks whose investment in unlisted non-SLR securities are within the prudential limits will be allowed to make fresh investment in such securities up to the prudential limits.

(n) Rationalisation of vigilance procedure in public sector banks

Governor indicated that Central Vigilance Commission has decided that only such vigilance cases in which an officer of the level of Scale V and above is involved need to be referred to the Commission for advice. Vigilance cases involving an officer in Scale IV and below may be handled by the banks themselves to enable expeditious disposal of the references. The modified arrangement is expected to provide a conducive environment for staff in public sector banks to perform their duties consistent with normal commercial judgement.

(o) Working Group on financial conglomerates

Governor indicated that an inter-agency Working Group renamed as the Working Group on Financial Conglomerates has suggested criteria for identifying financial conglomerates, a monitoring system for capturing intra-group transactions and exposures amongst such conglomerates and a mechanism for inter-regulatory exchange of information in respect of conglomerates.

(p) Prompt corrective action

Governor stated that the scheme was reviewed by BFS and it has been decided to continue with the PCA framework.

(q) Risk based supervision

Governor mentioned that it has been decided to extend the risk based supervision with some modifications to 15 more banks during the year 2004-05.

(r) Consolidated supervision

Governor observed that banks were advised to prepare and submit consolidated prudential reports to enable supervisory assessment of risks and adherence to certain prudential regulations on group basis. These reports are being reviewed by RBI on a half-yearly basis.

(s) Macro-prudential indicators

Governor said that the salient features of the macro-prudential reviews would be published on an annual basis.

Urban Co-operative Banks

Governor said that it has been the endeavour of RBI to develop the urban co-operative banking sector on sound line and proposed the following measures:

(a) Licensing of UCBs

In order to make the UCB sector strong, healthy and stable, Governor proposed:

- To consider issuance of fresh licences only after a comprehensive policy on UCBs, including an appropriate legal and regulatory framework for the sector, is put in place and a policy for improving the financial health of the urban co-operative banking sector is formulated early.

(b) Scheme of reconstruction of UCBs

A review of the progress made on implementation of the scheme of reconstruction of UCBs revealed that certain terms and conditions of the scheme, viz., infusion of funds and recovery of NPAs were not complied with. In the light of this experience, Governor proposed:

- To consider only such schemes of reconstruction which envisage re-capitalisation by the stakeholders, viz., the shareholders/co-operative institutions/Government to the extent of achieving the prescribed capital adequacy norms, without infusion of liquidity through settlement of insurance claims by DICGC, and schemes which lay a clear road-map for reducing the NPA level to tolerable limit within a stipulated time-frame.

Working Group on Development Finance Institutions

Governor mentioned that, a Working Group on Development Finance Institutions (Chairman: Shri N. Sadasivan) constituted for addressing the regulatory and supervisory issues relating to the term-lending institutions and refinancing institutions and for improving the flow of resources to them, has submitted its Report which is being put in the public domain.

Review of the regulatory and supervisory activities of the apex refinancing institutions

In order to ensure consistency and necessary convergence while retaining the features unique to each activity in the regulatory and supervisory framework of refinancing institutions (RFIs), Governor proposed:

- To constitute a Technical Group with representatives of RBI, apex refinancing institutions (RFIs) and outside experts to evaluate the efficacy of the regulatory and supervisory systems deployed by the RFIs, identify the gaps, if any, and to make recommendations for strengthening the framework. The Group may submit its report within four months.

Technology Upgradation

The status and progress regarding certain specific areas and further measures in technology upgradation were detailed by the Governor.

(a) Electronic clearing service and electronic funds transfer - Waiver of service charges

With a view to promoting electronic fund transfer (EFT) and encouraging electronic clearing service (ECS), Governor proposed to:

- Waive service charges on banks for both ECS and EFT transactions up to March 31, 2006.

(b) Board for Payment and Settlement Systems

Governor informed setting up of a Board for Payment and Settlement Systems (BPSS), which would function as a Committee of the Central Board.

(c) Real time gross settlement system

The live operations of RTGS system which commenced on March 26, 2004, has since stabilised with 25 banks. Governor expected that most of the commercial banks would be on the RTGS system by June 2004.

(d) Expert Group on central database management system

Governor informed constitution of an Expert Group (Chairman: Prof. A. Vaidyanathan) to guide the process of placing the publishable segment of central database management system (CDBMS) in the public domain for the convenience of researchers, analysts and other users.

(e) Working Group on electronic funds transfer for capital market

A Working Group on Electronic Funds Transfer for Capital Market consisting of representatives of SEBI, Stock Exchanges, National Securities Depository Limited and IRDA has been constituted by RBI. Governor observed that the

Group would assess the existing EFT facilities and make recommendations for increasing its coverage to facilitate T+1 settlement for the capital market.

Developments in Currency Management System

Since the mid-term Review of November 2003, a significant development has been, the fall in demand of coins as a result of which the reverse flow of coins has started. RBI has introduced single window services for all transactions in its Cash Department. Governor mentioned that while RBI has introduced issuance of receipts for counterfeit notes tendered across its counters, banks have also been advised to implement the same.

Conduct of Government Business

On-line Tax Accounting System

RBI had constituted a High Powered Committee (HPC) for operationalising an On-line Tax Accounting System (OLTAS). OLTAS is expected to be operationalised in June 2004. Further, CBDT would avail of electronic clearing scheme (ECS) facility of RBI for purposes of tax refunds up to Rs.25,000 to individual salaried tax payers in 12 cities to begin with. This facility would be extended to other cities in due course.

Standing Committee on Procedures and Performance Audit on Public Services

A Standing Committee was constituted on Procedures and Performance Audit on Public Services (Chairman: Shri S.S. Tarapore) to undertake procedures and performance audit on public services and regulatory clearances in RBI and to co-ordinate with the Ad hoc Committees on Customer Services set up by banks. Governor noted that the Committee has since submitted four reports which have emphasised that RBI should be a facilitator empowering the common person and safeguarding his rights in undertaking legitimate transactions.

(a) Report on foreign exchange transactions

The recommendations of the Committee on exchange control matters relating to individuals were examined by RBI and some of the suggestions have since been implemented.

(b) Government transactions relating to Individuals

In accordance with the Committee's recommendations on government transactions relating to individuals, RBI has initiated a number of steps to remove the deficiencies in the services provided by RBI and agency banks. Governor noted that necessary instructions have been issued to banks reinforcing the need for enhancing customer services.

(c) Banking operations

On the basis of the recommendations of the Committee on banking operations concerning deposit accounts and other facilities relating to individuals, the following measures have been implemented: (i) introduction of drop box facility for cheques and facility for acknowledgement for cheques through regular collection counters; (ii) delivery of cheque book over the counters on request; (iii) issue of statement of accounts at monthly intervals; (iv) informing the existing account holders at least one month in advance of any change in the minimum balance in savings accounts and charges for non-maintenance thereof; and (v) agreeing to the request for opening of non-resident ordinary (NRO) accounts jointly with residents.

The Reserve Bank is in agreement with the observations of the Committee on the disenfranchisement of the depositors as well as the need for thorough examination of operational procedures in the banks which are hampering settlement of claims of deceased depositors.

(d) Currency management

The Committee in its Report on Currency Management: Services Relating to Individuals (Non-business) recommended a more proactive role on the part of RBI and the scheduled commercial banks to further expand the customer service with quality.

(e) Ad hoc committees

Considering the progress made by the Ad hoc Committees constituted by banks to undertake procedures and performance audit on public services rendered by the bank and the need for taking appropriate action in redesigning procedures and practices, the currency of these Ad hoc Committees has been extended for a further period of six months. Governor underscored that RBI accords highest priority to the service of common persons.

Deposit Insurance

Governor noted that the the draft Banking Deposits Insurance Corporation (BDIC) Bill, 2003 is being revised on the basis of suggestions from the Government. The credit guarantee schemes of the Corporation has been discontinued as the credit institutions have gradually opted out of the scheme.

International Financial Standards and Codes

The recommendations of the Advisory/Technical Groups on International Financial Standards and Codes are being pursued by RBI, SEBI and IRDA relating to their respective areas. A review of the progress made so far in this direction was undertaken in order to identify areas where further action could be taken. Governor indicated that the review is being considered by a panel of advisers and is expected to be put in the public domain in two months.

Mid-term Review

As in the past, a review of the annual policy Statement will be undertaken in October/November 2004.

Alpana Killawala
Chief General Manager

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