THE ANNUAL REPORT ON THE WORKING OF THE RESERVE BANK OF INDIA

*For the Year July 1, 2001 to June 30, 2002**

PART ONE : THE ECONOMY : REVIEW AND PROSPECTS

I MACROECONOMIC POLICY ENVIRONMENT

Introduction

1.1 Policies for macroeconomic management in 2001-02 were geared to initiate and nurture the recovery of industrial activity and exports against the backdrop of sluggishness in several industries and the deepening of the synchronised slowdown characterising the global economy. A robust recovery in agricultural performance, comfortable food stocks, record lows in inflation, and a strong improvement in the balance of payments reflected in a large accretion to the foreign exchange reserves provided the enabling environment for the macroeconomic policy stance.

1.2 Real sector policies were guided by the objective of boosting domestic investment demand by expanding the participation of private enterprise and by promoting foreign investment. Trade policies focussed on an aggressive medium-term export strategy, both product- and market-specific, within the overall goal of raising India's share in world exports over a five-year span. The process of removal of quantitative restrictions (QRs) and the reduction/ rationalisation of tariffs was carried forward. Foreign investment policy extended the liberalisation of extant ceilings on foreign direct investment (FDI) in various sectors. Liberalisation was also effected in respect of the participation of foreign institutional investors (FIIs) in Indian corporate entities. Norms for overseas issuances by Indian companies and Indian direct investment abroad were eased significantly along with procedural simplifications. Fiscal policies renewed the commitment to consolidation and rectitude alongside a six-pronged strategy to reinvigorate the economy and return to a growth path consistent with its potential. Monetary policy continued its stance of ensuring adequate liquidity to meet credit demand, and pursued the objective of softening of interest rates consistent with a vigil on price stability. Channels of credit delivery were refined and augmented and the operational effectiveness of monetary policy was improved as an integral part of building the institutional infrastructure of an efficient and vibrant financial system. Banking and financial sector reforms were intensified with continued emphasis on deregulating the policy environment to enhance the operational efficiency of financial intermediaries, strengthening these institutions by benchmarking prudential standards against international best practices, improving the regulatory and supervisory function, and enhanced transparency, accountability and market discipline.

REAL SECTOR POLICIES: AGRICULTURE AND INDUSTRY

Agriculture

1.3 A number of steps were undertaken to reduce foodgrain stocks that are posing problems of storage and disposal. QRs on export of several food items including wheat and wheat products, coarse grains and pulses were dismantled in March 2002. The 'First In First Out' (FIFO) condition for export of foodgrains from the Food Corporation of India (FCI) stocks – requiring disposal of old stocks before newer arrivals could be sold - was waived in June 2001. The Central Issue Price (CIP) of wheat and rice was lowered by around 26 per cent in July 2001 for the Above Poverty Line (APL) consumers so as to increase the off-take under the Targeted Public Distribution System (TPDS). The quantum of foodgrains for the Below Poverty Line (BPL) consumers was increased to 35 kilograms per household. The Public Distribution System (PDS) was converted into a statutory entity in September 2001. The policy of dividing the country into five zones for selling subsidised wheat in the open market was removed in January 2002. Each State would be treated as a separate zone and the actual freight cost incurred by the FCI in transporting wheat to that State would be charged.

* While the Reserve Bank of India's accounting year is July-June, data on a number of variables are available on a financial year basis, *i.e.*, April-March, and hence, the data are analysed on the basis of the financial year. Where available, the data have been updated up to June 2002, and in some areas, information beyond end-June 2002 is also discussed. For the purpose of analysis and for providing proper perspectives on policies, reference to past years as also prospective periods, wherever necessary, has been made in this Report.

1.4 Several new initiatives under the “save grain campaign scheme” to reduce losses of foodgrains during the post-harvest period were initiated in 2001-02, including creation of additional storage capacities (estimated at 54 lakh tonnes), creation of additional capacity for bulk handling, storage and transportation facilities and creation of conventional godowns through private sector participation. Grain banks are proposed to be established in various locations of the country.

1.5 Forward trading was allowed in sugar in April 2001. A package of policy measures aimed at boosting sugar exports and forward trading was announced in November 2001. Three exchanges were given ‘in-principle’ approval to carry futures trading in sugar. A consortium was given an ‘in-principle’ approval to set up a multi-commodity exchange to undertake futures and spot trading in 30 commodities in July 2001.

1.6 A key objective of fiscal policy for 2002-03 is the acceleration of agricultural reforms, the removal of regulatory and procedural rigidities and an improved infrastructure in the agricultural sector. Assistance from Rural Infrastructure Development Fund (RIDF) is linked to reforms in the agriculture and rural sectors and funds for RIDF-VIII have been enhanced. The allocation for the Accelerated Irrigation Benefit Programme (AIBP) was also stepped up.

Manufacturing, Infrastructure and Services

1.7 FDI up to 100 per cent was permitted in a wide range of manufacturing activity and commerce, in special economic zones (SEZs) and in telecommunications, airports (including concessions for private sector participation in greenfield airports proposed in the Union Budget, 2002-03), courier services, drugs and pharmaceuticals, and hotel and tourism sectors. The defence sector was opened up for private participation. The Union Budget for 2002-03 put in place a tourism development package consisting of development of six tourism circuits to international standards during 2002-03 and permission for Special Purpose Vehicles (SPVs) to raise resources from both public and private sectors for infrastructure development in these circuits. Steps were also taken to address infrastructural constraints through the implementation of the National Highway Development Project, expansion in the ambit of National Telecommunication Policy (1999) through opening up of Domestic Long Distance telephony, and introduction of the Convergence Commission of India Bill (2001) in the Parliament. An Infrastructure Equity Fund of Rs.1000 crore was set up for providing equity investment for infrastructure projects.

1.8 The new policy for the automobile industry, announced in March 2002, allows foreign equity investment up to 100 per cent in this sector without any minimum capitalisation norms. It aims to promote the Indian automotive industry as globally competitive, with a balanced transition to open trade at minimal risk to the Indian economy and local industry. In the Union Budget, 2002-03 manufacturing of some auto components has been de-reserved. The Government is also planning to remove the outstanding export obligation of auto companies, given the imperatives of the Word Trade Organisation (WTO).

1.9 The Plan outlay on power, roads and national highways and railways was enhanced substantially to step up public investment in infrastructure. Measures were taken to address the issue of appropriate user charges necessary to provide adequate returns on investment. In the power sector, the focus of reforms shifted from generation to transmission and distribution. The Accelerated Power Development Programme (APDP) is being redesigned as the Accelerated Power Development and Reform Programme (APDRP) with enhanced Plan allocation. Access of the States to the fund under the Programme will be on the basis of agreed reform programmes.

EXTERNAL SECTOR POLICIES

Trade Policies

1.10 The Medium Term Export Strategy 2002-07 (MTES) announced in January 2002 sets out a road map for the export sector which would be co-terminus with the Tenth Five-Year Plan period. The MTES aims at increasing India’s share in world trade to one per cent by 2006-07 from the present level of 0.67 per cent. This implies doubling exports from the present level. The MTES includes product (220 commodities) and market identification for exports and indicative sector-wise strategies for identified potential sectors. Export market diversification is also a major objective of the Export and Import (EXIM) Policy with special focus on sub-Saharan Africa and the Commonwealth of Independent States (CIS).

Export and Import (EXIM) Policy (2002-2007)

1.11 The Five-Year EXIM policy for the period 2002-2007 announced on March 31, 2002 includes, *inter alia,* removal of all QRs on exports (except a few sensitive items reserved for exports through State Trading Enterprises), a farm-to-port approach for exports of agricultural products, special focus on cottage sector and handicrafts, and assistance to States for infrastructural development for exports (ASIDE).

1.12 28 Agri Export Zones (AEZs) were sanctioned in 14 states to promote the export of agro products and agro-based processed products. Export capabilities of the small scale sector, which accounts for about 50 per cent of India's exports, were strengthened through a programme for "Special Focus on Cottage Sector and Handicrafts" including promotion of cottage sector exports under Khadi and Village Industries Commission (KVIC), access to funds from Market Access Initiative (MAI) for units in the handicrafts sector, exemption from maintenance of average level of exports under Export Promotion Capital Goods (EPCG) Scheme, duty-free imports of specified items up to three per cent of the Free-on-Board (FoB) value of exports and benefit of export house status at a lower average export performance (Rs.5 crore). Similar incentives would be extended to industrial cluster-towns with export potential like Tirupur (hosiery), Panipat (woollen blankets) and Ludhiana (woollen knitwear).

1.13 Several measures including reduction in customs duty on imports of rough diamonds to zero and abolition of licensing regime for rough diamonds were undertaken to enable India to emerge as a major international centre for diamonds. Important measures were taken to give a fillip to jewellery exports, including reduction in value addition norms for export of plain jewellery from 10 per cent to 7 per cent and allowing mechanised unstudded jewellery exports at a value addition of only 3 per cent.

1.14 Facilities for SEZs under the EXIM policy include income tax concessions, exemption from Central Sales Tax (CST) on supplies from the Domestic Tariff Area (DTA), drawback/Duty Entitlement PassBook (DEPB) to DTA suppliers, exemption from external commercial borrowing restrictions, freedom to make overseas investment and carry out commodity hedging. For the first time, Overseas Banking Units (OBUs) exempt, *inter alia,* from CRR and SLR stipulations, would be set up in SEZs to provide access to external finance at international rates. In a post-budget announcement, 100 per cent deduction of export profits was allowed to all SEZ units commencing production on or after April 1, 2002 for a period of five years and thereafter at 50 per cent for the next two years. Supplies to SEZs from the DTA would be treated as physical exports instead of deemed exports for the purposes of duties, tariffs and central sales tax under the Income Tax Act and Customs Act.

1.15 In order to give a boost to the hardware industry, the Electronic Hardware Technology Park (EHTP) Scheme was modified to enable the sector to avail of the zero duty regime under the Information Technology Agreement (ITA-I). Net foreign exchange earning as a percentage of exports (NFEP) for these units has to be positive in five years instead of every year. There would be no other export obligation for EHTPs and supplies of ITA-I items with zero duty in the domestic market would be eligible for counting of export obligation.

1.16 Rationalisation and procedural simplification has been undertaken in respect of the Duty Free Replenishment Certificate (DFRC), DEPB, EPCG Scheme and Advance Licence Scheme (ALS). Various facilities would be extended to status holders like direct negotiation of export documents, 100 per cent retention in Exchange Earners' Foreign Currency (EEFC) accounts and extension of the repatriation period for realisation of export proceeds from 180 days to 360 days. With a view to further reducing transaction costs, various procedural simplifications are being introduced in the Directorate General of Foreign Trade (DGFT) and customs procedures.

1.17 Transport subsidy was extended to units located in North Eastern States, Sikkim and Jammu & Kashmir to offset the disadvantage of being far from ports. In order to encourage re-location of industries to India, import of plant and machineries was permitted without a licence where the depreciated value of such relocating plants exceeds Rs.50 crore.

Budget Proposals Relating to Customs Duties

1.18 Major changes relating to customs duties effected in the Union Budget for 2002-03 include reduction in the peak rate of customs duty from 35 per cent to 30 per cent, increase in the customs duties of tea and coffee (from 70 per cent to 100 per cent), spices, *i.e.,* pepper, cloves and cardamoms (from 35 per cent to 70 per cent), natural rubber and poppy seeds (from 35 per cent to 70 per cent), pulses (from 5 per cent to 10 per cent) and imposition of duty of 30 per cent on such non-edible oils that contain 20 per cent or more of free fatty acid.

1.19 The customs duty on dairy products was hiked to the WTO bound rate of 40 per cent from 30 per cent. The customs duty on imported liquors was reduced from 210 per cent to the bound rate of 182 per cent in accordance with WTO commitments; the rates of countervailing duty (CVD) applicable to liquors and wines were rationalised.

1.20 There was a reduction in customs duty on IT products. Customs duty on specified items of reeling,

twisting, weaving and processing machinery for silk textile industry was reduced from 25 per cent to 10 per cent. These items were exempted from Central Value Added Tax (CENVAT) along with 28 items of processing machinery, automatic shuttle looms and specified jute machinery; these concessions would be available up to February 28, 2005.

Post-Doha Developments

1.21 The Doha Declaration of November 2001 comprising a main Declaration, a Declaration on Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement and Public Health and a decision on implementation related issues and concerns sets out the future Work Programme of the WTO. The negotiating mandate focuses on reducing or eliminating tariff peaks and escalations as well as non-tariff barriers. With regard to General Agreement on Trade in Services (GATS), members are to make requests for market access by June 30, 2002 and initial offers of market access by March 31, 2003. India continues to focus on seeking enhanced market access for developing countries in future WTO negotiations. India has urged that that the work programe on implementation issues should be given the highest priority. Greater attention needs to be given to issues concerning Sanitary and Phyto-Sanitary Standards (SPS) and Technical Barriers to Trade (TBT) so as to fully realise gains in agriculture. India has also argued that the TRIPS agenda should reflect the concerns of developing countries. In the context of the Doha declaration, India has also called for a 'Development Coalition' of the bio-diversity rich countries of the world for the protection of traditional knowledge.

Policies for External Capital Flows

1.22 Various policy initiatives were undertaken to further liberalise the movement of cross-border capital flows especially in the area of outward foreign direct investment, inward direct and portfolio investment, non-resident deposits and external commercial borrowings.

Foreign Direct Investment

1.23 The policy framework governing inward foreign direct investment (FDI) was substantially liberalised under the automatic route. FDI up to 100 per cent was permitted under the automatic route for manufacture of drugs and pharmaceuticals, in the hotel and tourism sector and for mass rapid transport systems in all metropolitan cities (including associated commercial development of real estate). Similarly, airports, development of integrated townships, commercial premises, hotels, resorts, city and regional level urban infrastructure facilities such as roads and bridges, manufacture of building materials and courier services (subject to exclusion of activity relating to distribution of letters) were permitted 100 per cent FDI under the automatic route. FDI up to 49 per cent from all sources was permitted in the private sector banks under the automatic route.

Portfolio Investment

1.24 Indian companies were permitted in September 2001 to raise the 24 per cent limit on Foreign Institutional Investors' (FIIs) investment to the sectoral cap/statutory ceiling as applicable. As announced in the Union Budget for 2002-03, FIIs portfolio investment will not be subject to sectoral limits for FDI except in specified sectors. FIIs were allowed by the Reserve Bank on February 4, 2002 to trade in exchange traded derivative contracts subject to limits prescribed by the Securities and Exchange Board of India.

Non-Resident Deposits

1.25 Continuing with the policy of progressive liberalisation of the capital account, the non-resident non-repatriable (NRNR) account and non-resident special rupee (NRSR) account schemes were discontinued with effect from April 1, 2002. Existing accounts under the schemes would continue up to the date of maturity after which the amount would be credited to non-resident (external) accounts/non-resident (ordinary) accounts (for details see Section IX).

1.26 Ongoing liberalisation of current external transactions encompassed repatriation of current income like rent, dividend, interest and pension of non-resident Indians (NRIs) based on an appropriate certification. Indian corporates with proven track record were allowed to contribute funds from their foreign exchange earnings for setting up Chairs in educational institutions abroad, and for similar such purposes.

Indian Direct and Portfolio Investment Overseas

1.27 Existing limits for Indian direct investment outside India under the automatic route were raised to US $ 100 million. Two-way fungibility of American Depository Receipts (ADRs)/Global Depository Receipts (GDRs) became operational with the issuing of guidelines by the Reserve Bank in February 2002. The transactions will be demand driven and the custodian will monitor the re-issuance of ADRs/GDRs.

Foreign Currency Convertible Bonds (FCCB) up to US $ 50 million were brought under the automatic route.

External Commercial Borrowings and EEFC Accounts

1.28 The Reserve Bank allowed corporates on a case-by-case basis to credit even higher proportions of export proceeds to their EEFC accounts than 50/70 per cent allowed hitherto with a view to enabling them to take advantage of lower interest rates and prepay their external commercial borrowings.

FISCAL POLICY

1.29 The Union Budget for 2002-03 adopted a six-pronged strategy, *inter alia,* emphasising continuation of agricultural and food economy reforms, enhancement of public and private investment in infrastructure, strengthening the financial sector and capital markets, deepening structural reforms and regenerating industrial growth. The strategy for fiscal correction continues to rest on control of non-Plan expenditure, tax reforms, larger disinvestment proceeds and maintaining a higher growth in revenue relative to aggregate expenditure.

Expenditure Management

1.30 The prospects for expenditure management have been strengthened by the success achieved in containing non-Plan expenditure during 2001-02. The Union Budget 2002-03 envisages several measures for reinforcing the process of expenditure management. Various Ministries/Departments have identified around 17,200 posts for abolition, of which around 7,800 posts have been abolished so far. Fresh recruitments will be limited to one per cent of total civilian staff strength over the next four years. To contain the expenditure on subsidies, the Union Budget increased the issue price of urea and other fertilisers. Capital disbursements and the capital outlay have been enhanced in order to reverse the trend of fiscal adjustment occurring through reductions in public investment.

Tax Measures

1.31 The Union Budget aims at providing a modern tax regime with a view to reviving demand, promoting investment, accelerating economic growth and enhancing productivity. On the direct tax front, measures were aimed at further progress towards widening the tax base, rationalisation and simplification of tax structure and encouraging voluntary compliance. The two per cent surcharge for Gujarat earthquake relief was abolished and a surcharge of five per cent was imposed on all categories of tax payers except income up to Rs. 60,000. Tax on perquisites in case of employees with taxable salary (excluding perks) up to Rs.1,00,000 will be exempted from tax for 2002-03 and for the subsequent years the employer may opt to pay the tax on perquisites on behalf of the employees. Tax on distribution of dividend by domestic companies and mutual funds was abolished; however, the ultimate recipients of the income would be taxed as per the rate applicable to them. Corporation tax for foreign companies was reduced from 48 per cent to 40 per cent to correct the disparity between foreign companies and domestic companies.

1.32 Additional depreciation at the rate of 15 per cent was allowed on new plant and machinery acquired on or after April 1, 2002 for setting up of a new industrial unit or for expanding the installed capacity of existing units by at least 25 per cent to give stimulus to the industrial sector. Banks were allowed to deduct up to 7.5 per cent (up from 5 per cent) of their total income against provisions made for bad and doubtful debts. Further, the optional deduction on account of non-performing assets (NPAs) falling in the category of loss or doubtful assets was enhanced from 5 per cent to 10 per cent and a similar option of deduction was allowed to public financial institutions.

1.33 Investment in bonds issued by Small Industries Development Bank of India (SIDBI) and National Housing Bank (NHB) were exempted from capital gains tax under 54EC. Tax concessions announced on July 31, 2002 include, *inter alia,* deductions from income derived from specified investments under Section 80L of the Income Tax Act raised from Rs. 9,000 to Rs. 12,000, no tax be deductible on dividend up to Rs. 2,500 received from each company or a mutual fund and exemption of life insurance premia from any service tax.

1.34 The indirect taxes were further simplified by reducing the number of items attracting special duty of 16 per cent. The tax base was expanded by including specified services provided by the corporate sector similar to services provided by banks and non-banking financial institutions. The peak rate of customs duty was reduced while rationalisation and simplification of the rate structure was carried further along with concessions for specified equipment for ports and airports and the civil aviation sector, the steel industry, IT hardware and units in Special Economic Zones.

Structural Reforms

1.35 The Union Budget, 2002-03 also provided momentum to the consolidation of structural reforms. A key policy change envisaged was the dismantling of the Administered Price Mechanism (APM) and Oil

Box I.1

Administered Price Mechanism in the Petroleum Sector

The Administered Price Mechanism (APM) for petroleum and diesel was abolished with effect from April 1, 2002. The pricing of Aviation Turbine Fuel (ATF) had already been deregulated from April 1, 2001. The APM was a complex cross-subsidised system under which some petroleum products like kerosene and diesel were highly subsidised, while the prices of some products like petrol were fixed at a level higher than the import parity price. While it was expected to be self-balancing over a period of time, domestic prices of petroleum products were partially insulated from volatile international crude prices in the short-term.

The APM worked satisfactorily in dampening the pass-through of fluctuations in international prices to domestic inflation. On the other hand, lack of incentives for resource generation and technological upgradation resulted in widespread distortions that affected both industrial and consumer segments adversely. In the absence of price signals, inefficient use of fuel and a perverse duty structure resulted in a negative rate of protection for the refineries.

The APM was supported by the Oil Pool Account that was in operation since 1975. Oil pool deficits are outstandings payable to the oil companies by the Oil Co-ordination Committee (OCC). The oil pool went in deficit from 1989-90 onwards. This deficit rendered the public sector units in this sector non-viable and caused them to borrow heavily from the financial system in order to maintain supply lines.

With the dismantling of the APM, the oil companies are expected to set the prices of petrol and diesel in accordance with market forces, while prices for PDS Kerosene and domestic LPG will continue to be subsidised. These subsidies are planned to be phased out in the next 3 to 5 years. The cost of these subsidies would be borne out of the Consolidated Fund of India although the Government is expected to collect taxes on petroleum products to roughly offset these subsidies. Oil marketing companies will have flexibility to revise product prices; however, a regulator would be put in place to guard against cartels and other monopolistic practices by oil companies that could be harmful to consumers.

References

1. Government of India (1996), *Report of the Strategic Planning Group on Re-structuring of Oil Industries,* Ministry of Petroleum and Natural Gas, September.
2. ------- (1996), *Interim Report of the Technical Group on Fiscal Incentives Hydro Carbon Sector,* Ministry of Petroleum and Natural Gas, November.

Pool Account from April 1, 2002. The outstanding balances in the Oil Pool Account would be liquidated by issue of oil bonds to the oil companies. The pricing of petroleum products would increasingly be determined by the market forces. Private companies will be permitted to undertake distribution, subject to specified guidelines to be overseen by a Petroleum Regulatory Board. The subsidy on Liquefied Petroleum Gas (LPG) and kerosene oil was reduced from April 1, 2002 and these subsidies are proposed to be phased out in the next 3 to 5 years (Box I.1).

1.36 Measures were outlined to enhance social security coverage. The Insurance Regulatory and Development Authority (IRDA) recommended a regulatory framework for setting up pension funds to enable individuals to subscribe on a defined contribution basis to obtain the benefit of pensions on their retirement. The public sector insurance companies will provide health insurance to the needy people in the rural areas under the scheme called "Janraksha", which will enable a person to get treatment up to Rs.30,000 per year at selected and designated hospitals with a payment of Re. 1 per day as insurance premium. These initiatives are expected to accelerate the pace of pension reforms in India (Box I.2).

Box I.2

Pension/Provident Funds : An Indian Perspective

In India, pension schemes are generally in existence for the salaried workforce. The schemes can be broadly divided into the following categories: (i) Central Government pension and provident funds, (ii) State Government pension and provident funds, (iii) non-Government pension and provident funds (iv) public pension and provident funds and (v) National Social Assistance programme. These funds belong in the mandatory, publicly managed genre, with tax incentives to encourage voluntary contributions above the mandatory level. They adopt the pay-as-you-go (PAYG) model where the current revenue is expected to finance current pension obligations. There are, however, no such schemes for the self-employed.

Pension expenditure of the Central Government registered a very rapid growth during the 1990s. Pension and other retirement benefits amounted to 7.2 per cent of current revenues during 2001-02 (revised estimates) as compared with 3.8 per cent in 1990-91. For the States,

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pensions have been the fastest growing item of expenditure in their budgets – 'a ticking time bomb' as alluded to in the report of the Eleventh Finance Commission. The outstanding liabilities on account of provident funds amounted to about 15.1 per cent of the outstanding total liabilities of the Centre and 15.5 per cent of total States liabilities in 2000-01. Further, while the average primary yield on long-term Government paper of 15 years was 8.76 per cent in 2001-02, the interest rate on provident/pension funds was around 9.50 per cent. The effective cost for the Government turns out to be much higher if various fiscal concessions are considered. Furthermore, liabilities on account of pension payable to retired employees of aided institutions and local bodies are required to be added to the Government's pension bill. These liabilities are expected to rise in the future, pre-empting increasing proportions of current revenues and becoming a potential source of instability. Besides, these liabilities are partly funded; their true budgetary impact remains hidden as fresh inflows have been used to pay off liabilities in a Ponzi game. Furthermore, provident funds have also been invested in State Government guaranteed bonds, State Electricity Boards, irrigation projects and State financial institutions, which may carry default risk.

Contextually, several dimensions need to be considered in the design of pension reforms in India. Considerations relating to inter-generational equity, the structure of incentives favouring contractual savings, the fiscal impact of pensions and the accounting thereof assume importance. Morever, contingent liabilities may arise due to the nature of regulatory prescriptions pertaining to provident funds and pensions. These issues weigh in with equal importance as broadening the social safety net, ensuring safety and adequate returns and regulatory dimensions in terms of prescriptions governing operation of pension funds within the overall financial sector reforms. The Union Budget 2001-02 proposed a new pension programme based on defined contributions for those who enter Central Government services after October 1, 2001. As announced in the Union Budget for 2002-03, a High-Level Expert Group appointed for the purpose proposed a hybrid scheme that combines contributions from employees and the Union Government on matching basis, on the one hand, while committing to the employees a defined benefit as pension, on the other.

Initiatives for reforms in pension and provident funds in India are of recent origin. Project OASIS (Old Age Social and Income Security) prepared under the Ministry of Social Justice and Empowerment is the most important among them. Currently, pension reforms are considered as an integral part of financial sector reforms and fiscal consolidation. Development of a funded private pension system needs to be supported by a simultaneous strengthening of the financial market infrastructure. Appropriate regulation and supervision of pension and provident funds will hold the key to the sustainability of the reforms in the coming years. Various pension and provident funds catering to different sections of the employees needs to be under a common regulatory umbrella. In the emerging scenario, it may also become necessary to consider risk management and governance guidelines for pension and provident funds, including fully funded schemes. Caution is advocated against instituting any large-scale changes in the pension and provident funds system or regulatory regimes without ensuring appropriate reforms in other areas.

References

1. Government of India (2000), *Report of the Eleventh Finance Commission.*
2. Government of India (2002), Union Budget, 2002-03.
3. Reddy, Y.V. (2000), "Pension System in India: A Central Banker's Perspective", Speech at Pension System Reforms Conference, organised by Asian Development Bank Institute at New Delhi on November 24, 2000.

1.37 In order to encourage State-level fiscal reforms, the Union Budget provided additional allocations in respect of Centrally Sponsored Schemes – Accelerated Power Development and Reform Programme (APDRP), Accelerated Irrigation Benefit Programme (AIBP), Urban Reform Incentive Fund (URIF) and Rural Infrastructure Development Fund (RIDF).

1.38 Measures were taken to facilitate adequate credit flow to small scale industries and a new Laghu Udyami Credit Card (LUCC) Scheme was introduced for providing simplified and borrower friendly credit facilities to small businessmen, retail traders, artisans and small entrepreneurs, professionals and other self employed persons, including those in the tiny sector. A micro venture capital fund for small innovations is being set up by the Small Industries and Development Bank of India (SIDBI) in co-operation with the National Innovation Foundation to facilitate the transition of innovations into enterprises.

1.39 The Expert Committee to review the system of administered interest rate and other related issues (Chairman: Dr. Y.V. Reddy) provided a framework for reforms in the administered interest rate regime. In pursuance of the Committee's recommendations, the Union Budget, 2002-03 announced that interest rates on small savings would be linked to the average annual yield of government securities in the secondary market for the corresponding maturities. Such adjustments would be undertaken annually on automatic and non-discretionary basis, which would

considerably reduce the rigidities of the interest rate structure in India (Box I.3).

MONETARY POLICY FRAMEWORK

1.40 During 2001-02, the Reserve Bank continued to ensure that all legitimate requirements for credit are met consistent with price stability. Towards this objective, the Reserve Bank continued its policy of active management of liquidity. The overall stance of monetary policy for 2001-02 was stated as: (i) provision of adequate liquidity to meet credit growth and support revival of investment demand while continuing a vigil on movements in the price level and (ii) within the overall framework of imparting greater flexibility to the interest rate regime in the medium-term, to continue the present stable interest rate environment with a preference for softening to the extent the evolving situation warrants. Banks and financial institutions were sensitised to the possibilities of a reversal or tightening of monetary policy in case the underlying inflationary situation turns adverse or there are unfavourable and unexpected external developments.

1.41 The measures undertaken in 2001-02 in pursuit of the monetary policy objective included, *inter alia,* a 50 basis point reduction in the Bank Rate effective

Box I.3

Expert Committee to Review the System of Administered Interest Rates and Other Related Issues

With a view to achieving flexibility in interest rates, an Expert Committee was constituted by the Central Government on April 19, 2001 (Chairman: Dr. Y.V.Reddy) to review the system of administered interest rates and other related issues. The Committee submitted its Report on September 17, 2001.

The Committee observed that the basic philosophy of small savings is to provide a secure avenue for long-term saving by individuals. In India, small saving schemes were introduced at administered interest rates when banking and capital markets were underdeveloped and savers looked upon the government as a reliable banker. Over time, these instruments emerged as high-cost and non-transparent sources of financing fiscal deficits, distorting the term structure of interest rates and lacking a definite asset profile corresponding to the increasing liabilities.

The Committee observed that most of these funds are expected to be privately managed with larger and diversified investment portfolios in future. The medium-term objective of the Central Government should be to spell out a well conceived investment policy to facilitate switching over to fully funded long-term saving schemes managed independently and professionally.

In order to make the interest rate channel for monetary policy transmission more effective, all interest rates in the economy including small saving rates should respond to monetary policy changes. In this context, the Committee explored the possibility of linking the interest rates of small saving schemes to market related interest rates through suitable benchmarking. After considering all feasible options, the Committee recommended the average secondary market yield on Government securities as the appropriate benchmark as it is market determined, ensures real return and act as risk-free benchmark for other rates.

The Committee broadly agreed with the recommendations of the Shome Advisory Group on Tax Policy and Tax Administration with regard to short and medium-term instruments (maturity up to 6 years) and suggested that all tax incentives on short and medium-term financial assets as provided under Section 80L, Section 88 and Section 10 of Income Tax Act may be withdrawn. With regard to long-term savings, the Committee recommended that the tax concession at the time of accrual may be provided under Section 88 of IT Act. However, withdrawals at the time of maturity could be uniformly taxed at a rate of 10 per cent.

One of the terms of reference before the Committee was to explore the feasibility of transferring the entire net proceeds of small saving to States. The Committee identified the need to simultaneously address the 'overhang' problem created historically due to maturity mismatches between small saving deposits and loans extended to States by the Centre against small saving collections. The Committee felt, however, that complete decentralisation would be detrimental to the interests of the State Governments. Therefore, the National Small Saving Fund (NSSF) must continue as the conduit for mobilisation of small savings as well as repayment to the investors. The Committee felt that the entire net proceeds from small savings collected after March 31, 2002 should be transferred to the State Governments. Accordingly, the Central and State Governments should jointly repay the outstanding small saving liabilities as of March 2002, apportioned in accordance to their respective shares. The Central Government would have no share from the fresh collections after March 2002. Each State Government may be allowed additional market borrowings to maintain its budgetary resources. The State Governments should mandatorily prepay their liabilities to the Central Government ahead of the schedule, which would help them to replace their high cost liabilities of the past.

Reference :

1. Reserve Bank of India, (2001), "Expert Committee to Review the System of Administered Interest Rates and Other Related Issues" (Chairman: Dr. Y.V. Reddy), *Reserve Bank of India Bulletin*, November.

October 23, 2001; a rationalisation of Cash Reserve Ratio (CRR) through a reduction of 200 basis points from 7.5 per cent to 5.5 per cent in two stages and withdrawal of exemptions from CRR on all liabilities other than inter-bank liabilities; freedom to banks to price loans at sub-PLR rates; rationalisation and reduction in ceiling rates on rupee export credit by one percentage point across the board effective September 24, 2001 up to September 2002; a 100 basis point reduction of the repo rate in three stages; and refinement of the Liquidity Adjustment Facility (LAF) and standing liquidity facilities.

1.42 The Bank Rate changes combined with CRR and repo rate changes have emerged as signaling devices for interest rate changes and important tools of liquidity and monetary management. The LAF has evolved as an effective mechanism for absorbing and/ or injecting liquidity on a day-to-day basis in a flexible manner and, in the process, providing a corridor for the call money market.

1.43 For the purpose of monetary policy formulation for 2002-03, the growth rate of real GDP in 2002-03 was placed at 6.0-6.5 per cent in the April 2002 Monetary and Credit Policy statement. The rate of inflation is assumed to be slightly lower than 4.0 per cent. The projected expansion in broad money (M_3) and in aggregate deposits for 2002-03 is 14.0 per cent each and 15.0-15.5 per cent for non-food credit. Against this background, the Reserve Bank proposes to ensure that all legitimate requirements for credit are met during 2002-03 consistent with the objective of price stability. Towards this end, the Reserve Bank will continue its policy of active management of liquidity using the policy instruments at its disposal, whenever required. Unless circumstances change unexpectedly, the Reserve Bank will continue to maintain current interest rate environment with a bias towards softer interest rate regime in the medium-term. Furthermore, the long-term objective would be towards realignment of interest rates of all types of debt instruments, both the government and private sector, within a narrow band. The Reserve Bank will also continue its efforts to bring about development and smooth functioning of the financial market and pursue further financial sector reforms towards achieving a greater degree of efficiency, transparency and financial stability.

1.44 In pursuit of the monetary and credit policy stance for 2002-03, the CRR was reduced by half a percentage point to 5.0 per cent which was to be effective from June 15, 2002 but was subsequently advanced to June 1, 2002. A flexible stance was indicated with respect to the Bank Rate with a reduction up to 50 basis points envisaged as and when necessary. Flexibility was sought to be imparted to interest rate policy by encouraging introduction of variable rate systems for deposits and transparency in disclosure of maximum spreads over Prime Lending Rates (PLRs) and various charges payable by borrowers. The ceiling rate on foreign currency export credit was reduced by 25 basis points.

FINANCIAL SECTOR REFORMS

1.45 Financial sector reforms in 2001-02 continued to focus on structural and regulatory measures with a view to strengthening the financial system and improving the functioning of the various segments of the financial markets. During 2002-03 so far, reforms in these directions have been accelerated with priority attached to developing the technological infrastructure of the financial system, a redefinition of the regulatory function of the Reserve Bank and a stronger vigil on asset-liability management in an environment characterised by the interaction of technology with deregulation.

Development and Regulation of Financial Markets

1.46 One of the main objectives of policy measures in the recent years has been to improve the functioning of financial markets by broadening and deepening the various segments and by equipping them with adequate infrastructure.

Money Market

1.47 Besides ensuring orderly conditions, the Reserve Bank took steps to develop the call/notice money market into a pure inter-bank market in a phased manner. Lending in call money market by non-bank participants was reduced to 85 per cent of their average lending in 2000-01. Corporates have been phased out of this market since July 1, 2001. Further scaling down of non-bank lending in the call/notice money market to 75 per cent would be considered once the Negotiated Dealing System (NDS) and Clearing Corporation of India Limited (CCIL) become fully operational and widely utilised. The standing liquidity support to the banks and primary dealers was also rationalised by apportioning two-thirds of the facility as a normal facility extended at the Bank Rate and the balance one-third as back-stop facility which could be availed at a variable rate with a spread over the reverse repo/repo rate under LAF/NSE-MIBOR. Operational modifications were also effected in the LAF in order to facilitate transactions. The daily minimum reserve maintenance requirement of banks was

reduced from 65 per cent of CRR balances to 50 per cent for the first week while keeping it at 65 per cent for the second week, effective from the fortnight beginning August 11, 2001.

1.48 Repo auctions are generally conducted without any pre-announced rate; however, the Reserve Bank exercised its option and conducted a fixed rate repo at a cut-off rate of 6.0 per cent on March 5, 2002. Subsequently, the repo cut-off rate was reduced to 5.75 per cent on June 27, 2002. The Reserve Bank introduced longer term repos of 14 days on November 5, 2001. Prudential limits on exposure to call/notice money market including on call/notice money lending of PDs are slated to come into effect in October-December 2002 (see Section IX).

Government Securities Market

1.49 Efforts to deepen and widen the government securities market continued during 2001-02. The maturity profile of Government debt was elongated with issuances of bonds up to 25-year maturity. There was “passive consolidation” by reissuing existing stocks through price-based auctions. In order to cater to diversified investor needs, Floating Rate Bonds (FRB) were reintroduced in 2001-02 and bonds with call/put options were issued in July 2002. An indicative advance calendar for issuance of dated securities of the Central Government for the first half of 2002-03 was announced in March 2002 to improve transparency in primary issuance of Central Government securities.

1.50 The NDS (Phase I) was operationalised from February 15, 2002 to provide online electronic bidding facility in the primary auctions of Central/State Government securities and OMO/LAF auctions, screen-based electronic dealing and reporting of transactions in money market and securities markets. Contemporaneously, the Clearing Corporation of India Limited (CCIL) also commenced its operations for clearing and settlement of transactions in Government securities (including repos). The envisaged replacement of the existing Public Debt Act, 1944 by a Government Securities Act, would simplify the procedures for transactions in Government securities, allow lien-marking/pledging of securities as also electronic transfer in dematerialised form.

Foreign Exchange Market

1.51 In the foreign exchange market, the prime objective of the Reserve Bank is to manage volatility with no fixed target for the exchange rate which is determined by market forces. During 2001-02, capital account transactions were further liberalised, as mentioned earlier. The existing limit on overseas borrowing as well as investment of 15 per cent of unimpaired Tier I capital by banks was increased to 25 per cent. Banks were permitted to invest their FCNR(B) deposits in longer term fixed income instruments. The ceiling interest rate on FCNR(B) deposits for a maturity period of 1-3 years was revised downward.

1.52 Importers and exporters were allowed to book forward contracts, subject to a cap of US $ 50 million or equivalent. The facility to cancel and rebook forward contracts which was available only in respect of export transactions was extended to all forward contracts effective April 1, 2002. The EEFC scheme was further liberalised for exporters with proven track record.

Banking Sector Reforms

1.53 Policy measures undertaken in the context of the banking sector during 2001-02 were guided by the objectives of strengthening the banking sector through rigorous operational, prudential and accounting norms set to gradually converge to international standards, improvement in the credit delivery system and gradual narrowing of the divergences in regulatory framework of different types of institutions. Prudential tightening covered exposure and disclosure norms, guidelines on investment, risk management, asset classification and provisioning. Banks were encouraged to prepare themselves to follow international practices in respect of assigning capital for market risk. Initiatives in the direction of redefining the regulatory oversight of the Reserve Bank included mitigating the potential conflict of interest regarding issues of ownership, risk-based supervision, consolidated accounting and supervision, off-site monitoring and inspection. Policy attention was also drawn to issues in management of non-performing assets (NPAs) and related supervisory initiatives, including the setting up of asset reconstruction company and the revival of weak public sector banks. New avenues of banking activity were created in insurance and the access of the banking sector to foreign direct investment was enhanced during 2001-02.

Prudential Norms

1.54 Exposure limits defined in terms of banks' capital funds were tightened effective March 2002 for both individual and group borrowers. Foreign banks were brought on par with Indian banks for the purpose of exposure ceilings. The financing of equities and investments by banks was eased to allow banks to extend finance to stockbrokers for margin trading within

the overall ceiling prescribed for banks' exposure to capital market with adequate safeguards, including the requirement of dematerialised trading.

1.55 Banks were required to prepare for convergence with international standards on asset classification and provisioning norms. From the year ended March 2002, banks were required to make additional disclosures relating to movement of provisions held towards NPAs and depreciation of investments, the total amount of loan asset subjected to restructuring under Corporate Debt Restructuring (CDR) and amounts of sub-standard and standard assets subjected to CDR.

1.56 In order to ensure that banks follow a more prudent policy for utilising the gains realised on sale of investment in securities, they were advised to transfer the maximum amount of gains realised on sale of investment in securities to the Investment Fluctuation Reserve (IFR) Account which should reach a minimum of 5 per cent of their investment under “held for trading” and “available for sale” categories within 5 years, with the freedom to build up higher percentage of IFR up to 10 per cent of banks portfolios in the IFR.

Issues in Regulation and Supervision

1.57 The Board for Financial Supervision (BFS) evolved a country-specific approach to consolidated supervision through a multi-disciplinary Working Group which examined the introduction of consolidated accounting practices for consolidated supervision, in line with international best practices. The frequency of some of the off-site surveillance returns was increased to a monthly basis during 2001-02 and progress was made towards implementation of risk-based supervision.

1.58 The regulation of systemically important institutions performing payment and settlement services such as the Clearing Corporation of India Ltd., is to be performed by the Reserve Bank with oversight authority vested in the Board for Financial Supervision (BFS). Similarly, in view of the growing systemic implications of PDs operations for the stability of the financial systems, they have been brought in the purview of regulation of BFS.

1.59 In keeping with its approach to avoid the potential conflict of interest created by the ownership of regulated financial institutions, the Reserve Bank divested its entire holdings in the Securities Trading Corporation of India Ltd. and the Discount and Finance House of India. Similar disinvestment is proposed for its holding in the State Bank of India, the National Housing Bank and the National Bank for Agriculture and Rural Development. In pursuance of the objective of withdrawing from development financing functions, the Reserve Bank transferred assets on account of loans and advances to Development Financial Institutions out of National Industrial Credit (Long Term Operations) Fund to the Government, replacing them with long-term Government of India securities through private placement.

1.60 A Consultative Group of Directors of Banks/FIs (Chairman: Dr. A.S. Ganguly) was set up to strengthen the supervisory role of the Boards of banks. The major recommendations of the Group are discussed in Section X. Banks have been requested to place the Report before their Board of Directors. Certain recommendations of the Group require the approval of the Government or legislative amendments.

Management of Non-Performing Assets

1.61 Several initiatives were undertaken to reduce the level of NPAs in the banking system and to manage them better. A special one-time settlement (OTS) scheme for small and marginal farmers was put in place. Banks were advised to formulate a policy for the recovery of loans from small borrowers in all sectors irrespective of the nature of business or purpose. The Union Budget for 2002-03 announced the establishment of a pilot Asset Reconstruction Company to take over the NPAs of the banking sector and to develop a market for securitised loans.

Institutional Issues

1.62 Policy efforts to deepen the banking sector and infuse competition into financial intermediation were accelerated. Banks were allowed to freely price and issue rights shares while bonus shares were delinked from the rights issues. Foreign direct investment (FDI) in banks in the private sector was allowed up to 49 per cent under the automatic route with transfer of existing shares from residents to non-residents requiring approval of the Foreign Investment Promotion Board and in-principle approval of the Reserve Bank. In order to provide a level playing field the maximum limit of share holding of Indian promoters in private sector banks was raised to 49 per cent of their paid up capital. In the case of public sector banks, FDI and foreign portfolio investment was allowed up to 20 per cent. Foreign banks were allowed to set up subsidiaries in India. The Union Budget for 2002-03 announced that the Deposit Insurance and Credit Guarantee Corporation would be converted into the Bank Deposit Insurance Corporation.

Urban Co-operative Banks

1.63 Withdrawal of the stipulation of the minimum lending rate (MLR) was announced in the Monetary and Credit Policy for 2002-03. Urban co-operative banks (UCBs) were allowed to determine their lending rates subject to appropriate disclosure norms. UCBs were advised to review their interest rate structure on term deposits of different maturities and to make them comparable with the rates offered by commercial banks.

1.64 Prudential guidelines were issued to UCBs in order to minimise their exposure to credit and market risk. They were also required to begin additional provisioning to achieve the international norms relating to asset classification and provisioning by March 2004. Criteria for classification of UCBs as weak and sick were revised with a view to sharpening the focus of efforts to implement revival plans. Guidelines were issued to the State Governments on one-time settlement of NPAs for UCBs under their jurisdiction. Registration and licensing procedures were subjected to critical review in the light of recent problems in the sector and the danger of contamination in other segments of the banking system. Recommendations of the Madhava Rao Committee such as inclusion of Directors with banking experience in their Boards and formation of Audit Committees were required to be implemented by all UCBs. An external screening committee was set up to assist the Reserve Bank in an advisory role for considering proposals for setting up UCBs. An off-site surveillance system on the lines of monitoring systems for commercial banks was introduced for scheduled UCBs and will be extended to all UCBs in a phased manner. Similarly, the system of Asset-Liability Management (ALM) has also been introduced for scheduled UCBs.

Financial Institutions

1.65 In August 2001, capital adequacy standards for financial institutions (FIs) were modified with a risk weight of 20 per cent on all loans and advances granted to their own employees, which are fully covered by superannuation benefits and mortgages of flats/houses and 100 per cent risk weights for all other loans and advances granted to employees. Refinancing institutions were advised in June 2001 that they need not classify the Government guaranteed accounts as NPAs, even if they are in arrears and not reckoned for income recognition purposes, unless the guarantees are repudiated. Exposure norms for refinancing institutions would be applicable in respect of their direct finance and not on their refinance portfolio for which FIs have to devise their own norms approved by their Board. Disclosure requirements for FIs were enhanced to include the movement in the provisions held towards non-performing assets and depreciation in investment portfolio. The treatment of ‘time overrun’ in respect of projects under implementation for the purpose of asset classification was redefined/reclassified. Norms were prescribed for the FIs for entry into insurance business. The Reserve Bank also introduced CAMELS-based supervisory rating model for the FIs.

Corporate Debt Restructuring

1.66 A three-tier Corporate Debt Restructuring (CDR) System was introduced in August 2001 to provide a transparent mechanism for restructuring of debts of viable corporate entities affected by internal or external factors, outside the purview of Board for Industrial and Financial Reconstruction (BIFR), the debt recovery tribunals (DRT) and other legal proceedings. In pursuance of the proposal made in the Union Budget 2002-03, the Reserve Bank constituted a High Level Group (Chairman: Shri Vepa Kamesam, Deputy Governor) to review the operations of the CDR scheme, to identify the operational difficulties in its smooth implementation and to suggest measures to make the scheme even more effective. The Group has submitted its report which is under examination. As an interim measure, permission for debt restructuring would be given by the Reserve Bank on the basis of specific recommendations of the CDR Core Group, if a minimum of 75 per cent (by value) of the lenders constituting banks and FIs consent for the CDR, irrespective of differences in classification of the assets by banks/FIs.

Non-Banking Financial Companies

1.67 The major thrust of policy in respect of non-banking financial companies (NBFCs) during 2001-02 was on bringing about convergence in the operational, prudential and accounting norms and practices of NBFCs with those of the banking industry. With a view to further strengthening the regulatory/supervisory framework for NBFCs, guidelines were issued on investment policy and classification of investments, identification of loss assets and the need for a credit policy in respect of call/demand loans. Guidelines for the ALM system for NBFCs issued on June 27, 2001 became operational from the year ended March 31, 2002. The concept of ‘past due’ for the purpose of income recognition norms is to be dispensed with, effective from the balance sheet for the year ended

March 31, 2003. The maximum rate of interest that NBFCs can pay on their public deposits was reduced.

1.68 In order to inculcate a sense of discipline among NBFCs, it has been decided to take serious action against NBFCs progressively for non-submission of returns to the Reserve Bank. Such action may include imposition of penalties as provided for in the Reserve Bank of India Act, 1934 and also launching court proceedings, besides considering rejection/ cancellation of the certificate of registration (CoR). To start with, cases of NBFCs having public deposits of Rs. 50 crore and above, and defaulting in the submission of returns are being taken up.

1.69 The Reserve Bank continued its efforts towards educating the NBFC depositors about the regulatory framework, the role of the Reserve Bank in monitoring the functioning of NBFCs and the factors to be considered before investing money in NBFCs, *etc.*, through both the print and electronic media.

Money Laundering and Financing of Terrorism

1.70 Sharing the increasing international concern on the use of the financial system for money laundering and financing of terrorism, the Reserve Bank and the Government initiated various steps to check misuse of the financial system for laundering proceeds of criminal activities. With a view to safeguarding banks from being unwittingly used for the transfer or deposit of funds from criminal activities, it was decided to reinforce the existing instructions on Know Your Customer (KYC) norms and cash transactions. The policy, procedures and controls required to be introduced by banks including strict adherence to KYC procedures have been issued in consultation with banks.

1.71 In the light of recent international developments and recognising the need for a critical assessment of India's position *vis-a-vis* international standards on market integrity, the Standing Committee on International Financial Standards and Codes commissioned an internal technical group on 'Market Integrity'. The Report of the Group provides an assessment of India's position with respect to G-7 principles on Market Integrity and recommendations of the Financial Action Task Force (FATF) on anti-money laundering and terrorist financing which serve as a benchmark in this regard. The Report also provides an overview of international efforts to combat money laundering, briefly reviews the existing laws and regulations for the purpose of detection and law enforcement against criminal activities in financial sector, and notes the recent initiatives taken for prevention of money laundering. The full text of the Report on 'Market Integrity' has been placed on the website of the Reserve Bank.

POLICIES FOR CAPITAL MARKETS

1.72 During 2001-02, several changes were introduced in the settlement practices in the capital markets, including extension of the rolling settlement on T+5 basis to all scrips. The risk management system for the stock exchanges was strengthened in the aftermath of the irregularities in the securities market. The year also witnessed major institutional changes for improving corporate governance practices. The norms for issuance of shares in the primary market were eased further in order to encourage companies to come out with public issues. In the derivatives segment, the range of products was extended further to include index options, stock options and stock futures.

Primary Market

1.73 The Securities and Exchange Board of India (SEBI) amended the SEBI (Disclosure and Investor Protection) Guidelines, 2000 to provide for the inclusion of Foreign Venture Capital Investors (FVCIs) and State Industrial Development Corporations (SIDCs) as Qualified Institutional Buyers (QIBs) for participating in the book-building process. It also abolished the lock-in period for the pre-issue share capital of an unlisted company held by Venture Capital Funds (VCFs) and FVCIs and removed the restriction of a minimum issue size of Rs.25 crore in case of an Initial Public Offer (IPO) through book-building. The option to allocate the unsubscribed portion of the fixed price portion in a book-building issue to any category or lapse altogether was allowed. Buyback norms were relaxed by the Government and the cooling-off period for a fresh issue of a security after buyback was reduced to six months from two years.

Secondary Market

1.74 The SEBI extended compulsory rolling settlement on T+5 basis to 414 scrips from July 2, 2001 and advised the stock exchanges to introduce uniform settlement cycle (Monday to Friday) in respect of remaining securities. Rolling settlement on T+5 basis was extended to all scrips with effect from January 2, 2002. The settlement cycle was shortened to T+3 effective April 1, 2002. This brings the securities settlement system in India at par with international

standards, in line with the recommendations of the Report of the joint task force of the Committee on Payments and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO) on securities settlement systems.

1.75 Other reforms initiated by the SEBI included banning of all deferral products, including *badla*; introduction of a market-wide circuit breaker system applicable at three stages of the index movements and introduction of 99 per cent value-at-risk (VaR) based margin system for all scrips in the compulsory rolling settlement with effect from July 2, 2001; and shifting of the margining system from net basis to gross basis (sales and purchases) with effect from September 3, 2001. In order to widen the equity derivatives market, the SEBI permitted introduction of new derivative products. The stock exchanges, accordingly, commenced trading in index options in June 2001, followed by options on select securities in July 2001 and futures on select securities in November 2001. The FIIs were also permitted to trade in all exchange-traded derivative contracts subject to position limits effective February 2002.

1.76 Major initiatives were also taken to improve standards of corporate governance, including amendment to listing agreements requiring the companies to furnish segment-wise details of revenues, results and capital employed along with quarterly unaudited results, *etc.* The SEBI issued norms for speedy redressal of investors' grievances and prescribed Model Rules for stock exchanges to be implemented in phases. The SEBI advised the stock exchanges to amend listing agreements requiring companies to furnish statements and reports on their Electronic Data Information Filing and Retrieval (EDIFAR) system.

Mutual Funds

1.77 The disclosure norms for mutual funds were tightened to help investors take more informed investment decisions. The SEBI decided that mutual funds should disclose the performance of benchmarks in case of various types of equity-oriented, debt-oriented and balanced fund schemes while publishing half-yearly results. Detailed investment and disclosure norms for employees of Asset Management Companies (AMCs) and Trustee Companies were laid down in order to avoid any actual or potential conflict of interests. The SEBI prescribed that all mutual funds should enter into transactions in Government securities only in dematerialised form. Mutual funds were allowed to invest in the listed or unlisted securities or units of VCFs within the overall ceiling for such investments. To bring about uniformity in calculation of the net asset value (NAV) of mutual fund schemes, the SEBI issued guidelines for valuation of unlisted equity shares. With a view to improving the professional standards, certification by the Association of Mutual Funds of India (AMFI) was made mandatory for the appointment of agents/ distributors by all mutual funds.