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October 25, 2005

RBI Governor announces Mid-term Review of Annual Policy Statement for the year 2005-06

Highlights

Domestic Developments

- Based on the current assessment of a pick-up in agricultural output and in the momentum in other sectors, GDP growth projection for 2005-06 revised to 7.0-7.5 per cent from the earlier projection of around 7.0 per cent.
- Annual inflation, as measured by point-to-point variations in wholesale price index, receded from 6.0 per cent in April 2005 to 4.6 per cent in October 2005.
- Inflation in the range of 5.0-5.5 per cent as projected. Forward looking policy response is necessary to realise growth momentum and potential for higher growth without adding to inflation expectations.
- Money supply (M_3) may turn out to be somewhat higher than the earlier projection of 14.5 per cent for the full year. Aggregate deposit growth also expected to be higher than earlier projection.
- Year-on-year adjusted non-food credit is expected to increase significantly higher than 19.0 per cent projected earlier.
- Financial markets have remained stable and orderly, although interest rates have firmed up in almost all segments. The yield curve has steepened. Significant increase in CBLO volumes.
- Total liquidity sterilised in the form of MSS, LAF and surplus balances of Central Government increased from an average of about Rs.1,14,192 crore in March 2005 to Rs.1,20,076 crore in October 2005.
- The market borrowing programme of the Central Government has so far remained consistent with the projections set out in the Union Budget for 2005-06.

External Developments

- Exports in US dollar terms in the first half of 2005-06 increased by 20.5 per cent compared with 30.8 per cent in the corresponding period in the previous year. Imports rose by 33.1 per cent as against an increase of 37.3 per cent in the corresponding period last year. Hardening of international crude oil prices and import demand emanating from a pick-up in domestic industrial activity contributed to the import growth observed.

- Foreign exchange reserves stood at US$ 143.4 billion as on October 14, 2005, increasing from US$ 141.5 billion as at end-March 2005.

- Evolving developments in the balance of payments warrant careful monitoring in view of oil prices and continued strong investment demand.

- Foreign exchange market witnessed orderly conditions in the first half of 2005-06. The exchange rate of the rupee depreciated by 3.0 per cent to US dollar by October 21, 2005, from Rs.43.75 per US dollar at end-March 2005 to Rs.45.09 per US dollar. However, it appreciated by 4.2 per cent against the Euro, by 2.5 per cent against the Pound sterling and by 4.5 per cent against the Japanese yen during the period

Global Developments

- Global economic activity remained robust but slackened moderately in the second quarter of 2005; Likely growth of 4.3 per cent in 2005 from 5.1 per cent in 2004.

- Rise in oil prices has triggered inflationary pressures globally, remaining the single largest risk to the global economy.

- Risks to global growth also emanate from the persisting macroeconomic imbalances and the resulting abundance of global liquidity, asset bubbles, excessive leveraging in financial markets.

Overall Assessment

- On balance, macroeconomic and financial conditions have evolved as anticipated. Overall industrial growth has strengthened, monsoon fears have eased, non-food credit growth has been buoyant, the demand for government securities has been sustained and a pick-up in investment demand is evident.

- Some downward risks to the economic outlook have emerged in the recent months. Ensuring credit quality and increasing the pace of investment in infrastructure is important. Asset prices have registered a substantial increase. The overall positive sentiment, the business confidence of the private sector and the strength as well as resilience of the domestic economy would continue to determine capital flows.

Stance of Monetary Policy

- The Reserve Bank will continue to ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, consistent with the objective of price stability. Towards this end, RBI will continue with its policy of active demand management of liquidity through open market operations including MSS, LAF and CRR, and using all the policy instruments at its disposal flexibly, as and when the situation warrants.

- Barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy for the remaining part of the year will be: (i) Consistent with emphasis on price stability, provision of appropriate liquidity to meet genuine credit needs and support export and investment demand in the economy. (ii) Ensuring an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the growth momentum. (iii) To consider measures in a calibrated and prompt manner, in response to evolving circumstances with a view to stabilising inflationary expectations.

Monetary Measures

- Bank Rate kept unchanged at 6.0 per cent.

- Reverse Repo Rate increased by 25 basis points to 5.25 per cent, effective October 26, 2005. The spread between reverse repo rate and the repo rate under LAF maintained at 100 basis points.

- The cash reserve ratio (CRR) kept unchanged at 5.0 per cent.

Developmental and Regulatory Policies

Interest Rate Policy

- Indian Banks' Association being asked to review the benchmark prime lending rate (BPLR) system and issue transparent guidelines for appropriate pricing of credit.

Financial Markets

- The Reserve Bank has constituted a new department named as Financial Markets Department (FMD) in July 2005 with a view to moving towards functional separation between debt management and monetary operations.

- Intra-day short selling in government securities proposed to be introduced.

- NDS-OM module to be extended to all insurance entities which are mandated to invest in government securities.

- Screen-based negotiated quote-driven system for call/notice and term money markets and electronic trading platform for market repo operations in government securities are being developed by Clearing Corporation of India Ltd. (CCIL).

External Commercial Borrowings

- Special purpose vehicles (SPVs) or any other entity, notified by the Reserve Bank, which are set up to finance infrastructure companies/projects would be treated as financial institutions and ECBs raised by such entities would be considered under the approval route.

- Banks to be allowed to issue guarantees or standby letters of credit in respect of ECBs raised by textile companies for modernistation or expansion of textile units.

Credit Delivery Mechanisms

- Banks advised to fix their own targets for financing the SME sector so as to reflect higher disbursement; banks to formulate liberal and comprehensive policies for extending loans to the SME sector and rationalise the cost of loans to this sector with cost linked to credit ratings.

- A debt restructuring mechanism for units in the SME sector, in line with the corporate debt restructuring (CDR) mechanism prevailing in the banking sector, has been formulated by the Reserve Bank. The performance of the CDR mechanism was reviewed and the changes to the existing CDR scheme have been finalised.

- The Micro Finance Development Fund (MFDF) set up in the NABARD re-designated as the Microfinance Development and Equity Fund (MFDEF) and its corpus increased from Rs.100 crore to Rs.200 crore. The modalities in regard to the functioning of the MFDEF are being worked out.

- Internal Working Group proposed to examine the whole gamut of issues and suggest suitable revisions to guidelines in regard to relief measures to be provided in areas affected by natural calamities.

Financial Inclusion

- Measures proposed on credit delivery mechanisms with a view to ensuring financial inclusion of all segments of the population, in both rural and urban areas, a comprehensive framework to revive the co-operative credit system, revitalise the regional rural banks (RRBs) and reorient commercial banking towards the credit-disadvantaged sections of society.

- With a view to achieving greater financial inclusion all banks need to make available a basic banking `no frills' account either with `nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. All banks are urged to give wide publicity to the facility of such a `no-frills' account so as to ensure greater financial inclusion.

Prudential Measures

- Bank's aggregate capital market exposure restricted to 40 per cent of the net worth of the bank on a solo and consolidated basis; consolidated direct capital market exposure modified to 20 per cent of the bank's consolidated net worth. Banks having sound internal controls and robust risk management systems can approach the Reserve Bank for higher limits.

- General provisioning requirement for 'standard advances' increased from the present level of 0.25 per cent to 0.40 per cent; direct advances to agricultural and SME sectors exempted from the additional provisioning requirement.

- Supervisory review process to be initiated with select banks having significant exposure to some sectors, namely, real estate, highly leveraged NBFCs, venture capital funds and capital markets, in order to ensure that effective risk mitigants and sound internal controls are in place.

- General permission to banks to issue debit cards in tie-up with non-bank entities.

Institutional Developments

- By end-March 2006, 15,000 branches are proposed to be covered by RTGS connectivity, and the number of monthly transactions of the system is expected to expand from one lakh to two lakh.

- The National Electronic Funds Transfer (NEFT) system would be implemented in phases for all networked branches of banks all over the country.

- The pilot project for Cheque Truncation System is expected to be implemented in New Delhi by end-March 2006.

- National settlement system (NSS) to enable banks to manage liquidity in an efficient and cost effective manner to be introduced in the four metropolitan centres by end-December 2005.

- New company for retail payment systems proposed to be set up under Section 25 of Companies Act; to be owned and operated by banks and likely to get operational from April 1, 2006.

- Banks urged to test their business continuity plans periodically.

- Currency chest facility and licence to conduct foreign exchange business (authorised person licence) to scheduled UCBs registered under the Multi-State Co-operative Societies Act and under the State Acts where the State Governments concerned have assured regulatory coordination by entering into MoU with the Reserve Bank.

- Acquirer UCB to be permitted to amortise the losses taken over from the acquired UCB over a period of not more than five years, including the year of merger.

- Details of the scheme regarding implementation of the provisions of the Right to Information Act, 2005 have been placed on the Reserve Bank's website.

- The Reserve Bank has recently updated its nominal effective exchange rates (NEER) and real effective exchange rates (REER) indices. The new 6-currency indices and the revised 36-country indices of NEER and REER would be published in the the Reserve Bank of India Bulletin of December 2005.

The Third Quarter Review of Part I of the annual policy to be undertaken on January 24, 2006.

Alpana Killawala
Chief General manager

October 25, 2005

RBI Governor announces Mid-term Review of Annual Policy Statement for the year 2005-06

Dr. Y. Venugopal Reddy, Governor, in a meeting with Chief Executives of major commercial banks today presented the mid-term Review of the annual policy Statement for 2005-06. The Statement consists of two parts: Part I. Review of Annual Statement on Monetary Policy for the Year 2005-06; and Part II. Review of Annual Statement on Developmental and Regulatory Policies for the Year 2005-06. An analytical review of macroeconomic and monetary developments was issued, a day in advance, as a supplement to Part I of the Statement providing the necessary information and technical analysis with the help of simple charts and tables.

Domestic Developments

GDP Growth in 2005-06

Based on the current assessment of a pick-up in agricultural output and in the momentum in industrial and services sectors, Governor placed the GDP growth in 2005-06 in the range of 7.0-7.5 per cent as against around 7.0 per cent as projected earlier. He added that the *kharif* output may register an increase over the previous year's level. In addition, the improvement in water storage levels over the previous year augurs well for the outlook on *rabi* production. Prospects for sustained growth in industrial output have improved in an environment of rising investment and export demand, strong corporate profitability and buoyant business confidence.

Inflation Rate

Inflation, as measured by variations in the wholesale price index (WPI), on a point-to-point basis, receded from 6.0 per cent in April 2005 to 4.6 per cent by October 8, 2005 despite upward adjustments in the administered prices of petrol, diesel and electricity and increase in the prices of aviation turbine fuel, naphtha, furnace oil and iron and steel. On an average basis, annual inflation based on the WPI was 5.3 per cent as on October 8, 2005 as compared with 6.2 per cent a year ago. Governor said that the commitment to price stability has earned some success during the year so far. Given the outlook for inflation primarily in the context of the oil economy in India, however, it may be difficult to contain the inflation in the range of 5.0-5.5 per cent projected earlier without an appropriate policy response. It is also necessary to recognise and formulate a forward looking policy response in a manner that the growth momentum and the potential for higher growth is realised without adding to inflation expectations.

Monetary and Credit Indicators

Assessing the growth in monetary and credit aggregates, Governor said that money supply (M_3) has increased by 9.6 per cent in the first half and may turn out to be somewhat higher than the earlier projection of 14.5 per cent for the full year. Aggregate deposit growth is also expected to be higher than Rs.2,60,000 crore projected earlier. Non-food bank credit including investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP) etc., is expected to increase significantly, higher than 19.0

per cent projected earlier. Year-on-year adjusted non-food credit (including non-SLR investments) growth is at 27.8 per cent in the first half as compared with 21.4 per cent a year ago and is expected to increase significantly higher than 19.0 per cent projected earlier. Non-food credit has witnessed a structural shift towards the non-agriculture non-industrial sectors in recent years. However, credit off-take has been broad-based this year. Growth in non-agricultural non-industrial sector is led by housing, real estate and personal loans. Scheduled commercial banks' investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper (CP), etc., declined by 11.7 per cent in the first half as compared with a decline of 3.9 per cent in the corresponding period last year.

Fiscal Position and Government Borrowings

The revenue deficit and gross fiscal deficit (GFD) of the Central Government during April-August, 2005 accounted for about 78.0 per cent and 57.1 per cent of the budget estimates for 2005-06, as compared with 82.6 per cent and 38.2 per cent, respectively, in the corresponding period of the preceding year. The market borrowing programme of the Centre and States envisaged for 2005-06 is higher than in the previous year.

Governor mentioned that the market borrowing programme of the Central Government has so far remained consistent with the projections set out in the Union Budget. Underlying liquidity conditions and shifts in banks' portfolio preferences in favour of credit has, however, entailed some hardening of yields. Continued large borrowings from the market by the Centre and the States pose concerns for the efficient conduct of debt management as well as for monetary operations. Regarding market borrowing of the States, with the phasing out of Central Plan Loans to the States, higher devolution of taxes and grants from the Centre to the States and larger receipts from the national small saving fund (NSSF), States' market borrowings is not likely to be out of alignment with the net allocation for 2005-06.

Scheduled commercial banks' investment in government and other approved securities at Rs.14,283 crore in the first half of 2005-06 was lower than that of Rs. 28,526 crore in the first half of the previous year, partly on account of the pick-up in credit demand. A substantial support for the market borrowing programme has been coming from non-bank entities.

Liquidity Scenario

During 2005-06 up to October 14, 2005 additional liquidity of Rs.4,065 crore was absorbed under the MSS. Notwithstanding the MSS operations, surplus liquidity conditions resulted in the reverse repo volumes tendered under the LAF increasing from an average of Rs.29,809 crore in March to Rs.34,832 crore in August before declining to Rs.21,128 crore in October. Governor noted that up to July, the absorption of liquidity through the MSS was more than offset by decreasing reverse repo levels. Thereafter, LAF reverse repo increased sharply as liquidity conditions eased with the resumption of inflows from abroad. Total liquidity that remained sterilised (in the form of MSS, LAF and surplus balances of Central Government) increased from an average of about Rs.1,14,192 crore in March to Rs.1,23,844 crore in August before declining to Rs.1,20,076 crore in October 2005.

Financial Markets and Interest Rates

Financial markets have remained stable and orderly, although interest rates have firmed up in almost all segments. The average call money rate increased from 4.77 per cent in April to 5.06 per cent in October 2005 while it generally remained closely aligned with the LAF reverse repo rate. Treasury Bill rates increased. With a relatively higher increase in the long-term yields, there was a steepening of the yield curve. The average market repo rate increased from 4.63 per cent to 4.85 per cent, while the average collateralised borrowing and lending obligation (CBLO) rate increased from 4.58 per cent to 4.80 per cent. The average daily volume of CBLO increased significantly from Rs.5,185 crore to Rs.8,572 crore. Public sector banks kept their rates for deposits of over one year unchanged in the range of 5.25-6.50 per cent during April-September 2005. The benchmark prime lending rates (BPLRs) of public sector banks, private sector banks and foreign banks also remained unchanged in the first half of 2005. Equity market activity recorded a pick-up in terms of issuances. The BSE Sensex recovered from weak sentiment in April and rallied with intermittent corrections in the successive months and rose to a new peak of 8800 on October 4, 2005 after which it registered some decline.

External Developments

Exports, Imports and Trade Balance

Exports during the first half of 2005-06 increased by 20.5 per cent in US dollar terms as compared with 30.8 per cent in the corresponding period of the previous year. India’s merchandise export growth surpassed that of most Asian countries during this period. Imports rose by 33.1 per cent as against an increase of 37.3 per cent in the corresponding period last year. The overall trade deficit during the first half widened to US $ 20.3 billion from US $ 11.9 billion a year ago, reflecting the hardening of international crude oil prices and more significantly, import demand emanating from a pick-up in domestic industrial activity.

Balance of Payments

During 2004-05, the current account recorded a deficit of US $ 6.4 billion after remaining in surplus over the preceding three years beginning in 2001-02. The turnaround to current account balance deficit has entailed step-up in recourse to debt flows and a distinct moderation in the accretion to the reserves. Foreign exchange reserves at US$ 143.4 billion as on October 14, 2005 with net accretion of US$1.9 billion since April. There are significant shifts within balance of payments which have implications for the conduct of monetary policy. Import to GDP ratio having risen to 17.2 per cent in 2004-05, after hovering around 13.0 per cent during previous five years, the trade deficit is emerging as the key determinant of India’s balance of payments.

Governor explained that a key factor underlying the phenomenon of current account balances has been the buoyancy in net invisible earnings which has been sustained in the current financial year so far. Remittances from Indians employed abroad at 3.3 per cent of GDP seem to be of a significantly permanent nature. It is in this context that the current level of the trade deficit and the current account deficit appear to be manageable through normal capital flows. However, in view of the oil prices rise and continued strong investment demand, the evolving developments in the balance of payments warrant careful and continuous monitoring. He added that the substitution of debt by non-debt flows in preceding years gives room for manoeuvre since debt levels, particularly external commercial borrowings, have been moderate. The emphasis would continue to be on encouraging inflows through foreign direct investment and enhancement of the quality of portfolio flows.

Foreign Exchange Market

The Indian foreign exchange market has generally witnessed orderly conditions during the current financial year so far. The exchange rate of the rupee, which was Rs.43.75 per US dollar at end-March, 2005 depreciated by 3.0 per cent to Rs.45.09 per US dollar by October 21, 2005. However, it appreciated by 4.2 per cent against the Euro, by 2.5 per cent against the Pound sterling and by 4.5 per cent against the Japanese yen during the period.

The payment obligation on account of the redemption of India Millennium Deposits (IMDs) of about US $ 7.1 billion is due in December 2005. The Reserve Bank is closely coordinating with the State Bank of India (SBI) and other involved banks and it would be ensured that the discharge of liabilities would be without any adverse impact on Indian financial market.

Global Developments

Global Growth

Global economic activity has slackened in the second quarter of 2005, stalled by weak growth in the Euro area and Japan though domestic demand was sustained in the US. Growth has been robust in several developing countries, including those in Asia, led by China and India, Latin America, the Middle East and Russia. Global output growth to slow down moderately to 4.3 per cent in 2005 from 5.1 per cent in 2004.

Global Inflation

Rise in oil prices has triggered fears of generalised inflationary pressures globally. Consumer price inflation up in most advanced economies in the third quarter of 2005. Inflation has also risen in major emerging market economies, excluding China and in other developing countries. Oil price remain the single largest risk to the global economy exacerbated by the continued increase in global demand, geopolitical uncertainties, strong refining demand and a series of supply disruptions. It has a large permanent component which needs to be eventually passed to the consumers in medium-term but could lead to significant increase in domestic inflation and higher interest rates in the short-term.

Risks to Growth

Risks to global growth also emanate from the persisting macroeconomic imbalances and the resulting abundance of global liquidity which carries the potential of fuelling asset bubbles, excessive leveraging in financial markets and threats to global financial stability. The current configuration of good growth, low inflation, abundant liquidity, flat yield curves, lowering of credit risk premia and ever-expanding search for yields has benefited many emerging market economies. On the downside, the same combination of factors has allowed the macro imbalances to widen and has resulted in a build-up of debt, especially by the household sector. These factors have imparted an apparent stability to the financial system while sowing seeds of potential disequilibrium that might require a larger adjustment at a later stage. Monetary policy has also been tightened in several economies in emerging Asia, primarily in response to higher fuel prices. The indications in policy debates are towards either tightening or withdrawal of the accommodative stance.

Stance of Monetary Policy for the Second Half of 2005-06

Governor mentioned that the conduct of monetary policy during the first half of 2005-06 has been broadly in accordance with the stated stance. On balance, macroeconomic and financial conditions have evolved as anticipated. Overall industrial growth has strengthened, monsoon fears have eased, non-food credit growth has been buoyant, broad-based and supportive of the acceleration in industrial activity. However, the rising shares of housing and real estate in particular has warranted precautionary policy action to ensure credit quality. The demand for government securities from insurance companies and other non-bank financial institutions has been sustained. A pick-up in investment demand is evident and the business climate has improved considerably. Monetary conditions have evolved in an orderly manner. Liquidity mismatches have also been met in an orderly manner with the flexibility available, particularly under the LAF mechanism and operation of MSS. The pass-through of the escalation in international crude prices has been managed well and timed into the ebbing phase of inflation. Accordingly, the inflationary outcome has so far turned out to be consistent with initial projections and inflationary expectations are stable. Financial markets have remained stable and supportive of growth. Widening of the trade deficit has automatically absorbed the capital flows and economised on monetary policy action to sterilise these flows. Current account deficit remains within manageable limits, supported by rising international competitiveness of India's invisible exports and remittances from Indians working overseas.

However, several factors posing a downward risk to the outlook on growth and inflation have emerged in the recent months. Non-food credit expansion has been high. Despite high non-food credit growth, the share of credit to infrastructure remains low relative to the size and state of the economy. Inflation is low in terms of commodity prices but asset prices, especially housing prices, have registered a substantial increase. Asset price changes continue to pose a challenge for monetary policy as it can have a powerful effect on investment and/or consumption through a financial accelerator effect. Global crude oil prices continue to be high and volatile and an overwhelming part of the increase in recent years is now increasingly being regarded as permanent. Trade and current account deficit has been widening but the invisible surplus and capital inflows have ensured a comfortable balance of payments situation. International interest rates cycles had so far shown mixed behaviour but currently the general indications are that the accommodative stance is being withdrawn and, in some cases, may be tightened. This has implications for capital flows. Governor cautioned that these factors warrant close monitoring for sustaining the growth process with a tolerable level of inflation.

Upside inflationary pressures from oil prices can be expected to continue with attendant direct and indirect effects. So far, there has been only partial pass-through of international crude prices into domestic prices of petroleum products and second round effects have not yet become noticeably significant. At this stage, therefore, it is necessary to contain inflationary expectations in response to the evolving oil scenario and continue to take measures in a forward looking manner. It is necessary to be in readiness to take further measures as warranted to meet the challenges posed by the evolving situation, given the unfolding of the risks.

The Reserve Bank will continue to ensure that appropriate liquidity is maintained in the system so that all legitimate requirements of credit are met, consistent with the objective of price stability. Towards this end, RBI will continue with its policy of active demand management of liquidity through OMO including MSS, LAF and CRR, and using all the policy instruments at its disposal flexibly, as and when the situation warrants.

In sum, barring the emergence of any adverse and unexpected developments in various sectors of the economy and keeping in view the current assessment of the economy including the outlook for inflation, the overall stance of monetary policy for the remaining part of the year will be:

- Consistent with emphasis on price stability, provision of appropriate liquidity to meet genuine credit needs and support export and investment demand in the economy.
- Ensuring an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the growth momentum.
- To consider measures in a calibrated and prompt manner, in response to evolving circumstances with a view to stabilising inflationary expectations.

Monetary Measures

(a) Bank Rate

On a review of macroeconomic development, bank Rate kept unchanged at 6.0 per cent.

(b) Reverse Repo Rate

In view of the current macroeconomic and overall monetary conditions, it has been decided to increase the fixed reverse repo rate under the liquidity adjustment facility by 25 basis points with effect from October 26,2005 to 5.25 per cent. The repo rate will continue to be linked to the reverse repo rate. The spread between the reverse repo rate and the repo rate has been retained at 100 basis points, as at present. Accordingly, the fixed repo rate under LAF will be 6.25 per cent, effective October 26, 2005.

(c) Cash Reserve Ratio

The cash reserve ratio (CRR) of scheduled banks is currently at 5.0 per cent. While the Reserve Bank continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent, on a review of the current liquidity situation, it is felt desirable to keep the present level of CRR at 5.0 per cent unchanged.

Developmental and Regulatory Policies

Governor stated that the annual policy Statements as well as mid-term Reviews of the Reserve Bank have progressively sharpened the focus on developmental and regulatory policies to strengthen the financial system, with a view to ensuring financial stability as a prerequisite for high and stable growth. The Reserve Bank's approach has been to reorient its role in the context of the evolving conditions for improving institutional soundness, strengthening the regulatory and supervisory processes and developing the necessary legal and technological infrastructure. In this context, the Reserve Bank is continually broadening its consultative and participative process for wider involvement of all stakeholders in the financial system with a view to encouraging a more informed evaluation of the underlying content and quality of policies.

On the development and regulatory policies in this mid-term Review, the focus is one enhancing delivery of appropriate credit at a reasonable price, developing financial markets and enhancing the integration of various segments of the financial markets with proper checks and balances. Within the emphasis assigned to credit delivery to agriculture and the small and medium enterprise (SME) sector, developing a conducive environment for micro-finance institutions (MFIs) to cover financial services in addition to credit requires specific attention. With a view to ensuring financial inclusion of all segments of the population, in both rural and urban areas, a comprehensive framework to revive the co-operative credit system, revitalise the regional rural banks (RRBs) and reorient commercial banking towards the credit-disadvantaged sections of society assumes high priority.

Interest Rate Policy

On further deregulation of interest rates, Reserve Bank constituted an Internal Working Group on NRI Deposits which submitted its report in September 2005. Furthermore, the Indian Banks' Association (IBA) has been requested to constitute technical groups for preparation of discussion papers on review and deregulation of interest rate on savings bank deposits and lending rates on small loans up to Rs.2 lakh.

Review of BPLR system

Indian Banks' Association may, in consultation with its member banks, review the benchmark prime lending rate (BPLR) system and issue transparent guidelines for appropriate pricing of credit. Current system has not fully met expectations. Competition has forced the pricing of significant portion of loans far out of alignment with BPLRs and in non-transparent manner. There is a public perception that there is under-pricing of credit for corporates while there could be over-pricing of lending to agriculture and small and medium enterprises. Therefore, a need has arisen to review the current procedures and processes of pricing of credit through a well structured and segment-wise analysis of costs at various stages of intermediation in the whole credit cycle.

Financial Markets

Money Market

A screen-based negotiated quote-driven system for all dealings in call/notice and term money market and an electronic trading platform for conduct of market repo operations in government securities, in addition to the existing voice-based system, are being developed by Clearing Corporation of India Ltd. (CCIL).

Government Securities Market

As indicated earlier, in the post FRBM Act period, the Reserve Bank will reorient government debt management operations while simultaneously strengthening monetary operations in order to prepare for withdrawing from primary financing of the Central Government's borrowing programme, effective April 2006. Accordingly, the Reserve Bank has constituted a new department named as Financial Markets Department (FMD) in July 2005 with a view to moving towards functional separation between debt management and monetary operations. To begin with, the functions of the FMD include OMO, LAF, MSS and standing liquidity facilities; regulation and development of money market instruments and monitoring of money, government securities and foreign exchange markets. The functions of the FMD would also cover the Reserve Bank's operations in the domestic foreign exchange market, in due course, in order to achieve the desired integration with conduct of monetary operations.

The recommendations of the Technical Group relating to restructuring the underwriting obligations of primary dealers (PDs), allowing PDs exclusivity in primary auctions, introduction of 'When Issued' market and limited short selling in government securities were examined by the Reserve Bank in consultation with the Government. Accordingly, as a first step, it is proposed:

- to introduce intra-day short selling in government securities. Guidelines in this regard would be issued separately.

Operationalisation of Electronic Trading Platform

As indicated in the annual policy Statement of April 2005, a screen-based order-driven anonymous NDS Order Matching (NDS-OM) Module has been operationalised in August 2005. In the first phase, the NDS-OM module has been introduced for RBI-regulated NDS members. It is now proposed:

- to extend NDS-OM module to all insurance entities which are mandated to invest in government securities. Guidelines in this regard would be issued separately.

Revision of WMA/Overdraft Scheme for State Governments: Status

Advisory Committee to Review the WMA Scheme constituted in April 2005 (Chairman: Shri M.P. Bezbaruah) is expected to submit its report shortly. The report would then be discussed with the State Governments.

Foreign Exchange Market

The recommendations of the Internal Group on Forex Markets, particularly those on writing of covered options by corporates, hedging of economic risk of corporates in respect of their domestic operations arising out of changes in the landed cost of the imported substitutes of the commodities they consume/produce and crystallisation of overdue export bills, are under examination.

External Commercial Borrowings: Expansion

It is clarified that Special purpose vehicles (SPVs) or any other entity, notified by the Reserve Bank, which are set up to finance infrastructure companies/projects would be treated as financial institutions and ECBs raised by such entities would be considered under the approval route.

With a view to facilitating capacity expansion and technological upgradation in the Indian textile units after phasing out of the Multi-Fibre Agreement, it is proposed:

- to allow banks to issue guarantees or standby letters of credit in respect of ECBs raised by textile companies for modernisation or expansion of textile units. Such applications would be considered under the approval route subject to prudential norms.

Credit Delivery Mechanisms

Flow of Credit to Agriculture

It has been the endeavour of the Reserve Bank to improve the agricultural credit delivery mechanism to enable banks to provide adequate and timely finance at reasonable rates. During 2004-05, disbursements to agriculture by public sector banks under special agricultural credit plans (SACP) aggregated Rs.65,218 crore against the projection of Rs.55,616 crore. By end-June 2005, public sector banks had issued 183.5 lakh kisan credit cards (KCCs) with aggregate limits amounting to Rs.62,000 crore. As announced in the Union Budget for 2005-06, Rural Infrastructure Development Fund (RIDF) XI has been established with the NABARD with a corpus of Rs.8,000 crore. Cumulative sanctions and disbursements till August 2005, under various tranches of RIDF (I to XI) amounted to Rs.44,389 crore and Rs.26,693 crore, respectively.

Priority Sector Lending

An Internal Working Group (Chairman: Shri C. S. Murthy) was set up by the Reserve Bank to review the existing policy on priority sector lending including the segments constituting the priority sector, targets and sub-targets and recommend changes as necessary. The draft technical paper of the Group has been placed on the Reserve Bank's website for wider dissemination and comments. The technical paper has also been sent to the Government and the IBA for their views.

Credit Flow to Small and Medium Enterprises

As a sequel to the announcement made by the Hon'ble Finance Minister in the Parliament on August 10, 2005 in regard to a policy package for stepping up credit to small and medium enterprises, banks were advised to fix their own targets for financing the SME sector so as to reflect a higher disbursement over the immediately preceding year and to formulate liberal and comprehensive policies for extending loans to the SME sector. Banks also asked to rationalise the cost of loans to this sector with the cost transparently linked to the credit ratings. Units with investment in plant and machinery in excess of the small scale industries (SSI) limit and up to Rs.10 crore would be treated as medium enterprises (ME) and only SSI financing would be included in priority sector lending. Banks should make concerted efforts to provide credit cover to at least five new small/medium enterprises per year on an average, at each of their semi-urban/urban branches. Banks should increasingly adopt the cluster-based approach for financing the SME sector and ensure presence of specialised SME branches in identified clusters/centres with preponderance of medium enterprises to provide SME entrepreneurs easy access to bank credit and also equip their personnel with requisite expertise.

The Reserve Bank has constituted empowered committees at its regional offices to review the progress in SME financing and rehabilitation of sick SSI and ME units so as to ensure smooth flow of credit to these sectors. The Reserve Bank has also formulated a one-time settlement scheme for recovery of non-performing assets (NPAs) below Rs.10 crore for SME accounts and detailed guidelines have been issued to public sector banks for implementation. A debt restructuring mechanism for units in the SME sector, in line with the corporate debt restructuring (CDR) mechanism prevailing in the banking sector, has been formulated by the Reserve Bank and guidelines were issued to banks for implementation.

Restructuring and Development of Regional Rural Banks

As indicated in the annual policy Statement of April 2005, an Internal Group (Chairman: Shri A. V. Sardesai) was set up by the Reserve Bank to examine various alternatives available within the existing legal framework for strengthening regional rural banks (RRBs). The Group submitted its report in June 2005 which has been sent to the Government for their comments. The major recommendations of the Group include merger/amalgamation of RRBs to improve operational viability, change of sponsor banks to enhance competitiveness, strengthening of balance sheets in respect of merged entities, regulatory and supervisory strengthening, governance and management and scope for improving profitability.

Micro-finance

The programme of linking self-help groups (SHGs) with the banking system continues to be the major micro-finance programme in the country and is being implemented by commercial banks, RRBs and co-operative banks. By end-July 2005, as many as 16,53,047 SHGs were linked to banks and the total flow of credit to SHGs was Rs.7,063 crore.

The following measures have been initiated to give further impetus to the micro-finance endeavour:

- In pursuance of the Union Budget, 2005-06, the Micro Finance Development Fund (MFDF) set up in the NABARD has been re-designated as the Microfinance Development and Equity Fund (MFDEF) and its corpus has increased from Rs.100 crore to Rs.200 crore. The modalities in regard to the functioning of the MFDEF are being worked out.
- The Internal Group (Chairman: Shri H.R. Khan) constituted by the Reserve Bank to examine issues relating to rural credit and micro-finance

- submitted its report in July 2005. Important recommendations of the Group include providing comprehensive financial services in rural areas encompassing savings, credit, remittance, insurance and pension products and establishing linkages between banks and external entities based on two broad models viz., business facilitator model and business correspondent model. The recommendations of the Group are under examination.

Revival of Rural Co-operative Banking Institutions and Long-term Co-operative Credit Structure

The Task Force appointed by the Government (Chairman: Prof. A. Vaidyanathan) to propose an action plan for reviving the rural co-operative banking institutions, and suggesting an appropriate regulatory framework for these institutions submitted its report in February 2005. The Government has accepted the recommendations of the Task Force, in principle, and held consultative meetings with the State Governments.

Special Relief Measures by Banks in Areas Affected by Natural Calamities

The Reserve Bank has issued guidelines/instructions to banks in regard to relief measures to be provided in areas affected by natural calamities from time to time. These guidelines cover various relief measures pertaining to credit to existing borrowers, mainly in the agricultural sector. In the backdrop of the experience of recent calamities, it is proposed to constitute an internal Working Group to examine the whole gamut of issues and suggest suitable revisions to the existing guidelines, with a view to making them comprehensive.

Prudential Measures

Capital Market Exposure Limits: Rationalisation

The Reserve Bank has undertaken a review of the prudential limits on the capital market exposure with a view to rationalising them in terms of base and coverage. Accordingly, it is proposed:

- to restrict bank's aggregate capital market exposure to 40 per cent of the net worth of the bank on a solo and consolidated basis.
- to modify bank's consolidated direct capital market exposure to 20 per cent of the bank's consolidated net worth.
- to simplify and rationalise the exemptions in regard to the coverage.

Banks exceeding these limits either on solo or consolidated basis, should approach the Reserve Bank with a plan for bringing down the exposure within the permissible limits. Banks having sound internal controls and robust risk management systems can approach the Reserve Bank for higher limits. Guidelines in this regard would be issued separately.

Prudential Provisioning Requirements: Review

Traditionally, banks' loans and advances portfolio is pro-cyclical and tends to grow faster during an expansionary phase and grows slowly during a recessionary phase. During times of expansion and accelerated credit growth, there is a tendency to underestimate the level of inherent risk and the converse holds good during times of recession. Taking into account the recent trends in the credit growth, it is proposed:

- to increase the general provisioning requirement for 'standard advances' from the present level of 0.25 per cent to 0.40 per cent. However, banks' direct advances to agricultural and SME sectors would be exempted from the additional provisioning requirement. As hitherto, these provisions would be eligible for inclusion in Tier II capital for capital adequacy purposes up to the permitted extent.

New Capital Adequacy Framework: Status

Draft guidelines for implementation of the New Capital Adequacy Framework have been formulated and placed on the Reserve Bank's website. In line with international standards, banks were advised to adopt the Standardised Approach for credit risk with effect from March 31, 2007. Banks adopting the Standardised Approach would use the rating assigned by only those credit rating agencies which are identified by the Reserve Bank. Accordingly, an in-house Group of the Reserve Bank has been constituted for identifying the external rating agencies. Final guidelines would be issued on the basis of the recommendations of the Group and the feedback received thereon.

The Reserve Bank has issued a 'Guidance Note on Management of Operational Risk' in October 2005 to facilitate a smooth transition to the New Framework. Banks using BIA are encouraged to comply with 'Sound Practices for the Management and Supervision of Operational Risk' issued by the Basel Committee on Banking Supervision (BCBS) in February 2003.

The BCBS has undertaken the Fifth Quantitative Impact Study (QIS-5) to assess the impact of adoption of New Capital Adequacy Framework. Twelve banks identified to participate in the QIS-5.

Capital Adequacy Requirements

The banks have been advised that those banks which have maintained regulatory capital of at least nine per cent of the risk weighted assets for both credit as well as market risks in respect of 'held for trading' (HFT) and 'available for sale' (AFS) categories, as on March 31, 2006, would be permitted to treat the entire balance in the investment fluctuation reserve (IFR) as Tier I capital. Once the amount of IFR is so transferred towards Tier I capital, a headroom for raising an equal amount of Tier II capital would become available to the eligible banks, up to half of which could be raised through issuance of subordinated debt.

Internationally, banks raise capital through equity shares and instruments such as subordinated debt and preference shares which are eligible for inclusion in Tier I/Tier II/Tier III capital. Banks in India, however, do not currently have such options available except for raising Tier II capital through subordinated debt to a limited extent. The Reserve Bank is examining various types of capital instruments that could be permitted under the New Capital Adequacy Framework.

Corporate Debt Restructuring Mechanism

As mentioned in the annual policy Statement of April 2005, performance of the corporate debt restructuring (CDR) mechanism was reviewed. The changes to the existing CDR scheme have been finalised taking into account the feedback received. Operational guidelines in this regard would be issued separately.

Supervisory Review Process

Having regard to the recent trends in the credit markets, it is proposed:

- to initiate a supervisory review process with select banks having significant exposure to some sectors, namely, real estate, highly leveraged NBFCs, venture capital funds and capital markets, in order to ensure that effective risk mitigants and sound internal controls are **in** place for managing such exposures.

Financing of NBFCs

As indicated in the annual policy Statement, an Informal Working Group (Chairperson: Smt. Usha Thorat) was constituted to examine the issues involved in financing of NBFCs. The recommendations of the Group include extending bank finance to NBFCs for permissible activities; using NBFCs as business correspondents or agents; permitting banks to rediscount the bills discounted by NBFCs pertaining to the transport sector; using NBFCs as a conduit for providing long-term funds to the SME sector; and extending training facilities to NBFCs engaged in financing the SSI and agriculture sectors. The recommendations are under examination.

Credit Information Companies (Regulation) Act, 2005: Status

A Working Group (Chairman: Shri Prashant Saran) was constituted with representatives from the Reserve Bank, the IBA, the Credit Information Bureau of India Ltd. (CIBIL) and select banks. The Group, in consultation with the Ministry of Law, prepared the draft rules and regulations for implementation of the Credit Information Companies (Regulation) Act, 2005. The draft rules and regulations are being examined by the Reserve Bank.

Setting up of Banking Codes and Standards Board of India: Status

Modalities regarding setting up of an independent Banking Codes and Standards Board of India (BCSBI) on the model of the mechanism in the UK are being worked out in pursuance of the annual policy Statement of April 2005 in order to ensure that a comprehensive code of conduct for fair treatment of customers is established.

Financial Inclusion

The annual policy Statement of April 2005 while recognising the concerns in regard to the banking practices that tend to exclude rather than attract vast sections of population, urged banks to review their existing practices to align them with the objective of financial inclusion. With a view to achieving greater financial inclusion all banks need to make available a basic banking `no frills' account either with `nil' or very low minimum balances as well as charges that would make such accounts accessible to vast sections of population. All banks are urged to give wide publicity to the facility of such a `no-frills' account so as to ensure greater financial inclusion.

Issue of Co-branded Debit Cards by Banks

At present, banks are required to obtain the Reserve Bank's approval for issue of debit cards in tie-up with other non-bank entities for marketing and distribution purposes. In order to further liberalise the procedure, it is proposed:

- to accord general permission to banks to issue debit cards in tie-up with non-bank entities subject to certain conditions. Detailed instructions would be issued separately.

Anti-Money Laundering Guidelines: Status

In November, 2004 the Reserve Bank revised the guidelines on ‘Know Your Customer’ (KYC) principles in line with the recommendations made by the Financial Action Task Force (FATF) on Standards for Anti-Money Laundering (AML) and Combating Financing of Terrorism (CFT). Banks were advised to frame their KYC policies with the approval of their boards and ensure that they are compliant with its provisions by December 31, 2005. In order to ensure that the inability of persons belonging to low income groups to produce documents to establish their identity and address does not lead to their financial exclusion and denial of banking services, a simplified procedure has been provided for opening of account in respect of those persons who do not intend to keep balances above Rs.50,000 and whose total credit in one year is not expected to exceed Rs.1,00,000.

Institutional Developments

Payment and Settlement Systems

Electronic Payment Products: Status and Proposed Action

The coverage of Real Time Gross Settlement (RTGS) system has increased significantly. Connectivity is now available in 11,280 bank branches at 508 cities. By end-March 2006, 15,000 branches are proposed to be covered and the number of monthly transactions of the system is expected to expand from one lakh to two lakh.

The National Electronic Funds Transfer (NEFT) system for electronic transfer of funds would be implemented in phases for all networked branches of banks all over the country.

The pilot project for Cheque Truncation System, which aims at enhancing efficiency in the retail cheque clearing sector, is expected to be implemented in New Delhi by end-March 2006.

The clearing position of banks in various clearing houses would be settled centrally through a national settlement system (NSS) in order to enable banks to manage liquidity in an efficient and cost effective manner. Accordingly, it is proposed to introduce NSS in the four metropolitan centres by end-December 2005.

Umbrella Organisation for Retail Payment Systems: Progress
The Vision Document for Payment and Settlement Systems, 2005-2008 envisages establishment of an institutional structure owned by banks and other financial institutions for retail payment systems. The IBA constituted a Working Group to study the proposal. The Working Group has now recommended setting up of a company under Section 25 of the Companies Act, 1956 which would be owned and operated by banks. The recommendations are under consideration and the new organisation is likely to get operational with effect from April 1, 2006.

Business Continuity Plan: Contingency Plan
The Reserve Bank has drawn up a disaster recovery plan for all critical applications including RTGS, the performance of which is tested at quarterly intervals. There is also a need for banks to ensure that their plans for business continuity are adequate and comprehensive which could resume business functionalities quickly in a situation of disaster to transact normal business. Banks are, therefore, urged to test their business continuity plans periodically and ensure continuous service.

Urban Co-operative Banks
Vision Document for UCBs: Medium-term Framework
A medium-term framework for urban co-operative banks (UCBs) is being developed on the basis of feedback received on the draft 'Vision Document for Urban Co-operative Banks'. The Reserve Bank has signed a MoU with three State Governments, viz., Andhra Pradesh, Gujarat and Karnataka, and is in the process of entering into MoUs with other States having sizeable presence of UCBs. The draft Vision Document also envisages that facilities and opportunities available to commercial banks should, as far as possible, also be made available to UCBs other than unit and single district banks with deposits less than Rs.100 crore. Accordingly, it is proposed:

- to extend currency chest facility and issuance of licence to conduct foreign exchange business (authorised person licence) to scheduled UCBs registered under the Multi-State Co-operative Societies Act and under the State Acts where the State Governments concerned have assured regulatory coordination by entering into MoU with the Reserve Bank. The eligibility norms for these facilities would be notified separately.

Merger/Amalgamation of UCBs
Guidelines on merger/amalgamation in the UCB sector were issued by the Reserve Bank with a view to facilitating emergence of strong entities and for providing an avenue for non-disruptive exit of unviable entities. In order to further smoothen the process of merger in the UCB sector, it is proposed:

- to permit the acquirer UCB to amortise the losses taken over from the acquired UCB over a period of not more than five years, including the year of merger.

90 Days Norm for UCBs: Relaxation

The Reserve Bank has relaxed the 90 days delinquency norm for certain categories of UCBs on request. The relaxation would be valid up to end-March 2007.

Restructuring of Weak Scheduled UCBs

The Reserve Bank has begun a consultative process for revitalisation and rehabilitation of weak scheduled UCBs. 10 weak scheduled UCBs are in the process of restructuring and the Reserve Bank is monitoring their progress.

The Right to Information Act, 2005

Pursuant to the enactment Right to Information Act, 2005, the Reserve Bank has designated the Chief General Manager-in-Charge of Department of Administration and Personnel Management as the Chief Public Information Officer. Details of the scheme regarding implementation of the provisions of the Act have been placed on the Reserve Bank's website.

Computation of Exchange Rate Indices - New Series

The Reserve Bank has recently updated its nominal effective exchange rates (NEER) and real effective exchange rates (REER) indices. The 5-country indices have been replaced by new 6-currency indices. The Chinese Renminbi and the Hong Kong Dollar are included, while French franc and Deutsche mark are replaced by the Euro. The new indices use 3-year moving average trade weights in place of the fixed trade weights. The new series would be published in the the Reserve Bank of India Bulletin of December 2005. Simultaneously, the broader 36-country indices of NEER and REER, with 1985 as the base year, will be updated to 1993-94 as the base year.

Alpana Killawala
Chief General Manager

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