FOR RESTRICTED CIRCULATION

REPORT ON SELECTIVE CREDIT CONTROL SYSTEM

SEPTEMBER 1978

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INTRODUCTION

1.1 The Reserve Bank of India has been using certain control measures on bank advances against a few selected commodities since 1956. Several things have happened during these twenty two years. First, a fairly good amount of experience has accumulated. It would be useful to look back and evaluate this experience in order to find out how far these controls have served the purpose for which they were instituted and for which they have been operated all these years. Second, in the mean time the general economic context has changed. This necessitates examination of relevance of these control measures in their present form. The designs of other physical and credit controls that are closely related to selective credit control measures have in recent years been considerably modified. It might, therefore, prove useful to examine how far these latter set of controls need to be modified in order to fit in with the changing situations Third, occasionally criticism regarding certain features of selective credit control has been made both in banking and business circles to point out some of the difficulties faced in operating them. These deficiencies also need to be considered and made up.

Keeping such needs in mind, the Reserve Bank of India decided for the present one-man investigation into the working of its selective credit control.

1.2 The terms of reference laid down for the purpose are stated below. This investigation is meant to cover the following aspects:

"(i) to evaluate the effectiveness of the existing system of selective credit control including the process of implementation by the commercial banks, with particular reference to its influence on : (a) the stock held with the help of bank finance, and (b) the prices of respective commodities;

(ii) in the light of such evaluation, to suggest changes in the system and the process of implementation, both at the levels of the Reserve Bank and of commercial banks, as may be necessary, to improve the effectiveness of selective credit controls and to bring them in line with recent changes in the Bank's approach to credit planning and control;

(iii) to suggest an early warning system for the Bank to enable it to initiate action on its own in respect of selective credit controls before prices of sensitive commodities get out of hands; and

(iv) to make recommendation on any other matter considered germane to the subject of investigation."

1.3 These terms of reference were carefully analysed and the following questions were identified for defining the scope of the investigation:

- What are the basic elements of the existing system of selective credit control?
- What are the important successes and failures of the system and the process of its implementation?
- What are the major system and implementation-process deficiencies that need to be made up ?
- What should be the basic elements of the modified system which would help achieve better results?

This Report attempts to answer these and other related subsidiary questions.

1.4 The work on the investigation was started in the beginning of April 1978. Despite availability of short and limited time, attempt was made to meet a wide cross-section of executives in the Reserve Bank and commercial banks, businessmen, trade and industry associations, academicians and branch managers of different banks, all over the country. In addition to personal discussion, major commercial banks, and trade and industry associations also responded in fairly large numbers to the questions which were sent to them for the purpose of the present investigation. The questionnaires are reproduced in this Report as Annexures I and II. In addition, valuable information was also gathered from files in the Reserve Bank and commercial banks, particularly at branches of banks in different parts of the country. All this information proved valuable and helped in a large measure in the finalisation of the views contained in this Report.

1.5 Findings and recommendations contained in this Report have been deduced from facts and opinions collected in course of the investigation. Adequate facts in most cases were not readily available. Opinions on all major questions differed sharply between central bankers, bankers, borrowers and academicians. Therefore, a large measure of judgment had to be exercised in arriving at conclusions. As far as possible a balanced view has been attempted in order to accommodate different points of view and interests. Further, attempt has also been made to pick up recommendations from the realms of practice. No recommended feature is entirely new;everything has been at one stage or another a part of practice in India and found workable.

2

BASIC ELEMENTS OF THE EXISTING SYSTEM

2.1 Selective credit control is a widely accepted instrument of monetary policy. Almost all central banks use it to encourage or discourage the flow of credit into specific channels. In other words, these measures are meant to regulate the allocation of credit, so as to help ultimately fulfilment of broader national objectives. There is a wide variety of these control measures in use at present. They can, therefore, be classified in many ways. Some of these measures are positive in approach when they aim at increasing the flow of credit to certain specified sectors, activities, regions, purposes or classes of borrowers. As against this, some others are negative in approach. Sometimes, some of these measures are meant only to achieve certain immediate objectives. In other cases, they are aimed at long-term results. As for their scope, they can either be aimed at a narrow area of control or extended to cover a wide area.

2.2 At present there are several types of selective credit control measures in use in India. They include credit authorisation, norms for industry and also various schemes to encourage flow of credit to priority sectors. But, historically, in this country, the name selective credit control has been used only to cover a small set of negative measures which are used specifically to achieve the immediate objective of restricting the flow of bank credit for financing certain sensitive and essential commodities, when they get in short supply, and, there is pressure on their prices to rise. Generally, this control has been restricted to

commodities produced in the agricultural sector which are items of mass consumption. Fluctuations in their production and availability are fairly frequent and wide enough to often times render them items in short supply. In a buyer's market, there is a natural tendency to hold stocks for longer duration. Those who can manage, ~~they~~ also try to build up disproportionately high stocks so as to take advantage of the opportunity for high profits offered by the rising market. Businessmen's anticipations and expectations get vitiated and their actions put pressures on the prices of such commodities. Bank credit is found to be an important factor influencing such market situations. Part of the stocks are generally financed by the businessmen from out of funds borrowed from the banks. Therefore, if under such circumstances, the availability of bank credit against such commodities is reduced, the power of trade to buy and to hold on to stocks can to some extent be restricted and, therefore, the pressure on prices can be mitigated.

2.3 The Reserve Bank of India made use of the selective credit control, for the first time, when it issued a directive on May 17, 1956, asking the banks to refrain from excessive lending against paddy and rice and raised the existing margins by 10 per cent. According to the Bank's *Report on Currency and Finance* for the year 1956-57, 'credit extended ... appeared unduly large' and 'there were general indications that in certain centres bank accomodation was being partly utilised for speculative hoarding of paddy and rice'. This Report very clearly mentions the major objective of the selective credit control measures. They are 'intended specifically to achieve a reduction in excessive advances

against certain commodities' Further, the Report evaluates the success of these control measures also in terms of 'rapid reduction in credit outstanding'. This reduction it expects would reduce 'pressure on demand originating from bank credit'.

2.4 The Reserve Bank has been using selective credit control for the last twenty two years. With the passage of time the system has changed considerably. It now covers more number of commodities. But, this expansion has been moderate. Some commodities like jute which were included at one stage were subsequently dropped. Moreover, all commodities have not always been subject to all control measures, e.g., restriction in respect of level of credit did not apply to cotton textiles. Today, the selective credit control covers fully only the following commodities: various items of foodgrains; sugar, gur and khandsari; oil seeds, vegetable oils and vanaspati; and cotton and kapas. As on last Friday of March 1977, they accounted for 11.5, 33.2, 4.8 and 50.5 per cent respectively of total bank credit outstanding on that day against all these commodities put together. These figures include advances to Cotton Corporation of India but exclude advances to Food Corporation of India.

2.5 A notable development has been growing complexity. To start with the system included two measures of control: the margins and the level of credit. The Reserve Bank has all through been prescribing the minimum margins for advances against commodities under the selective credit controls. In the beginning, there was single margin for each commodity. Subsequently, distinctions began to be made on grounds of levels of stocks, type of borrower, varieties of the commodity, nature of credit instruments and documents, indigenous or

imported stocks or stocks for export, different regions and states of the country, stocks available and not available for free-sale, and, public and private sectors. This means that many different margins are at present laid down for each commodity. It has in many cases gone upto more than a dozen margins for one commodity and about half a dozen for a single account. This renders calculation of drawing power and therefore implementation difficult.

2.6 Laying down of higher margins means lower drawing power against a given value of stocks. But, this has never been considered sufficient for the purpose of control by the Reserve Bank. This control measure has been reinforced by the practice of laying down the level of credit as well. In other words, banks have not been left free to extend any amount of credit against these commodities, even if the margin requirement be fulfilled. In the beginning of 1956 banks were asked not to grant fresh credit limits to individual parties in excess of Rs.50,000. They were also requested to try to bring down the level of advances against the specified commodity to a level not more than 125 per cent of that in the corresponding period of the previous year. But, in 1957, the Reserve Bank shifted to the practice of laying down for each bank the aggregate level of advances against specified commodities. This was obviously a more strict method of controlling the level of credit. The practice showed that one major shortcoming of this method was the tendency towards neglect of the needs of the smaller parties. Therefore, in 1972, the basis for the permissible limit for advances

against selective credit control commodities was changed from bank-wise to party-wise 'to ensure that the banks do not offer large credit to few parties utilising the unused credit limits of other borrowers'.

2.7 The present basis for permissible limit is hundred per cent of the peak level of credit maintained by the party in any of the three preceding years. Here again there are a number of exemptions in vogue. The list has grown with the passage of time. The basis of exemptions has been the concession shown to new branches, small parties, cooperatives, warehouse receipts, imported or exported items, high-yielding varieties of commodity, manufacturing and processing units, farmers and public sector agencies.

2.8 In addition, there is also provision for complete exemption from selective credit control. These include some states in the eastern and northern parts of the country, public procurement, storage and distribution agencies including cooperative marketing federations and central or state warehousing corporations, rice mills when acting as government agents, rationed foodgrain dealers and consumer cooperatives, demand documentary bills, packing credit for exports, farmers, primary cooperatives, hybrid seeds and certain categories of manufacturing and processing units.

2.9 Thus exemptions in respect of margin requirements, permissible level of credit and, complete exemptions have become inherent and expanding elements of the system of selective credit control. In the process, so many

fine distinctions have been drawn in order to practice discrimination. The idea apparently is to benefit certain categories where such benefit is justified in terms of other national objectices. This has inevitably brought in what is popularly called a large element of fine tuning and consequent complexity and inbuilt leakages.

2.10 Another element which makes the system complex is a set of "do nots" for banks which have been introduced with a view to tighten the strings and to take care of some of the possible leakages. Under such prohibitory directives banks have been asked not to permit utilisation of permissible limit under one selected commodity for financing another selected commodity, not to make clean advances and not to lend against other security to parties dealing in selected commodities if such financing would result in circumventing the margin and level of credit requirements. Similarly, banks are also prohibited from discounting usance bills arising out of sale of commodities covered under selective credit controls, except in case of cotton textiles where bills upto sixty days are permitted. Or, in some cases, banks have been asked not to make permissible level of credit under one commodity, say wheat, available for another selective credit control commodity, say other foodgrains. Though necessary, this prohibitory element also renders the system more complex.

2.11 The third and the last measure under selective credit control has been the laying down of minimum rates of interest to be charged by the banks on amounts outstanding against the selected commodities. Here again

some amount of discriminatory practice has been followed and one minimum rate of interest for one commodity has been the exception. The distinctions have been drawn between the different levels of stocks held in different regions of the country, and, in case of sugar the stocks released or not released by the Government. Minimum rate of interest as instrument of selective credit control was used for the first time in 1970. In 1978 the new maximum rate of interest was made applicable to all advances including those coming under the selective credit control. Therefore, at present, the minimum rate of interest as instrument of selective credit control has in effect lost much of its significance. It is because present maximum and minimum rates applicable to selected commodities are such that the difference between the two in all cases is negligible.

2.12 To summarise, selective credit control in India has a restricted coverage. This name is used for a specific system of credit control which is exercised by the Reserve Bank on certain <u>selected commodities</u> whose supply is sensitive and they are items of mass consumption. The system was started in 1956 and has gradually developed to its present form over the last twenty two years. With the passage of time the system has tended to grow in scope and become more complex in character. Important measures under this control have been : <u>margin</u> requirements, permissible <u>level</u> of credit and the minimum rate of <u>interest</u>. The other supportive elements have been the provisions for <u>discriminations</u>, <u>exemptions</u> and <u>prohibitions</u>.

3

SUCCESSES AND FAILURES OF THE SYSTEM

3.1 Has the selective credit control proved effective? A system's performance can be evaluated only in terms of its objectives. What have been the objectives of this system of control? Generally, a set of three objectives is mentioned. First, it is stated that these controls are used when the prices of selected sensitive commodities are found rising in order to check that rise in prices. Second, it is also stated that in India one major cause of rise in prices of most of these mass consumption and agriculturally produced commodities is the speculative hoarding in anticipation of further rise in prices. Therefore, it is argued that the second objective is to check this tendency to build up excessive stocks by few and for long periods. Third, inventory build up requires finance. Bank credit is one major source of funds. Hence, the third objective in this chain of reasoning is to check the excessive rise in bank advances against these commodities so that pressure on demand originating from bank credit is reduced. Thus, the original question gets divided into three questions covering the three objectives.

3.2 Have selective credit control measures succeeded in checking the rise in prices of the selected sensitive commodities? The available evidence is not very conclusive. No direct and sophisticated study to answer this question has yet been attempted. This is largely because adequate and reliable data has been too difficult to get. But, a careful follow up of some specific cases of use of selective credit control, as reported in the Reserve Bank's Reports on Currency and Finance shows that in many cases some check on prices is noticed for some short periods. But, in most cases and in the long run the prices have continued to rise despite these controls.

3.3 The next question is whether these controls have succeeded in checking speculative inventory build ups. Once again the evidence is not entirely adequate. We do not have systematically collected reliable data on stocks of these commodities available to serve the present purpose. Therefore, only a sample of specific stock statements at many branches in different parts of the country were checked. Moreover, the borrowers and

bankers were also interviewed. But it does point easily towards something highly conclusive. It was found that in vast majority of cases, rise in margins did not result in lowering of stocks. The common practices were either to let irregularity in accounts continue for quite sometime or to hypothecate more stocks to regularise the existing drawings. In other words, the businessmen did not alter their plans and existing commitments because of rise in margins by the banks. The borrowers also had other sources of finance outside the organised money market available to them and in many cases arranged for funds from there. In a few cases some methods to circumvent the provisions of the control were also mentioned. All in all, influence of selective credit control on stock levels in practice was found to be negligible and exceptional.

3.4 Thirdly, have selective credit control measures proved effective in reducing excessive advances against certain commodities? The evidence in this regard is easily available and it is highly conclusive. These controls have in a large measure succeeded in checking the rise in bank advances against selected commodities. Data contained in the Reserve Bank's Reports on Currency and Finance, observations at branches and interviews with borrowers and bankers, all lead to the same conclusion.

3.5 Low effectiveness in respect of check on rise in prices of selected commodities, negligible effectiveness on speculative build up of inventories, and, high effectiveness in terms of reduction of excessive advances are not surprising findings. But, they need to be interpreted carefully so as to arrive at an overall and operationally meaningful conclusion. In this connection, it would be helpful to distinguish between direct and indirect objectives. If a control system does not succeed in controlling what is directly controllable, it loses its value and relevance. As for indirect objectives, no control measure can ensure high results because final outcome depends on how other related variables affecting the situation behave. Clearly, price rise and speculative inventory build ups cannot be directly and adequately influenced by the banking system. But, availability of bank credit is

directly and fully controllable. Price of a commodity is determined by many other factors, including, output, exports, imports, distribution and marketing. In the same manner, the speculative inventory build ups do not depend on mere availability of credit facility from banks. A system of control has therefore, to be judged largely in terms of its direct objective. Of course, ultimately it should also be examined in terms of other secondary and indirect objectives. After all, ultimate objective of all such activities is to promote economic welfare of the people.

3.6 There is evidence to show that the Reserve Bank has been fairly clear on this point. It has used selective credit control whenever it found a sensitive commodity in short supply and, therefore, tendency towards speculative build up of stocks and rise in its price. Moreover, it has also been assuming that action on its part would contribute merely towards a part of the solution of the complex problem of price. This point is clearly stated right in the beginning in its Report on Currency and Finance for the year 1956-57. 'The selective credit control measures adopted during the year were intended specifically to achieve reduction in excessive advances against certain commodities ...' And, then finally it adds : 'It is, of course, difficult to assess precisely the effect of these selective controls on prices since the level of prices is determined by several complex factors such as overall supply and demand, local shortages or surpluses, availability of transport, etc.' It ends with the statement saying that this control has 'probably restrained the uptrend in prices'. Further, in its self evaluation, the Reserve Bank throws up statistics to show that it raised margins to reduce excessive 'pressure of demand originating from bank credit'. It also gives figures to show that the credit did come down. Sometimes old margins are restored, again figures are given showing rise in bank advance and then reimposition of higher margins and the consequent fall in credit outstanding. This is how the Reserve Bank has kept on reporting year after year most of these twenty two years.

3.7 In other words, selective credit control when used has succeeded in reducing bank advances against selected commodities. But, this in itself may not have gone so far as to succeed in achieving a sizeable reduction

in excessive stocks or in bringing down prices to old levels. The consequent effect on prices and stocks might have also been cancelled in many cases by other factors behaving in the opposite direction. Or, other policies and controls might not have contributed adequately towards the solution of the complex price problem. It would, therefore, not be correct to relate the effectiveness of selective credit control directly to its impact on prices of specific commodities or the speculative inventory build ups. Insofar as it has succeeded in a large measure in restricting availability of bank credit against selected commodities as and when it was found necessary to restrict pressure on demand in a rising market, its relevance and effectiveness are adequately established. If despite a high measure of success in restricting availability of bank credit, only low and negligible success has been achieved in respect of price rises and inventory build ups, it certainly poses a problem which needs to be examined in the broader context of the total and complex problem of price behaviour of selected commodities and of a total strategy to regulate it.

3.8 It would be wrong to argue that it has been possible to get credit from banks, one way or the other, and the banks have not been able to implement the control. Businessmen in general are critical of selective credit control, and the criticism is most of the time expressed very strongly. This in itself is a big proof of the fact that supply of bank credit against selected commodities to them has largely been kept in check. In other words, it has really affected them. They often say that these control measures have not succeeded in general in bringing down prices of selected commodities and in eliminating speculative inventory build ups. They are, therefore, irrelevant, inconvenient and useless. Perhaps it is a case where a weak line of reasoning is adopted and what has really pinched is not stated because that represents a success of selective credit control. It is an important point which needs further scrutiny.

3.9 The statistical data presented by the Reserve Bank in its annual reports shows that bank advances against selective credit control commodities, although they have been rising slowly in absolute amounts, have fallen very sharply in relative terms, particularly during the seventies.

From almost 10% of total bank advances in 1970, they went down to around 4% in 1976 and 1977. No doubt this percentage used to be around 4% in late fifties as well. But, then it had gone up to around 16% in late sixties. Further, all these figures exclude advances to the Food Corporation of India. Even if we include the FCI figures after adjusting for a 50 per cent margin, there is still a fall from 16% in late sixties to 10% in late seventies. Moreover, the restriction on credit is felt more by the trading community because their share in total bank credit against selected commodities in most cases is small. On an average it comes to around 25 per cent. Other statistical evidence presented in the Reserve Bank's annual reports indicate that for trade as a whole the share in total bank credit has declined from 37% in March 1956 to 27% in June 1976. Moreover, the 1976 figure includes advances in respect of food procurement which constituted 60% of the total. It may also be noted that fall in share has been more pronounced in case of wholesale trade because the share of retail trade has not changed substantially over this period. It has stayed constant at around 2%. Thus, it appears that share of private wholesale trade in general and of selective credit control commodities in particular, in total bank credit has in seventies declined too sharply and too quickly. This is probably what has really affected the business community, and their criticism of selective credit control is in effect directed at such decline in their share of bank credit.

3.10 At this stage, it may be useful to draw distinctions between immediate short period and long period objectives of selective credit control, and between restriction on credit and denial of credit. The facts contained in the Reserve Bank's annual reports on these control measures in the Reports on Currency and Finance help in drawing such distinctions. In the fifties and till mid-sixties these control measures were being taken as mere short-term instruments. Issuance and withdrawal of directives and raising and lowering of margins were fairly frequent and followed each other almost alternately. As a selected commodity got in short supply margins were raised and as the position improved old margins were restored. But during the latter years, particularly in seventies, the objective acquired long-term allocative character as well with a view to get in line with plan

and other national priorities. BSR III is introduced and better statistics on credit outstanding against selected commodities is gathered and reported. From 1971 onwards a table showing share of selected commodities in total bank credit and another table showing relative shares of mills and factories, industrial users, and others in total credit against selected commodities start appearing as parts of write ups on selective credit control as a regular feature. They highlight two things: continuous and sharp decline in the share of advances against selected commodities in total bank credit, and, a large part of credit against selected commodities going to mills, factories and industrial users. In other words, the focus begins to capture the long-terms trends in respect of credit utilisation. The short-term ups and downs begin to receive secondary importance.

3.11 This difference in emphasis is a fairly evident fact. But, it needs to be interpreted in the context of the underlying conditions. The latter phase of the seventies coincides with the period when the concepts of credit planning and priority sectors get into vogue in the country. Further, it is also the period which faces extraordinary and prolonged inflationary pressures almost all around the world. Therefore, this shift towards long-term objectives of reallocating credit away from trade towards priority sectors is understandable. Low priority to trade is also reasonable. The criticism gains weight when it begins to be pushed almost to the position of no importance. Certainly trade in any economy is an important activity. What is the use of output if it does not reach the consumer? On other hand, it cannot also be ignored that overtrading and overstocking in anticipation of rise in prices are inherent parts of trade under free market mechanism. They do conflict with the social interest and need to be discouraged. Hence, in any exercise on credit allocation and planning and any scheme of priorities, trade cannot be put above manufacturing, agriculture and foreign trade. Moreover, one another important lesson that the experience of last twenty two years provides is that our trade has proved that they can survive even at 100 per cent margins. In fact, difference between 85 and 100 is very small. In other words, they have other sources to rely on. These include credit from producers, other traders, finance from unorganised money market and own funds.

Therefore, trade unlike industry and agriculture can to a fairly reasonable extent be considered more self-reliant, and, has therefore to be accorded lower priority. This implies that credit to agriculture and industry shall have to be adequate to meet most of the genuine need of the borrower. For trade only a smaller percentage of the need for funds ought to be met by banks. In other words, only a reasonable amount of credit should be extended to trade and the rest of the need should be left to be arranged from other sources. This is what low priority should mean. However, not to meet even the reasonable part of the credit need of private trade could certainly be interpreted as denial of credit.

3.12 The short-term objective of reducing pressure on demand when market for a commodity is marked with short supply can be met if margins are raised by 10, 20 or 25 per cent from their normal levels; that is they could go up to 50 per cent, and then again revert back to normal levels. This is what the general practice was in the early phase of selective credit control. But, in the seventies the general practice was that margins rarely went below 50 and touched as high as 85 per cent in May 1977. This sharp difference has been one reason giving rise to distinction between credit restriction and denial of credit. It appears this control has had to experience a sort of a cumulative process. Control tightening and development of ways to get over them progressed somewhat alternately. As the bankers and borrowers adjusted to raised margins and bank-wise limits for extension of credit against specific commodities in the early phase, the effectiveness of control in reducing excessive credit began to wear out. Hence when extraordinary pressure on prices came up in early seventies tightening was also extraordinary so as to effectively reduce credit against selected commodities. Not only margins were raised to unreasonable levels, the partywise limits were also instituted in 1972 which really cut credit hard, and to top it all the credit squeeze of 1974 and 1975 meant drastic and arbitrary cuts in credit to traders. That in effect also meant reaching the stage of denial of credit to private trade. There were cases when a vast majority of traders in many selected commodities could not get additional credit, and, in many cases it in fact went down. Many banks started the

practice of getting away from credit against selected commodities. In 1977, of the nineteen major banks only five were above the national average of 4 per cent share of credit against selected commodities in the total credit extended by each bank. There are cases when just in five years, from 1973 to 1977, a bank pulled down this per cent share figure from around 9 to 2. Visits to some mandi markets showed that many bank branches with premises in the mandi market were not touching advances against selected commodities at all. This has never been the objective of the selective credit control and no such directives were ever issued, but it has happened to many borrowers at many places and at the hands of many banks. There is, therefore, some weight in criticism of the control put forth by representatives of trade and industry. Denial of credit does not meet short or long term objectives of selective credit control. After all credit to trade must grow adequately with the growth of the economy, more particularly as the prices also rise. A reasonable part of this growing need must be met by the banking sector. Reasonable quantities of bank credit to them would also help rendering credit from the unorganised market somwwhat cheaper than it otherwise would be.

3.13 Often times, it is argued that by now a major reallocation of credit away from selected commodities has already taken place and the trade has some how adjusted. Why should there be an attempt to liberalise and permit another reallocation in favour of trade? As against this, it has been argued that unreasonableness must not be defended. It needs to be corrected. Although, it is also true that if more credit is extended to trade, it would not by far and large be used to pay the farmer promptly or to raise the turnovers in all cases, or to stock more when prices show tendency to fall. To be realistic we must assume that a businessman will do only what is in his interest. But, that should also not be taken to mean that none of his action would serve social interest. Many times traders do branch off into other activities. Some of their sons take to other independent ventures including industrial and processing units. More of cheaper credit from organised banking sector could in many cases be helpful in releasing funds which would serve as seed capital for the diffusion and multiplication of

entrepreneurship. History of the country has enough instances to substantiate such a positive assumption.

3.14 There is one line of reasoning in respect of the future of selective credit control that needs to be discussed. It is being argued that the environment has changed substantially. This change has rendered these control measures irrelevant and useless. It is no doubt true that monsoon has been favourable continuously for last several years and production of many agricultural commodities has been crossing record levels. The foreign exchange reserves have also been rising and are available for imports when necessary. Yet, it is also true that not all agricultural products are at present in excess supply and sizeable buffer stocks are not available in all cases. Moreover, pulses are in short supply and some of these cannot be imported even if we are in position to pay for them. India is a big country with large population and even small fluctuations in supplies of sensitive commodities of mass consumption can make big differences to their prices. No one has, therefore, seriously suggested that one could assume that in future there could be no shortages of these commodities or that the trade would not take to building up of speculative stocks when such conditions arise or that availability of bank credit would not make any difference to such situations. It is, therefore, not possible to suggest something which would carry big risks.

3.15 There are two aspects of this line of reasoning: the short and long views. No doubt, in view of the present improved situation for many of the agricultural products and with the price of some of them falling substantially, it should be appropriate time to loosen some of the measures under the selective credit control so as to remedy immediately the element of overtightening and gradually to come to normalcy where high degree of restriction on credit is not warranted at present. Obviously, this cannot be done in one sweep. In other words, it would not be possible to suddenly open the gates for trade for liberal access to more credit.

3.16 Insofar as the long-term view on selective credit control is concerned, it is not realistic to overreact to the present comfortable supply position in respect of most but not all agricultural commodities under selective control. On short period information for these few years, it would not be advisable to suggest a long-term policy of change, that is, to lift these control measures for good. It would not be realistic to argue that price depends only on demand and supply of a commodity in the market, and therefore, this control in the long run is not needed. It is no doubt possible to argue strongly that if in India the pulses are today in short supply, even if credit is totally denied to traders dealing in these commodities that would not bring the prices down as long as the supply position does not improve. But, it can also be argued equally strongly that even when the supply perfectly matches the demand and more credit is extended, it would make a difference. In other words, availability of credit does make a difference to the situation, particularly when it is a case of short supply.

3.17 To sum up, available evidence suggests that the selective credit control has been highly effective in achieving its direct objective of restricting bank credit against selected commodities. It can also be concluded that to that extent it has also contributed towards the fulfilment of its indirect objectives of holding the speculative inventory build ups and price rises in check. Without these control measures the position might have been worse. But, there is also evidence to suggest that during recent years curbs on bank credit against selected commodities had been tightened to the degree of unreasonableness verging on almost denial of credit in very many cases. The present comfortable position in respect of many of these commodities affords an opportunity to correct the element of overtightening, gradually in stages. In the long run, there is no strong reason to support any change in the policy of using these controls to achieve both short as well as long term objectives of credit policy.

4

SYSTEM DEFICIENCIES

4.1 Broadly considered, the system of selective credit control has three parts : the objectives, the control measures, and the process of implementation. A control system performs effectively when its objectives are clearly stated and understood, its control measures are designed judiciously to achieve the stated objectives and, the process of implementation is efficient to let the control measures operate smoothly and effectively. Having discussed the objectives in the previous chapter, it may be appropriate now to discuss the major deficiencies that were observed in course of investigation in respect of control measures and implementation process.

4.2 There are three major control measures which constitute the selective credit control system: the margins, the level of credit and the rate of interest. Margins are meant to perform two banking functions. They provide the cover to the banker against the risk of fall in the price of the goods against which he is making the advance. In fact, this used to be the major function. The other is that when deducted from the value of the security, it determines the drawing power of the borrower. This used to be the subsidiary and the incidental function. How much margin was to be stipulated was determined by the likely fluctuations in the price of the goods to be hypothecated to the bank. This is what is meant by the bankers' normal margin. But, once it became an instrument of selective credit control, its primary function was pushed to the background and the subsidiary function became the primary function. When the

aim is to reduce credit outstanding, the margin is pushed up to reduce the drawing power and the borrower is asked to regularise the account, i.e., to bring drawings to the level of the reduced drawing power.

4.3 Although the borrowers are required to sign demand promisory notes, the bankers are expected to practice adequate flexibility and give the borrowers a reasonable time to adjust. In practice it could sometimes take two or even three months. This time lag takes away much of the edge of the instrument insofar as short-term objective of the control is concerned. Further, it might work better if higher margins are used sparingly and only when needed to quickly reduce excessive bank credit extended against a selected commodity. For long-term purposes, if margins are kept at such high levels as 60, 70, or 85 per cent, continuously for many years with a view to restricting bank credit against a particular commodity, people tend to turn to other sources of funds. In case of agricultural products, and these are the commodities that come under selective credit control, a large part of the burden is passed on to the farmers by delaying their payments. In effect such a situation results in denial of credit when margins are above 50 per cent and are kept at higher levels continuously for several years. The normal bankers' margin is taken in general as 25 per cent and the margins should in the long run remain linked to this figure if they have not to lose their realism for bankers and borrowers.

4.4 Another major deficiency has been the extension of the list of margins against a single commodity. If there are two different margins for two different varieties of cotton, more credit can certainly be extended against

high-yielding varieties. But, a line needs to be drawn somewhere. Should selective credit control be rendered complicated to encourage the production of high-yielding varieties of cotton? It will have to be assumed that the branch managers can distinguish between two varieties of cotton. Failing this most of the cotton will be taken as high-yielding variety simply to avail higher drawing power. This is what really happens in practice. Therefore, a control measure should not aim at controlling what practically cannot be controlled. Similarly, the margins should not be used to influence the distribution of stocks between different regions of the country or between different firms in an industry. Such measures result in extending the scope of selective credit control too far and in getting into something which would not work in practice. This type of extension of objectives is a phenomenon of recent years and has invited criticism not only on the ground of overextension of the purpose of the margin but also because of the element of double or triple control, e.g., stock levels in some cases are also controlled by physical controls under the Essential Commodities Act, and the Tandon Study Group norms. Stocks of cotton with textile mills is one such case. The case for different margins for different levels of stocks, in different parts of the country for different types of mills is really very weak.

4.5 The level of credit is another measure of control. The banks have been asked not to permit drawings more than hundred per cent of the peak level of outstanding of the party in any of the three preceding years. This is really a powerful measure which was introduced in 1972.

Observations show that it has really proved effective in restricting credit. But, it has also been unjust in certain respects. Obviously, it does not fit in with short-term objectives. Under this rule credit cannot be varied to match the changing supply positions of different selected commodities. It is basically a long-term instrument of restricting credit against selected commodities. And, it did help largely in pulling the trend line in some cases sharply downwards. Its worst characteristic is its unprogressive approach. Under this rule, normally, i.e., without exemptions and prior approvals in exceptional cases, bank credit to a party could never go up. In other words, it does not provide for higher turnovers, higher stocks and rise in prices. In very many cases the credit availed from banks has actually gone down over the years. The question is being raised: why should credit be linked to past performance instead of its being linked to what a businessman wants to do in near future? It also makes the restriction too severe to new branches and new parties. Conceding highly limited scope to them has proved too little. It is, in fact, this rule which has lent a lot of support to criticism on grounds of denial of credit.

4.6 The third control measure had been the laying down of minimum rates of interest for advances against selected commodities. It meant higher rates on such advances; higher than the 'maximum rate of interest' for all other advances. Moreover, these rates were also varied in the short run to influence demand for credit. Different minimum rates for advances against the same commodity to different types of parties and for different purposes were

also prescribed. The general opinion and expert studies express serious doubts on the effectiveness of this instrument in achieving the desired change in demand for credit. It has only added to inconvenience, complexity and costs. Therefore, it is hard to find a strong argument to justify a rate 3 to 5 per cent higher than 'the maximum rate of interest', on advances against a selected commodity, or to make distinction between a trader and a manufacturer in respect of interest charged when both stock the same commodity and both could demand excessive credit to carry excessive stocks. Certainly, interest cost is a significant part of the carrying cost. It should effect the inventory decisions. But, in practice, in view of high tax rates and high profit expectations in a rising market, the rise in interest rate shall have to be really very high to produce the desired effect on inventory investments. And, that would imply high distribution costs, passing of a higher burden to consumers and further strengthening the pressure on prices.

4.7 In the area of implementation process two major deficiencies were observed. The first relates to delayed action and the second to growing complexity.

Selective credit control was originally designed as a set of measures to achieve short-term objectives. If a commodity gets in short supply and there is pressure on its price, restriction on advances against it can help in controlling the overall situation only if the latter can be achieved quickly. Quick action has been too difficult to materialise. Working backwards, the bankers normally permit 6 to 9 weeks for the borrowers to regularise the accounts. Another, 4 to 6 weeks are taken for the

directives to reach the branches through respective head offices. The Reserve Bank also takes 2 to 3 weeks to work out and despatch a directive. Thus, the total process roughly needs 12 to 18 weeks before an effect on credit outstanding can be felt. For agricultural commodities subject to high seasonality, this is a long period. Attempts should, therefore, be made to reduce the period to 6 to 9 weeks. This can be possible if regularisation can be restricted to 4 to 6 weeks, communication time to 2 to 3 weeks and decision making time to zero by initiating action before the price signals begin to show up. If this cannot be achieved, the selective credit control should not be expected to produce better results in the short period. This constraint should be taken into account when policies are formulated. But, it is possible to cut the time involved to half in practice if appropriate action is taken.

4.8 There is another dimension to delay. Directives, if they are lengthy and involved, they cannot be quickly understood and complied. The second, but far more serious implementation deficiency has been the growing complexity of the control design rendering the directives embodying them too difficult to interpret and apply. It appears there has been some relationship between overtightening and growing complexity. The more the tightening, the more the representations requesting exemptions, or, in other words the leakages. It also means more distinctions, discriminations and introducing all sorts of fine tunings. It is certainly not easy to distinguish between leakages and flexibilities. But, it may be useful to consider seriously the alternative strategy of less

tightening and less of fine tuning. Over years it has become a practice that businessmen get together into smaller and smaller interest groups to claim special treatment under a particular control measure. It is interesting to find that a study of selective credit control in five European countries also highlights this point: 'Systems that multiply the categories entitled to special treatment become less effective and more vulnerable to the pleadings of special interests'.* This trend needs to be reversed in the interest of system efficiency, i.e., for avoiding wastes arising from usage of complex control systems which do not work efficiently. It is, however, not to suggest a policy of 'no control, no complexity'. What we need is a trade off between tightening and complexity. Less complexity can be traded for less tightening, and, yet the overall result can be better for all: the monetary authority, the bankers and the borrowers.

4.9 One suggestion which was made most frequently and most insistently was for simplification of the control system so that it could be implemented smoothly without straining the relations between bankers and borrowers, and, without diluting the objectives of the control. What does simplifications mean in this context? Opinions may differ. But, what most people desire is not mere improvement in drafting the directives or compact presentation of up-to-date rules of the game. They mean much more than this: the simplification of the system design itself.

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* Hodgman, D.R., Selective Credit Controls in Western Europe, Chicago (Ill.), Association of Reserve City Bankers, 1976, p.2

And, if this latter objective is achieved, the linguistic problems also get reduced. There is a simple way to define simplification. A document produced by the Reserve Bank: "Selective Credit Controls: Position as on August 20, 1977"(Summary of the Provisions of the Directives to Scheduled Commercial Banks on Advances Against Selected Commodities) covers in thin type cyclostyled 15 foolscap pages. Reducing the whole thing by redesigning the system without diluting the major objectives to about 3 such pages would certainly mean a big simplification. This is possible by reducing the number of rows and columns of the abovementioned statement. In other words, it would need cutting down the lists of control measures, discriminations, exemptions and prohibitions.

5

THE MODIFIED SYSTEM

5.1. The future of selective credit control measures needs to be considered in terms of their relevance and effectiveness. In the short period, the objective has been to achieve reduction in bank advances against selected commodities whenever they are in short supply with a view to reduce pressure on their demand arising from extension of bank credit. In the long period, implicitly the objective has been to restrict share of bank credit against selected commodities in total bank credit in line with the national priorities. These control measures have been fairly effective in restricting supply of bank credit against selected commodities. The success over short periods has not been as marked as it has been in producing the long period effect, particularly during the seventies.

5.2 Despite significant improvement in supply position of most of the selected commodities at present, it is not considered safe to assume that the improvement would continue over the long period and would extend to all commodities. Moreover, the short period fluctuations could still be expected to assume the proportions of a serious problem. Therefore, these control measures are still very relevant. But, there is certainly scope for modifying the selective credit control system to make it more relevant to the changing economic scene and to increase its effectiveness, particularly in the short period. The opportunity can also be used for rationalising the system by remedying some of the weak features which have invited serious criticism.

5.3. It is suggested that the basic structure of the existing selective credit control system should be retained. But, it needs to be emphasized that the system does need drastic modification. A few major changes would be adequate to achieve the desired improvements. Therefore, the recommendations contained in this Report do not aim at installing an entirely new system. Further, the recommendations are meant to be parts of a total plan or a single package. In other words,

the recommendations are not meant to be implemented separately in bits and pieces. Doing so would seriously affect the results of the modification exercise. For the purpose of the system redesign, the desired objectives are higher degrees of relevance and effectiveness, and, reasonable and practical compromise between the interests of the society, the borrowers and the banks. As for strengthening the implementation process, the major objectives are deliberate and drastic simplification, better compliance and cut in delays.

5.4. One element of the selective credit control system has been the practice of laying down of minimum rates of interest to be charged by the banks on advances against selected commodities. In many cases two or three **different** rates have been laid down based on different classifications of borrowings. Till March 1978, these minimum rates were one or one and one-half per cent lower than the maximum lending rate for all other advances. But, now the reduced maximum lending rate has been made applicable to all advances, including those under selective credit control. The banks used to charge 3, 4 or even 5 (or more) per cent higher than prescribed minimum rates on advances against selected commodities. Now they cannot charge more than the maximum lending rate. At present, the differences between the current maximum lending rate and the prescribed minimum rates for selected commodities are negligible. It is highly doubtful if slightly higher interest charged on advances against selected commodities, or 2 or 3 slightly different minimum rates against one selected commodity, affect borrowing or inventory decisions of the businessmen significantly. Even 3, 4, or 5 per cent higher interest rates compared to rates on bank advances against other commodities might not make much difference to demand for credit against selected commodities or the carrying cost of inventories. It can safely be assumed that in the absence of minimum rates the banks are not going to reduce their present rates on advances against selected commodities and lose revenue. Laying down minimum interest rates as an element of selective

credit control system, on the other hand adds to complexity in operations. Its absence would lead to considerable amount of simplification. It is, therefore, recommended that laying down of minimum rates of interest as part of selective credit control measures should be dropped. At best, the banks can in general be advised to charge interest on advances against selected commodities at rates nearer the maximum lending rate so as to reflect low priority to such advances.

5.5. The most frequently used selective credit control measure is the stipulation of minimum margins against selected commodities by the Reserve Bank. When it is considered necessary to reduce credit outstanding against selected commodities, the Reserve Bank raises the minimum margins in respect of specific commodities. As the banks apply the raised margins to individual borrowers, the drawing power is reduced. It is a part of the rule of the game that when the supply position of the concerned selected commodity does no longer remain short, the minimum margins should be reduced back to normal by the Reserve Bank. Varying the margins is therefore in essence a short-term instrument of credit control. It loses its significance if the normalcy does not seem to return back over a number of years. Also, it is widely accepted as reasonable in business and banking circles if the margins are raised when necessary by 10, 20, or 30 per cent over the normal bankers' margin and the higher margins do not continue over long periods.

5.6. The borrowers are expected to either pay back money to banks so as to be within the reduced drawing power or to hypothecate more goods to maintain the old drawing power at raised margins. What is really desired is the recourse to the first alternative. The history of selective credit control in India in its earlier phase suggests that this short-term objective is better achieved when rises in margins are not too high and do not stay for long at the raised levels. In the latter phase, it appears, the practice of hypothecating more goods became more common. In the short run, very high margins also encourage continuance of out of order accounts for longer durations. In the longer run very

high margins for long periods encourage higher inventories and less reliance on bank credit. Taking margins to 75 or 85 per cent and to keep them at those levels for long is, therefore, not a desirable policy. Assuming normal bankers' margin of 20 or 25 per cent, the margins should not be raised beyond 50 per cent. If the desired effect is not produced by such levels of margins, the remedy does not lie in raising them further to unreasonable levels but in supplementing this measure of control with other measures of control. Again, the Indian experience suggests this. Information supplied by the bankers and borrowers at the branch level leads to the conclusion that most of the check on credit against selected commodities exercised by the banks in the seventies was due not so much to extraordinarily high margins but to party-wise levels of credit. This is, however, not meant to defend the existing rule for fixing party-wise levels of credit.

5.7. Given a reasonable rule for party-wise level of credit and reasonable policy in respect of margins, it is possible to achieve a fair measure of fluctuations in credit outstanding in the short period against selected commodities. Similarly, it is also possible to exercise check on such credit in the long period through such policies. It is neither reasonable nor desirable to carry things to levels when an ordinary business cannot survive without following unacceptable business practices. When it is asserted that credit availability does matter in influencing the price behaviour and inventory build ups, it must also be added that credit controls can help only up to a point. That point is reached when businessmen begin to react dysfunctionally by adopting worse alternatives or production and movement of goods begin to suffer. It is, therefore, advisable to always distinguish between credit restriction and denial of credit. Margins should never be pushed to 85 per cent. After all, complete denial needs only 100 per cent margin.

5.8. It is recommended that the Reserve Bank should follow a definite policy in respect of margins to ensure that (a) minimum margins against selected commodities do not go beyond 50 per cent, (b) they should move downwards as early as practically feasible so as to serve truly as a short-period instrument of credit control, and (c) there should be only one margin for each selected commodity.

5.9. In some cases there are at present more than a dozen minimum margins for a single commodity; some times even half a dozen applicable to just one account. Such differences in the margins do not contribute to the efficacy of selective credit control. On the contrary, they only add to complexity and hence difficulties in implementation. They have arisen because of the concession or a favoured treatment shown to certain priority categories of cases where it is considered necessary not to subject them to very high margins. The concession argument carries weight when the margins are pushed to and kept at very high levels. There is no other strong reason to justify this feature. In fact, in a reasonable system of credit control, it should be treated as a leakage and the aim should be to minimise leakage and maximise simplicity. It is, therefore, recommended that the Reserve Bank should lay down only one minimum margin for each selected commodity. Of course, there would be some cases of general exemption. Also, in case of industry some discrimination would be necessary. These are covered later in the Report.

5.10. It is also recommended that the present level of margins should be lowered. This should be done in a way so that the reduction in margins does not immediately raise credit outstanding against selected commodities very significantly, and, that the new margins reflect the present and anticipated supply positions of respective selected commodities. This cautious approach is necessary and is sought to be followed through phasing of the implementation of recommendations provided in the end of the Report. No specific recommendation in respect of margins is possible

because these might need change with change in underlying economic conditions determining the supply position of each commodity over the next six months. But, in order only to reflect by way of illustration the thinking underlying this Report, the following set of minimum margins are for the present considered reasonable. These should be applicable to all cases of borrowings from banks against selected commodities falling under trade and processing. They would not apply to cases of total exemption; and their application to industry has been discussed separately in this Report.

Selected Commodity	Minimum Margins (in per cent)
Paddy and Rice	30
Wheat	30
Other Foodgrains (excluding pulses)	30
Pulses	50
Sugar, Gur and Khandsari	40
Oilseeds	50
Vegetable Oils	50
Vanaspati	50
Cotton and Kapas	40

It is also envisaged that as condition further improves in respect of some of these commodities the margins could further be reduced to 20 or 25 per cent. On the other hand, in the opposite case, each one of these margins could reach 50 per cent. In other words, in no case should a margin exceed this figure.

5.11. Financing of sugar stocks with sugar mills have thus far been treated as a special case, because of the government release of these stocks. Therefore, very low minimum margins were stipulated. For the same reason, the Tandon Study Group also did not recommend norms for inventory for this industry. With decontrol of sugar, the Reserve Bank may like to fix inventory norms for this industry. Once this is done,

the system recommended here could apply in its entirety to financing of sugar stocks with sugar industry as well. In the interim period, the present practice may continue.

5.12. The most effective measure for restricting the supply of credit against selected commodities has been the party-wise level for bank advances. At present this rule as laid down by the Reserve Bank permits credit extension to each party only upto hundred per cent of the peak drawings during the past three years. Thus bank credit against selected commodities cannot go up except in those cases which are either exempted or are specifically permitted by the Reserve Bank. The rule has, therefore, largely succeeded in sharply reducing in recent years the share of bank credit against selected commodities in total bank credit. This can be viewed as the achievement of the long-term objective of restricting the supply of bank credit to private wholesale trade in accordance with its low priority. In the long run it might have to some extent also discouraged indirectly excessive inventory build ups and overtrading. On the other hand, this rule has been described as unreasonable because it denies bank credit for growth of trade. More importantly, the rule as it has been practised over last several years, does not provide for achieving the short-term objective of varying the amount of bank credit against selected commodities with changes in the state of the market. In other words, irrespective of improvement or deterioration in the supply position of a commodity, the bank credit has in practice in most cases remained pegged to hundred per cent of the peak level of the past three

years, or, has gone down. Obviously, such a rule is entirely arbitrary in its character. It does not provide for a basis for arriving at permissible levels of bank advances in individual cases so as to take care of the growing needs of business. Similarly the needs for variation in credit in the light of the changing states of the market in the short period, and for regulating the share of bank credit in accordance with national priorities in the long period, are not clearly provided for. It is, therefore, necessary that this rule should be replaced by a more reasonable and more acceptable rule.

5.13. In order to check overtrading and excessive inventory build ups, the Reserve Bank has laid down norms for inventory for the industrial sector. Industrial units are not expected to exceed these norms. Provision for specific deviations has also been made to take care of the exceptional circumstances. Adequate flexibility is a part of the system. As part of monthly follow up, the banks have been asked to ensure that the norms are in general observed. This implies that if the norms are observed, there can be no excessive inventory build ups. There are no norms for trade at present. Obviously, there is big difference between industry and trade. An industrial unit is constrained by its installed capacity in the short period. In case of trade there is no such constraint. Its turnovers and inventory levels could reasonably be expected to fluctuate very sharply, at least in the individual cases. Moreover, access to other sources of funds for trade is much easier. Therefore, basis for supplying credit and for fixing the norms for that purpose has to be different in case of trade. Further, it needs to be recognised that the bankers' task of the appraisal and follow up of advances in the case of trade is not equally easily manageable. Also, it will have to be assumed that industry would always get much higher priority in comparison to trade in any scheme of credit allocation at the national level.

5.14 In the light of the reasoning presented above, it is suggested that as a part of the policy the following distinction in the basis of lending as between industry and trade should be considered reasonable. In case of industry, the banks follow up the inventory norms to ensure that the stocks actually held at the end of each month are within the norms laid down by the Reserve Bank. This is not easy. But it is manageable because of the limited number of industrial borrowers to whom the norms are applicable and better inventory control and accounting systems followed by such units. It would, however, not at all be realistic to assume that it would be possible for the banks to ensure observance of norms by individual trading parties. They are too many in numbers and there are so many practical limitations on both sides, bankers' as well as borrowers', which render such a task too difficult, at least for many more years to come. This assumption is reasonable also because certain governmental agencies do exercise control on stocks with trade in time of serious shortages as well as surpluses in respect of the essential commodities. It is, therefore, suggested that norms in case of trade, as against industry, should apply only for the purpose of determining the permissible level of bank credit against selected commodities. In other words, norms in case of trade should not apply for regulating the inventory levels, i.e., as part of follow up of ensuring that the stocks actually held are within the prescribed norms. The purpose of the norms would, therefore, be limited only to ensure that the banking system finances only that part of the credit need of trade which has been considered reasonable at the national level. The rest will have to be arranged by trade from its own and other market sources.

5.15 Again, although highly desirable, it is not considered reasonable, on grounds of practicability, to suggest norms in respect of debt-equity ratio or equity to total outside liabilities ratio for trade.

Hopefully, in future the trading firms would improve their accounting systems and be more willing to share information with their bankers. At that stage, it would become possible to formulate a more desirable and sophisticated basis for supplying credit to trade. For the time being, therefore, the practicality of the situation demands that the basis for financing trade by the banks should be somewhat narrower and less sophisticated than what had been recommended by the Tandon Study Group for industry. Whatever the basis, it should certainly be progressive in character so that it could serve also as a stepping stone for a more refined basis in future. It is also visualised that such basis should be appropriate for trade in any commodity. The special features necessary to achieve the short and long term objectives of selective credit control should be built into such a basis so as to serve as the new rule for arriving at permissible levels of credit against selected commodities.

5.16 The new rule recommended to replace the existing rule is explained below. Under the new rule, the starting point should be the turnover of the party for the current year, or, the year for which the permissible level is being determined. The next step would be to deduct gross profit from net sales to arrive at the cost of goods sold for the year. This figure divided by 12 would give the monthly figure of the cost of goods sold. The Reserve Bank should lay down norms for financing for each selected commodity in units of so many months of cost of goods sold. And, it should ask the banks to finance only that part of the inventory which does not exceed the prescribed norm. For the present, it is recommended that the Reserve Bank

should fix the following norms for traders in respect of the existing list of selected commodities :

Selected Commodity	Number of Months of Cost of Goods Sold
Paddy and Rice	1½
Wheat	1½
Other Foodgrains (excluding pulses)	1½
Pulses	1
Sugar, Gur and Khandsari	1½
Oilseeds	1½
Vegetable Oils	1
Vanaspati	1
Cotton and Kapas	1½

5.17 Only two figures should be used for fixing the norms: 1 and 1½ months. Any third figure would open the gates for the multiplicity of figures and take things again towards complexity. However, if at some stage a change in norms is considered very necessary, the specific cases may be examined by an ad hoc Group of Experts, appointed for the purpose, along the same lines as the Central Committee of Direction for Tandon Study Group Norms for Industry, to make the necessary recommendations.

5.18 Two points need to be specially noted in this context. The commodity situations are implicitly classified only into two categories: in short supply and not in short supply. Under these two states of the market, for the purpose of selective credit control, 1 and 1½ months of cost of goods sold are considered reasonable upper inventory limits for the purpose of financing by the banks. They need to be judged along with the fact that counting of bill facility as part of credit extended and deduction of goods not paid for before arriving at drawing power are in the interest of simplicity not being recommended. In the short period, variations of 50% upwards and 33% downwards are

provided for. In the long run, the figure of $1\frac{1}{2}$ month should reasonably ensure that bank credit will not be used for overtrading and excessive inventory build ups. Yet, trade will be able to get more credit with rise in the turnover.

5.19 The second element of the new rule should be the fixing of the turnover index for each selected commodity for the current year. It is, therefore, recommended that the Reserve Bank should lay down at least a month before the commencement of the season for each selected commodity a percentage figure to be multiplied by the base year figure for each borrower to arrive at the acceptable turnover figure for the current year. This figure of net sales with pro rata adjustment for gross profit would yield the acceptable figure of cost of goods sold for the party for the current year. Cost of goods sold divided by 12 and multiplied by the norm for the commodity would give the permissible level of credit for the party for the current year. The drawings at any stage in the current year should not exceed the lower of the two figures: the permissible level of credit, and, the drawing power.

5.20 To be realistic, it will have to be assumed that, say in 1978, the latest audited balance sheet and profit and loss statements shall in most cases be available only for 1976. Therefore, it is being suggested that 1976, or two years prior to current year, should be taken as the base year for the purpose of working out the permissible level of credit. In other words, the turnover or net sales of 1976 should be multiplied by the turnover index laid down by the Reserve Bank for 1978 to arrive at the estimate of net sales for the current year, or 1978. In this connection, it may be noted that things are changing fast, and at present, already the vast majority of trading firms do submit their audited annual financial statements to their banks. They

are submitted a little late. This delay has already been provided. It would, therefore, not be realistic to argue that new rule cannot be applied in practice because of non-availability of accounting information in majority cases. Nor would it be possible to object on grounds of the reliability of such information, or the sophistication involved in the analysis of such statements. For the present purpose, balance sheet is in fact not at all necessary. Only two figures from the profit and loss statement are needed: net sales and gross profit. These two figures a banker must in every case try to get, and these are not likely to be window-dressed upwards in practice.

5.21 Further, it should also be noted that the method that is recommended here should not present any serious problem of application in practice. All its important parts are already in use in financing trade, particularly in agricultural products. The practice of one nationalised bank where the system is a bit more sophisticated than what is recommended here, has been studied in detail before formulating the present recommendations. Other banks also follow similar methods. As for the turnover index, the Reserve Bank in the past was laying down an index for the level of credit. Therefore, in so far as application of the new rule is concerned, it should not pose serious practical problems of understanding and calculations. Everything suggested here is already fully familiar to bankers and borrowers.

5.22 The application of the suggested rule for determining the permissible level of credit can be illustrated with the help of a hypothetical example. Suppose firm x trades in cotton. Its net sales for 1976 as per audited statement are Rs.60 lacs. Further suppose, the Reserve Bank has fixed 125 as the turnover index for 1978 on the base of 1976, for cotton and kapas. Therefore, the estimated net sales for 1978 for firm x work out to Rs.75 lacs. Similary, its gross

profit for 1976 is Rs.2.40 lacs, which pro rata works out to Rs.3.00 lacs for 1978. Hence its cost of goods sold for current year is estimated at Rs.72 lacs, which on monthly basis work out to Rs.6 lacs. Assuming that the Reserve Bank norm for financing cotton and kapas trade is 1½ months of cost of goods sold, the permissible level of credit for 1978 works out to Rs.6 lacs x 1½ months = Rs.9 lacs. Further, taking 40% as the margin laid down by the Reserve Bank for cotton and kapas, the things could work out as follows :

(Rs. in lacs)

Stocks Actually Held	Turnover of Stock	Permissible Level of Bank Credit	Drawing Power	Drawing Not to Exceed
6.0	12.5	9.0	3.6	3.6
9.0	8.3	9.0	5.4	5.4
15.0	5.0	9.0	9.0	9.0
18.0	4.2	9.0	18.0	9.0

5.23 Thus, it is evident that the actual number of turnovers achieved by the party would depend on the stock actually held. The drawings from the bank would be limited by the drawing power and the permissible level of credit. Therefore, the margins would also play important part in determining the drawings and the turnovers. For example, if the party wishes to draw up to permissible level of credit, it will have to carry adequate stocks to provide the stipulated margin. At 30 per cent margin, in that case, it would have a turnover of 5.8, at 40 per cent margin of 5.0 and at 50 per cent margin of 4.2, with stock levels of Rs.12.9 lacs, 15.0 lacs and 18.0 lacs respectively. In any of these cases the permissible level of credit from the banking system shall be Rs.9 lacs and it shall not be exceeded. At the same time, the trading firm will have to carry more stocks to provide the margins and/or to carry out its own inventory policy out of its own funds or funds raised from other sources.

5.24 The norms for financing trade suggested in this Report are considered reasonable for the following reasons. They would permit stock levels much higher than the actual levels of stocks of finished goods generally maintained by the industry at present. This provides for the higher degree of seasonality in agriculturally produced commodities. These norms permit a good level of 4 to 6 turnovers. Moreover, bill finance will continue to be excluded and creditors in respect of goods will not be excluded. Representatives of trade and industry consider these figures as reasonable and have in fact themselves suggested such norms. Moreover, rough calculations show that the trade under the modified system may get marginally a little higher bank credit than at present. The present economic condition in fact justifies more. Further, the modified system promises more credit to trade with rise in production and prices. At the same time it provides enough scope to the monetary authority to keep bank advances to trade against selected commodities in check both in short and long periods, as and when that is found necessary. They can tighten margins, indices and norms. Further, it is also assumed that selective credit control would continue to be supported by other physical and direct controls, buffer stocks and price support programmes. Selective credit controls need not be turned complex to achieve a large set of objectives. The experience shows that multiplicity of objectives generates complexity which in turn lowers the effectiveness.

5.25 The existing measures of selective credit control, particularly the minimum margins and level of credit have been made complex by introducing a number of discriminations based on nature of activity of the borrower, varieties of commodity or type of risk cover available. All such distinctions are in practice dysfunctional to the central objective of the selective credit control. They should, therefore in most cases be dropped to render the control system simple and more effective.

5.26 The only meaningful distinction is between manufacturing, processing and trading activities. Their nature of operations, constraints, scopes for overtrading and accesses to other sources of finance differ. In so far as industry is concerned, norms for inventory for it have already been laid down by the Reserve Bank. As long as an industrial unit stocks raw material within its norms, the question of excessive inventory build up does not arise. The banks have been asked to ensure this in case of industry. Of course, it is assumed that these norms would also be changed when necessary to reflect changes in the availability of the material in the market. Industry is also subject to control through financial norms which determine its permissible bank finance. As long as an industrial unit conforms to both types of norms laid down by the Reserve Bank, it is not fair to subject them further to higher margins under selective credit control. In fact, margins higher than the normal bankers' margin are not at all justified in their case. The existing selective credit control directives permit them the worse of the two alternatives. Therefore, when an industrial unit conforms to the two norms of the Reserve Bank or full discipline envisaged under the Tandon Study Group formulation, minimum margins under selective credit control should not be applied to it. But, as long as it does not comply with the two norms stated above, it must provide the same margin for its entire stock of selected commodity as has been prescribed for trade. It may, however, be noted that even in that case industry would get better treatment compared to trade because of non-applicability of level of credit rule for trade to it.

5.27 The processing units, like roller flour mills, rice mills, registered oil mills, industrial users of cotton and sugar, gur and khandsari units, etc., are at present exempt from the permissible level of credit measure. They have in fact been treated as production units. The norms suggested in this Report have been worked out specifically for trade. In case of processing units, like the industry, the stocks shall comprise of raw material, work-in-process and finished goods. Hence, norms for them shall have to be fixed as in case of industry for all three types of stocks if the control has to be meaningful. But, most of processing units are small in size and too numerous. At the present level of sophistication among borrowers and bankers, it is not advisable to lay down norms for such units and to subject them to a rule for permissible level of credit. They should, therefore, continue to be exempt from the permissible level of credit measure. Yet, the bankers may be advised to follow the spirit of the norms even in case of processing units. They should try to ensure that such units do not carry stocks of selected commodities in excess of 1/6 of their annual consumption of the commodity, particularly when it is in short supply. Whenever, excess stocks are observed, the bankers should not finance the excess stocks of selected commodities. Of course, provisions in respect of minimum margins should fully apply to processing units. This means that the full system comprising of minimum margins and permissible level of credit is to be applicable in its entirety only to trade.

5.28 There is a strong case for total exemption from selective credit control for the small borrowers. These would largely include retailers and farmers. In practice it is difficult to seggregate advances against selected commodities in case of composite advances to retailers rendering implementation too difficult. Similarly, it has also been difficult to comply with credit guarantee or warehouse receipt stipulations. Such procedural difficulties have in fact led to neglect of such advances to a large extent. This is an area of business where control proves to be too much of a procedural burden and the related benefits are not too high. Moreover, in the long period, these are cases which come under priority advances. It is, therefore, recommended that advances against selected commodities upto Rs.50,000 to a party should be totally exempt from selective credit control without any qualifying conditions. The only condition should be that a party would deal with only one bank at a time and furnish written undertaking to this effect as part of the loan agreement to the present banker. As for the rest, the banks should be left free to follow their own safeguards and procedures. Deliberately, no discrimination as between farmers and retailers is being suggested. There is no good reason for such discrimination.

5.29 It is also recommended that restrictions in respect of new branches and new parties should also be permitted to completely fade out as the modified system is adopted gradually in stages. These restrictions do help in keeping credit against selected commodities in check, but in an unjust manner. There is no good reason why a new branch should not lend against these commodities to the extent it can find potential to expand its business, subject of course to the observance of selective credit control measures, particularly in areas where those commodities happen to be important local products. The same logic applies to new parties. But, in this case, there may be some fears in respect of old firms reorganising into many more new firms. This risk is negligible.

It is adequately taken care of by the new rule in respect of level of credit. This is precisely why it is necessary to start all calculations from audited figure of net sales in the past and to lay down the turnover indices at the national level. Arbitrariness is limited only to the first year of an entirely new firm.

5.30 Credit against selected commodities by way of purchase of demand documentary bills drawn in connection with the movement of these commodities are at present exempt from the selective credit control. Exemption is also accorded to credit facilities against selected commodities as priority items under exports and imports. Advances against selected commodities in some states in north and north-east are also exempt from selective credit control. All these exemptions as they stand at present should continue. Cases for further liberalisation were examined but found unreasonable.

5.31 All other exemptions in vogue at present, unless explicitly recommended for retention, should be dropped. The modified system, recommended in this Report, should apply uniformly to all trading units in private as well as public sectors. There are some public agencies which carry buffer stocks of selected commodities. Such stocks should be financed separately as special cases and be treated as totally exempt from selective credit control. Most of the other exemptions are in fact rendered superfluous because of general exemption to advances against selected commodities to a party upto Rs.50,000. And, as for the rest, there is strong case for dropping exemptions in respect of public, semi-public or cooperative agencies. They might not be motivated to build up speculative inventories. But, they might very well carry excess inventories of selected commodities out of sheer lack of motivation to achieve high turnovers and to manage inventories efficiently. In both cases the effect on movement and availability of goods would be unfavourable. Efficient inventory management is necessary for every one stocking scarce resources and particularly for all those who handle essential commodities of mass consumption.

5.32 There are at present certain prohibitions in respect of clean advances to parties availing credit facility from banks against selected commodities, discounting of usance bills and advances to such parties against collateral securities, primarily with a view to check the circumvention of control measures. This need would continue to exist. Therefore, all these prohibitions in their present form should continue.

5.33 A few improvements in the implementation process are also considered necessary. It appears that at present decisions in respect of selective credit control in the Reserve Bank are taken up on a continuous basis as and when the specific cases for decision come up. Instead, it is suggested that all major decisions relating to selective credit control should become parts of two comprehensive exercises preceding the two agricultural crop seasons. This would not only facilitate a systematic and total examination, but also considerably reduce the uncertainties and disruptions faced by the bankers and the borrowers. Of course, a few decisions will always have to be taken in between to act in response to the short period changes in the state of the market of selected commodities. Such cases as a policy should be minimised. Representatives of trade and industry and various public and private agencies would continue to put up requests for change as and when necessary. They should be encouraged to do so only twice during the year. It is hoped that this recommended practice would improve relevance, effectiveness and acceptability of the selective credit control.

5.34 The comprehensive bi-annual exercises should cover decisions in respect of deletions and additions to the list of selected commodities, the minimum margins, norms for financing, turnover indices, exemptions, discriminations and prohibitions. A somewhat new area of decision making under the modified system would be the laying down of the turnover indices for each selected commodity in percentages in relation to the base year. They should be decided and communicated to the banks a little before the arrival of the produce on the market. It would, therefore, need information on anticipated supply position of each selected commodity:

stocks, crop forecasts, likely imports and exports. This demands evolving a simple methodology, defining information needs and sources, gathering and analysing information in respect of each commodity. It would involve a little extra work and a marginal increase in manpower. More importantly, it would demand orientation towards a specific type of decision making analysis.

5.35 Effective implementation demands action at the branches of the banks at the earliest opportunity, and, therefore, cut in delays. This means decisions must be made and communicated to the branches of the banks before the produce begins to arrive in the market. Therefore, information needs to be gathered and analysed before the decisions can be taken. Information system and communication system acquire critical importance. Much of the efficacy of the selective credit control, particularly in terms of its short period objectives, can be diluted if supply positions and their likely effect on prices of selected commodities cannot be anticipated at least six weeks before the produce begins to arrive in the market. In other words, a sort of early warning system needs to be developed. A large amount of information is at present collected by the Economic Department in the Reserve Bank and position notes in respect of each selected commodity are also prepared. Therefore, what is really needed is the further strengthening and toning up of the existing information system so as to make it serve more efficiently as an early warning system. It may also be noted in this connection that the Reserve Bank had appointed an internal review group on Market Intelligence for Sensitive Commodities which reported in November 1976. It is assumed its recommendations, which in most cases would help achieve the abovementioned needs, would in due course be implemented to strengthen the information system.

5.36 There are, however, a few aspects of the information system which need to be specially highlighted and emphasized. The process of information gathering should in all seriousness start with the sowing of the

crops. Second data on acreage sown and the crop prospects should be gathered and made available for decision making, and, it should receive more attention than the data on actual output, stocks and prices. Third, in addition to the sources already in use and to be further developed by the Reserve Bank, efforts should also be made to share information with other agencies specially interested in specific selected commodities. Sometimes they have lot of nonquantitative information on market expectations and anticipations. For example, it was found in course of this investigation that the Textile Commissioner's Office and the East India Cotton Association had lot of useful information available with them and it was really very fresh. Fourth, all information should be used more for the decision making analysis. Commodity notes shall always include some descriptive and review material. But, it needs to be emphasized that analysis specifically geared to the decision areas identified in this Report as parts of the modified system would need some fresh work and outlook. Fifth, as part of follow up, continuous information on supply and price positions of all selected commodities and continuous reviews would be necessary. A large part of such work is being done at present. What is recommended here is a slight change in approach and emphasis. For example, proposed bi-annual comprehensive decision making and continuous reviews over the interim period are deviations from current practice. Further, putting in of some extra effort to get more relevant information more quickly and to use it specifically for specific decisions are also meant to improve the current practice. An early warning system basically means gathering and using information more quickly and more purposefully.

5.37 It is estimated that all the features of the modified system of selective credit control could in its simplified form be accomodated in about 3 cyclostyled foolscap pages or about 6 printed pages of a small-sized brochure. One major shortcoming observed in course of this investigation, particularly in dialogues with bankers and borrowers, has been lack of understanding of the objective of selective credit control.

Knowledge of specific control measures was also found to be often times faulty and dated. One reason for it was the complexity of the system itself which rendered proper understanding of the directives too difficult. Second, these directives took too long to reach the branches through the circulars from respective head offices. A delay of two months was frequently noticed even in large city branches. Third, there was no document to show all uptodate information at one place. The information lies scattered in the files containing various circulars issued from time to time. Fourth, in vast majority cases there was no difference between the directives and circulars. In other words, communication from the Reserve Bank to the head offices of banks was passed on as it was to the branches without making it usable for the branch managers. Moreover, it needs to be noted that not even 1/3 of the total branches at present handle advances against selected commodities. Something needs to be done to remedy delayed, inadequate, dated, and imperfect communication. A useful suggestion in this regard is that the Reserve Bank should every six months bring out a six page brochure containing all uptodate selective credit control provisions. This could also be indented by banks as part of a standing arrangement so that it could be centrally printed and supplied to all the banks to be quickly despatched to the branches. This would certainly improve matters. The Reserve Bank does produce a chart at present containing selective credit control provisions. Further, effort along the lines indicated above would meet the need better.

5.38 Department of Banking Operations and Development of the Reserve Bank conducts regularly the inspection of the banks. Often times, it has also conducted surprise inspections of some branches specifically to detect cases of non-compliance of the provisions of the selective credit control. With the implementation of the modified system, such inspections will also have to be reoriented to the new provisions particularly the norms and the turnover indices. Two more suggestions are made in respect of the inspection. First, the Reserve Bank inspection should give special attention to those cases where out of order position in the accounts subsequent to the

raising of margins or non-compliance in respect of permissible level of credit continue for more than a month. Such cases should be commented in detail. Second, all observed cases of non-compliance should be in the end, every year, tabulated systematically for each type of non-compliance. Such yearly reports should be used as part of information for decision making in the Reserve Bank. They should also be circulated amongst banks so that they could improve their own audits and inspections and follow ups of implementations of selective credit control. The banks, in turn, should also be advised to tabulate annually non-compliances observed in their internal audits and inspections with a view to strengthen their feedbacks and follow ups.

5.39 The recommendations contained in this Report have been formulated such that their implementation would make the system of selective credit control more relevant to its objectives and more reasonable so as to be more acceptable in banking and business circles. No system is good if it cannot be implemented effectively and with ease. Therefore, rationalisation from complexity towards simplicity has been deliberately and strongly pursued. The effort has also been made to bring about a judicious blend of the short and long period objectives and the interests of the society, the banker and the borrower. Special attention has been accorded to the farmers and the small traders. Moreover, one needs to be doubly cautious in matters of money and finance. Therefore, effort has also been made to balance boldness with caution. Boldness lies in suggesting a new and progressive direction for change; the caution, on the other hand, has been practised by keeping the magnitude of change low and rate of change slow. Therefore, it is further recommended that the implementation should be made in three phases, each comprising of one year. In the first year, recommendations pertaining only to minimum margins and related exemptions and discriminations should be implemented. In the second year, the recommendations relating to permissible level of credit and exemption for retailers and farmers should be taken up for implementation. In the

third year, recommendations in respect of new parties and new branches should be implemented.

5.40 Lastly, it is also recommended that in order to facilitate implementation a small handbook explaining with practical illustrations the application of the various provisions of the modified system should be prepared by the Reserve Bank and supplied to the banks for reproduction and distribution to the branches. The Reserve Bank should also constitute a small internal group to monitor the implementation and to answer the queries of the banks and the borrowers. Also, during the implementation period the banks should be advised, when in doubt, to follow the old system.

6

SUMMARY OF OBSERVATIONS AND RECOMMENDATIONS

6.1 The Reserve Bank of India has been using selective credit control since 1956. This investigation focuses primarily on the following questions. What are the basic elements of the existing system of selective credit control ? What are the important successes and failures of the system and the process of its implementation ? What are the major system and implementation process deficiencies that need to be made up ? What should be the basic elements of the modified system which would help achieve better results ? As far as possible a balanced view has been attempted in order to accommodate different points of view and interests. Attempt has also been made to pick up recommendations from the realms of practice. No recommended feature is entirely new. All have at some stage and somewhere been part of practice in India and proved workable (Paragraph 1.1 to 1.5)

6.2. In India, the name selective credit control is used for a specific system of credit control which applies to a few selected commodities whose supply is sensitive and which are items of mass consumption. With the passage of time the system has tended to grow in scope and get more complex in character. Important measures under this control have been minimum margins, permissible level of credit and the minimum rates of interest. The other supportive elements have been the provisions for discriminations, exemptions and prohibitions. (Paragraphs 2.1 to 2.12)

6.3. Available evidence suggests that the selective credit control has been highly effective in achieving its direct objective of restricting bank credit against selected commodities. To that extent it has also contributed towards the fulfilment of its indirect objectives of holding the speculative inventory build ups and price rises in check. Without these control measures the position might have been worse. But,

there is also evidence to suggest that during recent years curbs on bank credit against selected commodities had been tightened to the degree of unreasonableness verging on almost denial of credit in very many cases. The present comfortable position in respect of many of the selected commodities affords an opportunity to correct the element of overtightening gradually in stages. In the long run, there is no strong reason to suggest some change in the policy of using selective credit control to achieve short as well as long period objectives of credit policy (Paragraphs 3.1 to 3.17)

6.4. The minimum margins laid down in recent years in respect of selected commodities have been too high, touching 60, 75 and 85 per cent levels. Further, there have been too many margins against a single commodity - in some case even more than a dozen. The level of credit measure, though highly effective, has been criticised severely for its unprogressive character because it does not provide for growth. Moreover, it does not help achieve the short-period objective. The laying down of minimum rates of interest for selected commodity advances, many times more than one rate for one commodity, do not seem to help much in achieving the objectives of selective credit control. On the contrary, they add to inconvenience, complexity and distribution costs. Too many discriminations and exemptions have added to complexity rendering implementation difficult and inefficient. Another major difficulty in implementation process has been delayed action which reduces in a large measure the efficacy of selective credit control, particularly in respect of short-period objectives. (Paragraphs 4.1 to 4.9).

6.5 The future of selective credit control measures needs to be considered in terms of their relevance and effectiveness. These measures are still very relevant. However, there is scope for modifying the control system to make it more relevant to the changing economic scene and to increase its effectiveness, particularly over the short period. The opportunity can also be utilised for rationalising and simplifying the system to remove some of its weak features, which affect implementation process adversely. (Paragraphs 5.1 and 5.2).

6.6. It is recommended that the basic structure of the existing selective credit control system should be retained. A few modifications would be adequate to achieve desired improvements. Since, laying down of minimum rates of interest does not achieve significant results and adds to complexity, it is recommended that this measure as part of the system should be completely dropped. (Paragraphs 5.3 and 5.4).

6.7. It is recommended that the Reserve Bank should follow a definite policy in respect of margins to ensure that (a) minimum margins against selected commodities do not go beyond 50 per cent (b) they should move downwards as early as practically feasible so as to serve truly as a short-period instrument of credit control, and (c) there should be only one margin for each selected commodity. The minimum margins should fluctuate between 20 and 50 per cent. Attempts should be made to gradually reach this position. (Paragraphs 5.8 and 5.10).

6.8. The most effective measure for restricting the supply of credit against selected commodities has been the party-wise level for bank advances. The present rule in this regard is unprogressive, arbitrary and not geared to short-period objective at all. It should therefore be replaced by a better rule. Such a rule is recommended in this Report. It is based on norms for financing trade and turnover indices to be laid down by the Reserve Bank of India twice each year. A distinction has been drawn between industrial, processing and trading units. The former two categories shall continue to be exempt from party-wise levels of credit. Norms for trade shall be used only for the purpose of fixing the permissible level of credit and not for regulating the actual inventory levels, to ensure that the banking system finances only that part of credit need of trade which has been considered reasonable at the national level. Changes in norms should be examined by an expert committee which could be appointed _ad-hoc_ for the purpose. (Paragraphs 5.12 to 5.15)

6.9 The recommended rule is based on the turnovers of the trading parties and the norms for financing stocks at different levels of turnovers. Norms shall be in terms of 1 or $1\frac{1}{2}$ months of the cost of goods sold depending on supply positions of different selected commodities at different times. And, there should be one norm for each selected commodity. Turnover indices are to be laid down in percentages related to the base year for which the audited figures of net sales are available. These indices multiplied by net sales of base year shall give acceptable estimate of net sales for the current year. The drawing at any stage in the current year should not exceed the lower of the two figures: the permissible level of credit and the drawing power (Paragraphs 5.16 to 5.20).

6.10 The actual number of turnovers achieved by trade would depend on the stocks actually held. The banks shall finance only upto the permissible level of credit as determined by the estimated turnover and the norm in respect of each party. Moreover the actual drawings shall have to be within the drawing power. The suggested norms shall permit approximately 4 to 6 turnovers. Moreover, under the suggested rule credit supply would increase with rises in turnovers and prices. Yet, it permits greater scope to the Reserve Bank for regulating advances against selected commodities through changes in margins, norms and turnover indices. (Paragraphs 5.21 to 5.25)

6.11 Existing control measures have become very complex because of so many distinctions and discriminations. It is recommended that in most cases these should be dropped. This Report suggests only one meaningful distinction between manufacturing, processing and trade for the purpose of selective credit control. Details of discriminations based on this distinction have also been spelt out. (Paragraphs 5.26 and 5.27)

6.12 There is a strong case for total exemption from selective credit control for the small borrowers : retailers and farmers. It is, therefore, recommended that advances against selected commodities upto Rs.50,000 to a party should be totally exempt from selective credit control subject only to one condition that a party would deal only with one bank at a time. (Paragraph 5.28)

6.13 It is also recommended that restrictions in respect of new branches and new parties should also be permitted to completely fade out as the modified system is adopted gradually in stages. A few important exemptions have been recommended for retention. All other exemptions are dysfunctional to the objectives of the control system, and, should therefore be dropped. (Paragraphs 5.29 to 5.31)

6.14 All prohibitions in force at present to prevent leakages and circumventions were found reasonable and they should continue in their present form. (Paragraph 5.32)

6.15 It is suggested that all major decisions in respect of selective credit control in the Reserve Bank should become parts of two comprehensive bi-annual exercises to facilitate a total and more systematic examination of policy issues and to reduce the uncertainties and disruptions faced by bankers and borrowers.

Ad hoc decisions should be minimised and public representations should be encouraged only twice during the year. Implementation of the modified system would involve a little extra work for handling new type of information and decisions involving marginal increase in manpower requirement and orientation towards such type of work. (Paragraphs 5.33 and 5.34)

6.16 Effective implementation demands cut in delays in the process. Information and communication systems would therefore need improvement. Extra effort will be needed to get more relevant information more quickly and to use it to expedite the decisions and communication of the decisions. An early warning system basically means this. (Paragraphs 5.35 and 5.36)

6.17 The Reserve Bank should every six months bring out a small brochure containing all uptodate provision in respect of selective credit control. The RBI inspection shall also need reorientation in respect of the modified system. The D.B.O.D., should systematically tabulate the observed non-compliances and share annual report in this regard with the banks. The Reserve Bank should also bring out a small manual in respect of practical applications of the modified system to facilitate implementation at the branch level. It should also constitute a small internal group to monitor implementation, and advise banks to follow the simple rule in course of early phase of implementation: when in doubt, follow the old system. (Paragraphs 5.37, 5.38 and 5.40)

6.18 It is recommended that the implementation should be made in three phases of one year each. In the first year, recommendations pertaining only to minimum margins and related exemptions should be implemented. In the second year, the recommendations relating to the permissible level of credit and total exemption for retailers and farmers should be implemented. In the third year, recommendations in respect of new parties and new branches should be implemented. (Paragraph 5.39)

ACKNOWLEDGEMENTS

Valuable guidance and information for this investigation was received from executives of the Reserve Bank, commercial banks in public and private sectors, trade and industry associations, borrowers and academicians. All this help is gratefully acknowledged. It is regretted that individual names are not mentioned. This is only because the list runs into several hundred.

Particular mention must be made of the valuable guidance received from Dr. I.G. Patel, Governor, Dr. K.S. Krishnaswamy, Deputy Governor and Dr. A.K. Banerji, Executive Director of the Reserve Bank of India. Invaluable help in arranging visits, gathering and analysis of information and preparation of the Report was received from Shri J.G. Gogate, Director, Shri A. Seshan, Deputy Director, Dr. D. Singh, Research Officer and Kum. V. Vimala, Staff Officer, all of the Banking Division, Economic Department, Reserve Bank of India. All this is also gratefully acknowledged.

September 15, 1978. (Sampat P. Singh)

dg:/-

ANNEXURE I

One-Man-Committee on Selective Credit Control
Questionnaire for Commercial Banks

1. Kindly state the total number of branches of your bank and also the number of your branches accounting for at least 85 per cent of advances against each of the commodities coming under the Selective Credit Control, as on the last Friday of December 1977.

2. How much time does it usually take for the Head Office, after the receipt of a directive in respect of Selective Credit Control from the RBI, to make it available to the concerned branches ? Kindly also state minimum and maximum number of days required for this purpose.

3. Do you attach copy of the Head Office guidelines for implementing the concerned directives ? If so, kindly state nature of such guidelines and also enclose two or three specimens.

4. How do you ensure proper implementation of RBI directives in respect of Selective Credit Control ? Kindly explain the system in detail.

5. What are the important types of operational difficulties raised by the branches in implementing the Selective Credit Control ?

6. Have your branches experienced any difficulty in interpreting the provisions of the directives ? If so, kindly give some specific instances of such difficulties as pointed out by your branch managers.

7. In what ways do the borrowers find it difficult to co-operate with the managers, particularly in respect of implementing margins and ceilings ?

8. What are the methods that are usually followed in order to comply with the raising of the margins ? Kindly state alternatives normally adopted by the borrowers.

9. There are two types of credits a party may avail : (i) against a sensitive commodity under Selective Credit Control, and (ii) against other commodities or clean advances. How do your branches control overall credit to a party such that the purpose of selective credit control is fully achieved ?

..2.

10. Would it be a better alternative to the present system of Selective Credit Control if credit outstanding ceiling in respect of each sensitive commodity were fixed for each bank as part of credit planning on a period to period basis, and, then the rest was left entirely to the discretion of each bank ?

11. Kindly mention steps to be taken by the RBI which would help to (i) simplify Selective Credit Control and (ii) its more effective implementation.

12. Do your branches maintain price register (or some other record) in respect of sensitive commodities to help them in scrutinising the valuation of stock as shown by the borrowers in periodic stock statements ? Kindly attach a copy of proforma of such register and also indicate the sources from which the prices are collected by the branches and the periodicity of updating the register.

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ANNEXURE II

One-Man-Committee on Selective Credit Control Questionnaire for Trade and Industry Associations

1. What specific difficulties borrowers face in availing credit from banks against sensitive commodities coming under the purview of the Selective Credit Controls ? Kindly be brief and mention specific difficulties point by point.

2. How do individual borrowers usually adjust when (i) banks raise the margins, and (ii) apply ceilings on total credit permissible against these commodities, under directives from the Reserve Bank of India ?

3. How much time is usually permitted by the banks to the borrowers for adjusting to the changed requirements of the RBI directives : (i) when margins are raised and (ii) when ceilings are lowered ?

4. What do you think is the best way for the banks to ensure that they do not finance speculative holding of sensitive commodities, particularly when their prices are rising or are expected to rise rapidly ?

5. Suppose the essential commodity/ies in which you are interested is/are taken out of the purview of the Selective Credit Control, how would it help the individual borrowers ? Kindly mention specific advantages point by point ?

6. Kindly give reasons why the commodity/ies in which you are interested should be taken out of the purview of the Selective Credit Control.

7. Kindly suggest ways in which the Selective Credit Control can be simplified so as to help the borrowers.

8. Any other observation in respect of Selective Credit Control.

dg:/-

ANNEXURE III

List of Secretarial Staff

1.	Dr. Dineshwar Singh	-	Research Officer
2.	Kum. V. Vimala	-	Staff Officer
3.	Shri T.K. Karthykeyan	-	Economic Assistant
4.	Shri P.G. Mathai	-	Clerk Grade I
5.	Shri A.C. Johnsingh	-	Clerk Grade II
6.	Shri R.C. Shinde	-	Peon

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