Annexure I

Repos and Reverse Repos Undertaken by RBI

1. With the objectives of improving short-term management of liquidity in the system and to even out interest rates in the call/notice money market, Reserve Bank of India has been undertaking repos (through auctions) since December 1992. Only banks and institutions having current account and SGL Account with RBI at Mumbai were eligible to participate in the repos auctions.

2. The repos were described to be in the form of sale of dated government securities by the RBI for very short periods with a confirmed buy-back provision. Initially, repos were conducted for one, two or three days covering Fridays in a weekly cycle. This was later replaced by a 14 day cycle covering the reserve make up periods. After March 1995, repos auctions were discontinued due to lack of demand caused by tight liquidity conditions. When the Repos auctions were resumed in early 1997, the practice of conducting auctions on a 3-4 day cycle had been introduced. Shorter period repos provide greater maneuverability to Reserve Bank in deciding the quantum of liquidity to be absorbed and the repo rate depending upon demand and supply conditions.

3. In terms of clause (a) of Subsection (1) of Section 28 of the Securities Contracts Regulation Act (SCRA), the provisions of the Act shall not apply to the Government, RBI etc. or any person who has effected any transaction with or through the agency of any such agency as is referred in this clause. As such, the Government of India Notification dated June 1969 would not apply to RBI repos.

4. From the angle of accounting, RBI has treated repos as buy/sell transactions. The main reasons for this perhaps have been the lack of definition of repo as a composite instrument in RBI Act or for that matter any legislation in India. RBI is authorised to purchase or sell Government securities under Section 17(8) of the RBI Act, 1934. Further, RBI cannot borrow any amount in excess of its paid up capital. This is an additional technical reason for RBI not treating repos as its borrowing.

5. In tune with the Bank's stipulation of a minimum three days for market repos, both repos and reverse repos had the period restriction of minimum three days till October 1998 when this stipulation was withdrawn.

6. The profusion of liquidity in the money market facilitates access to cheaper rupee funds which could be deployed by speculators for arbitraging between rupee and forex markets. This reportedly happened during November 1997 in the wake of East Asian melt down when the players took positions in the foreign exchange market at the time of a volatile Rs./US $ exchange rate. In this context, a pro-active liquidity absorption through repos was indicated. "Volume Tender Repos" appeared to present an operationally convenient method of conduct of repos by the Bank as an immediate measure. The practice followed in Germany was a pointer where the Bundesbank undertakes two different types of repos viz. "Volume tenders" and "interest rate tenders".

7. Since November 1997 the repos are being undertaken by RBI on fixed interest rate. The Fixed Rate Repos have acted as a strong intervention tool in the money market by setting a sufficiently high floor to call money rates thereby discouraging arbitrage between money and

foreign exchange market by certain players who take advantage of any imbalances in the forex market and in the process further accentuate the slide of rupee in an uncontrolled manner. The credibility, effectiveness and force of fixed rate repo are evident from the fact that the repo rate has come to be looked upon by the market as RBI's signal on short term interest rate.

8. The Bank has also been using the instrument of "reverse repos" for releasing liquidity into the system for short periods; this is used in conjunction with refinance facilities to ease conditions of liquidity stringency marked by very high call rates. While repos are open for participation to major participants in the money market viz. banks and institutions having both current and SGL accounts with the Bank, reverse repos are generally conducted through only with Primary Dealers (PDs). The reverse repos operations through PDs have the twin objective of (a) providing liquidity support to the PDs at the Bank rate to meet their obligations as Primary Dealers and (b) beyond the liquidity support limits, releasing funds at discretionary interest rates during periods of liquidity stringency in the system.

9. The export refinance and the general refinance facilities provided to banks at the Bank Rate do have a sobering effect on the call/notice money rates and it is an automatic mechanism for easing liquidity when call/notice money rates cross the bank rate. However, the reverse repos operations are more secure compared with refinance facilities as title passes to the Bank in the case of former and only equitable interest in the collateral is created in the latter case.

10. Further, reverse repos is an indirect instrument with market related and flexible rates whereas refinance facility is more of a direct instrument and sector specific. Therefore, as a matter of policy, with the objective of moving over to indirect instruments of monetary control, liquidity management and money market intervention by the RBI could gradually be shifting to repos/reverse repos operations.

11. Also, the Primary Dealer System has the objective of providing Primary Dealers (PDs) preferred access to open market operations and later exclusive access to them in RBI's open market operations. Keeping in mind this medium term objective, the reverse repos operations (for injecting liquidity) are carried out at present only through Primary Dealers. However, since September, 1998 PDs were provided advances against their SGL holdings in order to bring flexibility in the matter of availment of liquidity support. The lack of flexibility in the case of reverse repos was attributable to two factors viz. lack of provision for premature reversal and also roll-over on the date of maturity. Bank may consider reverting to reverse repos as a means of providing liquidity support in the case of PDs by providing for roll-over of repos with adequate safe-guards.