The consumption basket is getting diversified towards value added food products such as meat, poultry, fish, vegetables and fruits. It is important for production to respond to these shifts in consumption. There is also a growing recognition that agriculture is becoming increasingly unsustainable from the point of view of environmental balance due to practices such as mono-cropping, over exploitation of natural resources, excessive irrigation and the intensive use of chemical fertilisers. The focus, therefore, needs to be on crop diversification and broad-based agricultural development that will not only cater to the changing consumption pattern and reduce imports, but also take advantage of India's global competitive strength in various agricultural products. The agro processing industry holds considerable potential in this context to emerge as the main driver of diversification of agriculture.

7.28 Efforts towards diversification must be complemented by a greater focus on recent gains from the impact of new advances in biotechnology and disease-resistance. Emerging areas like floriculture, horticulture, genetic engineering and organic farming hold high growth potential and have to be earmarked for prioritisation in investment. Furthermore, India has export potential in dairying, sericulture and horticulture which remains unexploited due to input heterogeneity and lack of marketing infrastructure.

7.29 The process of diversification calls for micro-level planning with emphasis on crop specific inputs, creating proper marketing infrastructure, cold storage, transportation facilities and supportive policies. There is a need for value addition in agricultural products through processing, packaging, and supply chain management so that farm incomes expand, employment is generated and rural poverty is alleviated. This cannot take place without directed policy actions, given the complexity inherent in diversified farming activity and the difficulties connected with the linking of farms to relevant markets. Policy action will itself have to be diversified keeping in view the needs of different agricultural and allied activities and the varied agro-climatic regions. Just as the spread of the Green Revolution was aided by a package approach across the country involving the coordinated supply of inputs, technology, seeds and extension of credit, there is clearly a need now for the creation of similar packages for diversification of agriculture in different regions. This also calls for vertical integration and public-private partnership in these activities, the modalities for which will have to be worked out. The thrust of diversification has to be on high value added products keeping in view the market demand both within and outside the country.

7.30 Efficient and well developed agricultural markets are necessary to enable farmers to deal with inherent risks associated with the perishability of their produce, to get remunerative prices and to secure smooth access to input supplies. Towards these objectives, the agricultural marketing system in the country needs to be integrated and strengthened. In this regard, speedy implementation of the Model Law on Agricultural Marketing and Contract Farming in all the States and the Union Territories would facilitate development of competitive agriculture markets in the private and the co-operative sectors and encourage contract farming.

7.31 Deceleration in the yields of many crops is an area of concern calling for research and development to evolve high-yielding and pest–resistant varieties of seeds, dry land farming and reclamation of waste lands. It is also recognised that adoption of new technology, especially new variety of seeds, entails higher risk than the use of traditional seeds. Measures to mitigate risks such as spread of irrigation facilities, better water management and adequate crop insurance must be emphasised.

Industry

7.32 The recovery of the industrial sector which began in the first quarter of 2002-03 has been steadily gaining momentum. Indian industry is engaged in a process of transformation due to competitive pressures, rapid technological progress, deregulation of product and financial markets and organisational change. Industrial restructuring has focused on niche strategies and core competencies while phasing out inefficient units. Enhanced quality consciousness through implementation of techniques like Total Quality Management (TQM) and Six Sigma have had a favourable impact on the quality of output of the manufacturing sector. Another significant development has been the changing composition of exports in favour of manufactures and technology-intensive products. There are also indications of improvement in the investment climate.

7.33 An issue of concern has been the fluctuations in industrial output in the second half of 1990s with adverse consequences for the competitiveness of manufactured products. While export demand imparts a competitive dynamism to industry, there is a need to broad-base competitive ness over a wider spectrum of products. Moreover, while strong export demand tends to support overall industrial demand, there is a need to generate domestic demand on a more enduring basis to sustain the growth momentum. In particular, concerted efforts need to be made to generate demand for those industries which are operating much below capacity levels such as 'food products', 'machinery and equipment (other than transport)', 'transport equipment and parts' and 'other manufacturing industries'. In industries in which production is approaching existing potential, the focus must be on building new capacities.

7.34 India has the potential to be a major beneficiary of the phasing out of the Multi Fibre Agreement (MFA). The dismantling of MFA import quotas in 2005 offers the textile sector significant opportunities to capitalise on the expansion of overseas markets. At the same time, however, competitive pressures will intensify and continuous improvement in product quality will become an imperative to defend existing market shares. It is crucial, therefore, to develop appropriate skills and upgrade technology to fully exploit the available opportunities. Industrial growth should typically accelerate in India's current stage of overall development. This acceleration has not taken place despite the wide-ranging industrial reforms in the 1990s. In a labour abundant country such as India, labour-intensive industries should be expected to grow faster. With the ongoing tariff reforms, some of the biases against labour-intensive industries have now been reduced. Further work needs to be done to identify policy actions that can help to induce high industrial growth that is particularly labour-intensive.

7.35 Small and medium enterprises (SMEs) occupy a unique position in the Indian economy due to their significant contribution to exports and value addition to domestic supply chains, employment generation, expansion of entrepreneurial base and diversification of the industrial sector. There is an urgent need for a comprehensive review of the policy framework for the small scale sector with a view to consolidating and carrying forward recent initiatives towards infrastructural support, technology upgradation, preferential access to credit, and preferential purchase policy. In particular, there is a need for a critical appraisal of the policy of reserving the items for production in the small scale sector. The Union Budget, 2004-05 has de-reserved 85 items for the small scale sector. While this is certainly a welcome policy change, there is a need for accelerated phasing out of the remaining reserved items. The focus should be on improving the competitive ability of SSI units through improvements in their efficiency and quality levels.

7.36 The persisting delay in execution of Central Sector Projects (CSPs) is another area which requires careful monitoring. While there has been some reduction in the cost overrun during 2003-04 as compared with the previous year, the proportion of delayed projects to total projects has increased. Many of the railway projects which are more than five years old are delayed due to inadequacy of funds and tardy progress in acquisition of land. The cost overrun of the delayed projects mainly relates to the projects in power and surface transport sectors. Issues regarding civil works, equipment supply, timely award of contract, feasibility studies and project appraisal continue to affect the speedy implementation of the CSPs. Adequate attention needs to be paid to ensure completion of projects in a time bound manner to avoid cost overruns.

Services

7.37 The services sector has emerged as the engine of growth of the Indian economy. The strength of the services sector needs to be leveraged in view of its enormous growth potential and positive externalities for the commodity producing sectors. While the rising share of services in the GDP is an encouraging sign of greater degree of diversification of the Indian economy, the corresponding decline in the shares of commodity producing sectors implies that overall productivity gains in the economy would depend increasingly on the degree of efficiency attained by the services sector.

7.38 The sustainability of high growth of services would hinge upon high quality of production and delivery, continuous improvement in productivity and pro-active supply responses in markets where tastes and patterns change rapidly. Customisation will be the hallmark of strategies for gaining market shares. The global market for the new drivers of service sector growth –Information Technology Enabled Services (ITES) and Business Process Outsourcing (BPO) services – is becoming intensely competitive and is being compressed by protectionist pressures. Diversification of range of services offered as well as geographical markets, further innovations and ensuring customer satisfaction would remain crucial to maintaining India's competitive advantage in major international markets. Improvement in efficiency in the delivery of infrastructure services such as transportation, power, water supply and other urban services is critical to the enhancement of productivity in the commodity producing and services sectors alike. At this stage of development, construction activity holds the key for enhancing productivity and improving employment prospects across the economy. The modernisation of construction techniques would help in reducing overall costs in all infrastructure sectors and housing.

FISCAL POLICY

7.39 An important goal of fiscal consolidation through the implementation of FRBM Rules, 2004 is to eliminate the revenue deficit by 2008-09. This is sought to be achieved by raising the tax-GDP ratio through augmentation of tax receipts from sustained growth and better compliance. Moreover, emphasis needs to be on withdrawing exemptions and rationalising the tax structure so as to eliminate subjectivity in the tax system. In this context, it is also worthwhile to explore the applicability of a uniform tariff rate on imports. Given the downward rigidities characterising revenue expenditure, the attainment of the goals set out in the FRBM Rules would be contingent upon the realisation of the assumed revenue buoyancies. The Kelkar Task Force has made useful recommendations for boosting of revenues for the period 2004-05 through 2008-09 – a single goods and services tax (GST), removal of the plethora of exemptions granted to import and excise taxes, widening the net by expanding the service tax base and improving the tax compliance.

7.40 On the expenditure front, there is continued need for a review of the expenditure on subsidies and reorienting them so that the benefit accrues to the needy. It is also important to ensure that the quality of expenditure is enhanced by better targeting, elimination of waste in execution and emphasising value of output especially in delivery of services affecting the poor such as drinking water, sanitation, primary education and health. This, in turn, has wider ramifications for the productive capacity of the economy, given the paramount importance of public investment in critical areas of the Indian economy.

7.41 The emerging fiscal scenario of a number of State Governments underscores the need for concerted efforts towards achieving durable fiscal consolidation. This, in turn, entails appropriate user charges and cost recovery of social and economic services, apart from restructuring of state PSUs. The focus of adjustment, therefore, needs to be on fiscal empowerment and pro-active enactment of fiscal responsibility legislation by all the State Governments. In this regard, particular emphasis needs to be placed on strengthening the ability of the States to deliver efficiently the critical social services such as public health and primary education. The delivery of quality secondary education and medical services is also essential for further enhancement of the quality of life of all citizens.

EXTERNAL SECTOR

7.42 The growing strength of India’s external sector has provided the enabling conditions to accelerate the pace of external liberalisation. This has considerably mitigated the inward-looking bias of past regimes and has brought forth a healthy response in terms of export earnings and the inflow of remittances. Liberalisation of foreign exchange transactions has to be backed up by price alignments in the form of reduction in tariff rates. The experience of most emerging markets suggests that internationally competitive tariff rates contribute towards export performance on a sustained basis.

7.43 The ongoing process of capital account liberalisation would deepen the foreign exchange market and make cross-border transactions increasingly sensitive to movements in interest rates and exchange rates. Capital account liberalisation is a process which has to be managed keeping in view the supply response of the economy and vulnerabilities or potential for shocks. Markets tend to react asymmetrically with a strong negative bias to reversals, unless there is already a crisis situation. The process of capital account liberalisation has to take into account the revealed preference for hierarchy in different types of capital flows. A key issue in managing the capital account is credibility and consistency in macroeconomic policies and the building up of safety nets to provide comfort to the markets. This also underscores the importance of prudential regulations over financial intermediaries in respect of their foreign exchange exposures and transactions, which are quite distinct from capital controls. It is the changing mix of controls that characterises the process of managing the liberalisation of the capital account. Furthermore, capital controls may be price based, including tax regimes, or may comprise administrative measures. Depending on the legal framework and governance structures, the mix between the two would vary. As liberalisation advances, the administrative measures would get reduced and price-based measures would be relied upon increasingly, but the freedom to change the mix should always be demonstrably available to assuage market sentiments in times of stress.

7.44 Outward FDI is receiving increased policy attention, not merely as a means of contending with capital inflows but also as a growing expression of competitiveness and entrepreneurial energy of Indian industry. FDI may be for resource-seeking, market-seeking, acquiring domain-knowledge or for business synergies. A greater integration with the global economy would be fostered and resilience imparted when India not only receives FDI but also promotes outward FDI.

FINANCIAL SECTOR

7.45 The Reserve Bank has been focusing on developing a competitive operating environment in the financial sector in terms of markets, institutions, products and practices. The increasing market orientation of the financial system helps in improving allocative efficiency of resources. At the same time, however, it exposes both public sector and private sector

financial intermediaries to various risks, necessitating prudential regulation and supervision. The litmus test of regulatory design in a competitive environment is to strengthen financial stability while at the same time minimising the costs of financial regulation. This, in turn, implies that as the process of deregulation deepens, regulatory initiatives have to be reoriented towards more pro-active supervision of the financial system. It is in this context that the Reserve Bank's supervisory strategy has been to move away from micro-prescription oriented on-site supervision to risk-based supervision. A key element of a market-oriented risk-based supervisory strategy is to develop sound corporate governance practices, which would minimise the need for process-focussed supervision. The Reserve Bank, therefore, has been emphasising corporate governance and better risk assessment within banks and financial institutions, both public and private. The announcement in the Union Budget of a Task Force to examine the reforms required in the co-operative banking system, including the appropriate regulatory regime, is indeed welcome. The
imperative of improving risk management systems must be seen as much from the angle of financial stability as from the process of economic development. Improved risk assessment systems are expected to enable banks to take greater exposures to sectors such as agriculture and small scale industries in which collateral valuations often pose difficulties. This is all the more important as the pattern of credit demand has been changing in recent years. Demand for bank credit from large corporates has been declining because of financial restructuring, improvements in productivity, optimisation of inventory cycles, better cash flow management, increased access to external commercial borrowings and improved internal generation of funds. With better risk assessment capabilities, banks should be able to shed their risk averse attitude and extend more finance to hitherto unbanked segments of agriculture, industry and services.

7.46 The critical challenge at this juncture is to improve the allocative efficiency of resources and at the same time guard against the risks of disruptive financial imbalances. The mandate of financial stability, in the Indian context, thus has to be seen in the broadest sense of the term, calling for a three-pronged strategy of ensuring uninterrupted financial transactions; maintaining a level of confidence in the financial system amongst all the participants and stakeholders; and ensuring orderly conditions in the financial markets to guard against potential adverse effects on real economic activity. The growing integration of financial markets, especially the increasing inter-linkages between domestic financial markets and the foreign exchange market, while desirable for economic efficiency, heightens the risk of contagion. As a result, special defence mechanisms need to be mounted for ensuring financial stability in the face of increasing uncertainties in the global financial scenario.

7.47 Management of the financial sector has been oriented towards gradual rebalancing between efficiency and stability and the changing shares of public and private ownership. Enhanced competition among diverse players has been encouraged. Regulation of urban cooperative banks is hampered by the system of dual control and speedy resolution of the issue is imperative to ensure the future health of the sector. Considerable improvements have taken place in prudential governance as also in moving away from administrative measures to market-orientation. Improvements in efficiency and stability are evident and there is merit in continuing with such rebalancing while refocusing on consolidation, governance and movement towards Basel II – *albeit* gradually, as in the past. Consolidation has started to encompass development finance institutions, public sector banks, private sector banks and non-bank financial companies. As the consolidation proceeds, it is necessary to design a road map so that over a period, there is a convergence between real sector reforms in India, a substantially liberalised capital account and an efficient but stable financial system, in particular the banking system, with an optimal diversity of players consistent with the growing size and complexity of the Indian economy.

7.48 The Reserve Bank favours a process of gradual convergence with international standards and best practices with suitable country-specific adaptations. This has also been the guiding principle in the approach to the New Basel Accord. Having decided, in principle, in April 2003
to adopt the Basel Accord, the Reserve Bank is overseeing a road map for migration to Basel II with reviews of the progress made at quarterly intervals. To begin with, all banks in India will adopt the Standardised Approach for credit risk and Basic Indicator Approach for operational risk. After adequate skills are developed, both in banks and at supervisory levels, some banks may be allowed to migrate to the Internal Ratings Based (IRB) Approach. The Reserve Bank is also putting in place supervisory policies to address the potential systemic risks arising due to operations of large and complex financial conglomerates.

7.49 There are, however, several areas which are likely to pose regulatory and supervisory challenges in the years ahead. First, the level of rating penetration is not yet adequate and it is restricted to issues (rather than issuers, as required by Basel II). Secondly, Basel II provides scope for the supervisor to prescribe higher than the minimum capital levels for banks for, *inter alia*, interest rate risk in the banking book and concentration of risks/ risk exposures. Thirdly, there are several issues in cross border supervision which have to be dealt with. Fourthly, although Basel II could actually imply a degree of pro-cyclicity of minimum capital requirements, there is a need to ensure that prudential norms are, in general, business cycle-neutral.

MONETARY POLICY

7.50 With the growing financial integration across borders, the conduct of monetary policy is becoming increasingly complex. It is not a coincidence that most of the uncertainties facing monetary policy at the present juncture are essentially international in character. The future evolution of international capital flows depends as much on the national fundamentals as on the stance of monetary policy followed by leading central banks in the world. The path of inflation is similarly governed not only by domestic economic activity, but also by the extent of liquidity emanating from capital flows and the movements in international commodity prices. Although the policy objectives remain rooted in the domestic macroeconomic circumstances, the process of monetary policy formulation has to factor in global macroeconomic developments, particularly, trends in world economic growth and trade, international price trends and movements in international interest rates and exchange rates.

7.51 The pursuit of price stability remains a key objective of monetary policy, especially in a country like India where a large majority of the population have no insurance against inflation. There is, thus, a need to consolidate the gains from reining in inflationary expectations especially as cross-country experiences suggest that public confidence can dissipate very quickly in the case of adverse movements in prices. An added dimension is the increasing sensitivity of domestic inflation to the movements in international commodity prices, with the opening up of the economy. The pursuit of price stability in future will call for a carefully crafted strategy in which monetary policy will not only need to address the demand side of the economy but also strike a fine balance in assessing the supply side of inflation, while enhancing prospects for growth.

7.52 Bank loans continue to be special in the Indian economy. This raises several issues in relation to credit culture, credit delivery and credit pricing. First, persistence of the large gap between lending rates and deposit rates remains a matter of concern. Policy-related barriers to reduction in the lending rate such as statutory pre-emptions and small saving interest rates have been eased considerably in recent years and asset quality has also improved. With almost all the structural rigidities having been reduced, bank-level efforts are now necessary to ensure that the benefits of low cost deposits are passed on to the customers. Secondly, there is the issue of stepping up loans to relatively disadvantaged sections of borrowers, including small and medium enterprises and the agricultural sector. To many of the borrowers in these sectors, it is, in fact, the availability of credit more than the price of credit which is of prime importance. This is especially so because interest rates in informal markets which serve as an alternative to bank finance, particularly in rural areas, are sometimes at usurious levels relative to the formal sector. The persistence of this large differential, *ipso facto*, implies that the formal credit mechanisms are not able to penetrate into the informal system. It is in this context that the recommendations of the Vyas and the Ganguly Committees assume significance. Whereas the Vyas Committee has recommended expansion of bank financing, especially direct lending, to agriculture, the focus of the Ganguly Committee has been on putting in place a strategy of lending to small scale industries in view of their potential for high growth.

7.53 To conclude, considerable progress has been made in preparing the ground for realising the full potential of the Indian economy. The drag imposed by high levels of unemployment, poverty and inequity has brought to the fore the urgency attached to actualising this potential. This is consistent with the renewed emphasis on equity in the reorientation of growth strategy that is underway. The process of structural reforms has imparted a resilience and a momentum to the economy even as the pursuit of macroeconomic and financial stability has produced gains in terms of low and stable inflation relative to several emerging economies and a vibrant and well-functioning financial system equipped with the wherewithal of intermediating the financing requirements of high and sustained growth. The regulatory and supervisory function is getting increasingly tuned to the fast changing financial environment. Issues in governance and transparency are at the forefront of this change even as efforts are being intensified to put in place the appropriate legislative framework for the smooth functioning of the financial sector.

VIII MONETARY AND CREDIT POLICY OPERATIONS

8.1 The conduct of monetary policy during 2003-04 was guided by the objective of provision of adequate liquidity to meet credit growth and support investment demand in the economy while continuing a vigil on movements in the price level. Ensuring macroeconomic stability was a concurrent objective with intensified monitoring of price movements, in view of the hardening of international commodity prices, especially crude oil, and the likely impact of the liquidity overhang in the system. Strong capital inflows posed a challenge for monetary management. The Reserve Bank responded with a policy mix of sterilisation, prepayment of external debt and liberalisation of foreign exchange transactions to maintain monetary conditions in line with the overall objectives. The need to fortify monetary management with additional instruments of sterilisation in the context of the large volume of capital inflows led to the institution of a Market Stabilisation Scheme (MSS). Interest rates on nonresident deposits were gradually aligned with those prevailing in the international markets in view of the rapid expansion in banks' external liabilities. These measures were reinforced by refinements in the Liquidity Adjustment Facility (LAF) scheme to strengthen the operating procedure of monetary policy. The Reserve Bank undertook parallel initiatives to improve the credit delivery system, especially in respect of agriculture and small and medium enterprises (SMEs).

MONETARY POLICY OPERATIONS

Monetary Measures

8.2 The Reserve Bank reduced the repo rate by 50 bps to 4.5 per cent effective August 25, 2003.

8.3 The Reserve Bank continued to pursue its medium-term objective of reducing the cash reserve ratio (CRR) to the statutory minimum level of 3.0 per cent of banks' net demand and time liabilities (NDTL). In line with this policy stance, there was a cut in the CRR by 25 bps on June 14, 2003.

Liquidity Management

8.4 The Reserve Bank continued to modulate market liquidity through a mix of repo operations under the LAF and outright OMO. As capital flows persisted, the reduction of Government paper in the Reserve Bank's portfolio necessitated a switch from outright OMO to repo operations thereby burdening the instrument of day-to-day liquidity management with the absorption of liquidity of an enduring nature.

8.5 In this context, the Reserve Bank appointed two groups, *viz*., a Working Group on Instruments of Sterilisation and an Internal Group on Liquidity Adjustment Facility to search for alternative instruments of sterilisation. On the basis of the recommendations of the Working Group on the Instruments of Sterilisation, the MSS was instituted in April 2004. In terms of the scheme, the Government issues securities to mop up the excess liquidity emanating from the Reserve Bank's operations in the foreign exchange market and parks the proceeds in an identifiable cash account, *viz*., the MSS account to be maintained and operated by the Reserve Bank. As a result, the primary liquidity generated by the accretion to the Reserve Bank's foreign currency assets is counter-balanced by a reduction in the Reserve Bank's net credit to the Centre.

8. 6 LAF repo operations were conducted to mop up the usual spurt in liquidity at the beginning of the year. Bids ebbed in May and June as the Centre's market borrowing programme gathered momentum. Repo bids soared – both in number and average size – in July with the easing of liquidity conditions, reinforced by the return flow of advance tax payments and the seasonal easing in cash demand. A 50 bps cut in the repo rate in August 2003 briefly closed the differential with the call rate and caused a temporary lull in repo biddings. A mix of open market sales and a series of 28-day repos to rationalise expectations were reflected in some reduction in LAF repos in October. Repo bids picked up again from November with the persistence of capital inflows as well as the gradual cessation of outright OMO. Accordingly, LAF repo operations had to not only provide an anchor to call rates but also act as the main sterilisation instrument. This pushed up the average daily repo outstanding to Rs.54,915 crore in March 2004, despite an outflow of over Rs.25,000 crore during March 26-31, 2004 on account of the build-up of bank reserves and transfer of the proceeds of ONGC disinvestment to the Government's account with the Reserve Bank.

8.7 The pressure on the LAF began to build up in April 2004 due to strong capital inflows as well as the usual seasonal easing in credit demand. As a result, outstanding LAF repos jumped to an average of over Rs. 74,000 crore during April and May 2004. The pressure on the LAF window started abating by June due to a combination of factors such as seasonal currency demand, the beginning of the Government's borrowing programme, slowdown in capital inflows and the switch to the MSS.

8.8 The Reserve Bank introduced a revised LAF scheme on March 29, 2004 based on the recommendations of the Internal Group on LAF. Daily repo/reverse repo variable rate auctions were replaced by 7-day fixed rate repo auctions and daily fixed rate reverse repo auctions, with a spread of 150 bps. The 14-day variable rate multiple price repo auctions, however, would continue for some time, but would be phased out in due course.

8.9 The Market Stabilisation Scheme (MSS), operationalised in April 2004, has emerged as a key instrument of liquidity management. The issuance under the MSS in April 2004 amounted to Rs. 23,000 crore reflecting the bunching of capital flows. An unscheduled auction amounting to Rs. 5,000 crore of dated securities under the MSS was held on April 8, 2004 to counter-balance the large accretion to the Reserve Bank's foreign currency assets (Rs.16,746 crore during April 1-9, 2004). The total stock of Treasury Bills and dated securities issued under the MSS amounted to Rs.39,730 crore by end-June 2004, in excess of the indicative allocation of Rs.35,500 crore for the quarter April-June 2004. With the abatement of capital inflows in May-June, funds invested in the MSS (Rs. 16,730 crore) essentially reflected a drawdown of the surplus parked in the LAF (Rs. 15,000 crore).

8.10 The total amount raised under the MSS amounted to Rs. 46,480 crore by August 14, 2004, inclusive of Rs.20,000 crore raised through dated securities with a residual maturity of up to 2.5 years.

Interest Rate Policy

8.11 The Reserve Bank continued to take policy initiatives to impart a greater degree of flexibility to the interest rate structure. In order to enhance transparency in pricing of loan products by banks, the April 2003 Monetary and Credit Policy Statement advised banks to announce their benchmark prime lending rates (BPLRs), taking into account the actual cost of funds, operating expenses and a minimum margin to cover the regulatory requirement of provisioning/capital charge and a profit margin. By April 2004, almost all commercial banks had adopted the new system of BPLR. With a view to providing consistency in interest rates offered on non-resident deposits, an interest rate ceiling linked to the LIBOR/SWAP rates was imposed on NRE deposits in stages during 2003-04.

8.12 The rationalisation of small saving schemes and the interest rates paid thereon remains an important policy priority in view of the high fiscal cost and in terms of the implications for the interest rate structure. Recommendations of the Advisory Committee to Advise on the Administered Interest Rates and Rationalisation of Saving Instruments (Chairman: Dr. Rakesh Mohan) in respect of introduction of a Senior Citizens Savings Scheme and discontinuation of the Deposit Scheme for Retiring Employees and 6.5 per cent Saving Bonds 2003 (non-taxable) have been implemented with some modifications.

CREDIT DELIVERY

8.13 The Reserve Bank assigns the highest priority to nurturing a conducive credit culture among financial intermediaries, corporates and households. Credit delivery, in particular, to agriculture, SMEs and infrastructure is critical to sustain growth. In these sectors, the issue of availability of credit is often as important as the cost of credit, especially as the rates of interest on alternative sources of finance from the informal sector are prohibitively high. It is in this context that the Reserve Bank continued to pursue initiatives to ensure flow of adequate bank credit at reasonable rates of interest.

8.14 The monetary and credit policy has taken several initiatives to improve the credit delivery mechanism and credit flows to different sectors. Pursuant to the announcements in the November 2003 Mid-Term Review of the Monetary and Credit Policy, the Reserve Bank constituted an Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof. V.S. Vyas) and a Working Group on Flow of Credit to SSI Sector (Chairman: Dr. A.S. Ganguly) to recommend measures to improve the credit delivery mechanisms for agriculture and SMEs, respectively.

Monetary Policy Stance for 2004-05

8.15 The Reserve Bank's Annual Policy Statement announced in May 2004 was framed against the backdrop of a macroeconomic assessment that provided grounds for optimism. Considering the India Meteorological Department's initial forecast of a normal monsoon and under the assumption of a sustained growth in the industrial sector and good performance of exports, real GDP growth for 2004-05 was placed in the range of 6.5 to 7.0 per cent. Taking into account the inflation trends and assuming no significant supply shocks and appropriate management of liquidity, the inflation rate in 2004-05, on a point-to-point basis, was placed at around 5.0 per cent. Given the 'pass through' of international price trends to domestic inflation, it was stated that the inflation rate during 2004-05 is likely to be influenced to a significant extent by international oil prices and trends in commodity prices. Consistent with the projected real GDP growth and inflation,expansion of money supply(M3) for 2004-05 is placed at 14.0 per cent. Non-food bank credit adjusted for investment in CPs, shares/debentures/bonds of PSUs and private corporate sector is projected to increase by 16.0 – 16.5

per cent. The Mid-term Review of the Annual Policy would review the macroeconomic developments since the announcement of the Annual Policy and, if necessary, revise the projections.

8.16 Taking into account the assessment of the macroeconomy and assuming no unexpected exogenous shocks or adverse inflationary developments occur, the overall stance of monetary policy for 2004-05 is: (i) provision of adequate liquidity to meet credit growth and support investment and export demand in the economy while keeping a very close watch on the movements in the price level, and (ii) consistent with the above, while continuing with the *status quo*, to pursue an interest rate environment that is conducive to maintaining the momentum of growth and macroeconomic and price stability.

IX DEVELOPMENT AND REGULATION OF FINANCIAL MARKETS

9.1 The maintenance of stable and orderly conditions in financial markets assumed priority for the Reserve Bank in 2003-04. Taking advantage of the headroom provided by the comfortable liquidity conditions, the marked improvement in Central Government's finances and somewhat muted demand for banks' non-food credit in the first half of the year, the Reserve Bank carried forward the development of the money, debt and foreign exchange markets over which it has direct regulatory jurisdiction. Satisfactory operation of paperless and straight through settlement of transactions through the Negotiated Dealing System (NDS)/Clearing Corporation of India Limited (CCIL) brought with it significant gains for the functioning of markets. It facilitated speeding up the process of phasing out non-banks from the call/notice money market and simultaneous growth of a buoyant repo market outside the LAF. New modules in the NDS-CCIL system were introduced leading to a switch to the Delivery *versus* Payment (D*v*P) III mode in the Government securities market from April 2, 2004. Measured liberalisation of external transactions was undertaken with a view to adding depth to the foreign exchange market and freeing outflows by resident corporates and individuals. Sensitising market participants to the risks embedded in sudden shifts in market conditions in accordance with global developments remained a concurrent priority.

MONEY MARKET

9.2 The Reserve Bank continued to foster balanced development of different segments of the money market. The strategy for market development was characterised by initiatives to introduce new instruments, reduce dependence of participants on uncollateralised exposures, facilitate price discovery in the short-end and upgrade the payment system infrastructure. The smooth operation of NDS/CCIL enabled progression in the endeavour to develop the call segment as a pure inter-bank market. Exposures of non-banks in the call/notice money market were brought down from 85 per cent of their average daily lendings during 2000-01 to 75 per cent in June 2003, to 60 per cent in December 2003 and further to 45 per cent in June 2004.

9.3 With effect from February 7, 2004, primary dealers (PDs) were permitted to borrow up to 200 per cent of their net owned funds (NOFs), as at end-March of the preceding financial year, on average, in a reporting fortnight. An endeavour of the Reserve Bank has been to improve transparency in the call/notice money market. Effective the fortnight beginning May 3, 2003, reporting of call/notice money market transactions on the NDS was made mandatory, irrespective of whether executed on the NDS or outside and whether the counterparty is a member of the NDS or not. Necessary changes in the software and dissemination of data to NDS members was executed in July 2003.

9. 4 Collateralised Borrowing and Lending Obligation (CBLO) was operationalised as a money market instrument through the CCIL on January 20, 2003. With a view to developing the market for the CBLO, it was exempted from CRR. Furthermore, securities lodged in the gilt accounts of the bank maintained with the CCIL under the Constituents' Subsidiary General Ledger (CSGL) facility and remaining unencumbered at the end of any day can be reckoned for SLR purposes. The wider usage of the instrument is expected to receive impetus from the establishment of real time connectivity between the Public Debt Office (PDO) of the Reserve Bank and the CCIL and value-free transfer of securities between market participants and the CCIL.

9. 5 The Reserve Bank has been making efforts to develop the repo market, so as to provide a stable collateralised funding alternative with a view to promoting smooth transformation of the call/notice money market into a pure inter-bank market and for deepening the underlying Government securities market. To broaden the repo market, the Reserve Bank enabled non-banking financial companies, mutual funds, housing finance companies and insurance companies not holding SGL accounts to undertake repo transactions with effect from March 3, 2003. These entities were permitted to access the repo market through their ‘gilt accounts’ maintained with the custodians. Necessary precautions were built into the system

to ensure 'delivery *versus* payment' (D*v*P) and transparency, while restricting the repos to Government securities only. Rollover of repo transactions in Government securities was facilitated with the enabling of D*v*P III mode of settlement in Government securities which involves settlement of securities and funds on a net basis, effective April 2, 2004. This provided significant flexibility to market participants in managing their collateral.

GOVERNMENT SECURITIES MARKET

9.6 The Reserve Bank stepped up efforts to broaden and deepen the Government securities market during 2003-04. Initiatives to promote liquidity in the Government securities market took the form of relaxation of restrictions relating to transactions in the Government securities, introduction of new instruments such as interest rate derivatives to enable participants to hedge market risk and initiation of stricter prudential regulation and surveillance.

9. 7 During 2003-04, the Reserve Bank continued to issue Floating Rate Bonds (FRBs) as an instrument for hedging interest rate risk by investors in the context of elongation of the maturity profile of Government debt in the recent period. During 2003-04, FRBs were issued in three tranches (May 20, August 8 and November 10, 2003) accounting for 16 per cent of the total issuances of dated securities, excluding those issued by way of private placements with the Reserve Bank. The interest rate on these bonds was calculated by adding a fixed spread (determined in the auction) over a variable base rate. With a view to simplifying the price discovery process in the secondary segment of the Government securities market, the design of determining the variable base rate of FRBs was modified with effect from the auction held on May 19, 2003. In terms of the modified design, the base rate was set equal to the average cut-off yield in the preceding three auctions (instead of six) of 364-day Treasury Bills with annual resetting instead of semi-annual. During 2004-05 (up to August 10, 2004), FRBs were issued in three tranches (May 7, July 2, and August 10, 2004) of Rs. 6,000 crore each accounting for 14.4 per cent of budgeted issuances of dated securities.

9.8 Development of the Separate Trading for Registered Interest and Principal of Securities (STRIPS) market received impetus from the steps taken to realign the coupon payment dates with four identified dates so as to create a critical mass for issue of coupon STRIPS. Accordingly, a new security, *viz.*, 6.01 per cent Government Stock 2028 was issued on August 8, 2003 with coupon dates of the new security aligned with the set of coupon payment dates, *viz.*, March 25 and September 25 as identified by the Working Group on STRIPS. The enabling legal provisions for STRIPS will come into effect with the passage of the Government Securities Bill.

9. 9 Banks and PDs were permitted to undertake transactions in exchange traded IRFs in June 2003. Operational guidelines were formulated to enable participation of the entities regulated by the Reserve Bank.

9.10 The LAF module was operationalised on January 13, 2004 in the Reserve Bank's PDO-NDS. LAF auctions were announced by providing all parameters such as issue, duration, type of auctions, opening and closing time. Market participants submit bids within the cut-off time on the system. Members facing genuine systems problems are permitted to submit physical bids. The Treasury Bill auction module was operationalised on October 22, 2003 on the PDO-NDS. The auction is announced and processed online in a straight through process (STP) on the system. These two modules are being further fine tuned, encompassing new features and feedback received from market participants.

9.11 The Reserve Bank permitted market participants to sell Government securities from April 2, 2004 against confirmed purchase contracts, provided the previous purchase contracts were either guaranteed by the CCIL or have the Reserve Bank as the counterparty. A sale transaction would be settled either in the same settlement cycle as the preceding purchase contract or in a subsequent settlement cycle so that the delivery obligation under the sale contract is met from the securities acquired under the purchase contract. This dispensation would not only reduce the market risk of participants but also facilitate rollover of repos. It was operationalised by switching over to the D*v*P III mode of settlement of Government securities transactions under which securities are settled on a net basis (as against gross basis under the D*v*P II mode).

FOREIGN EXCHANGE MARKET

9.12 A number of measures were undertaken during the year to deepen the foreign exchange market and impart flexibility to market participants. The focus was on providing an enabling environment for all entities to engage in foreign exchange transactions. A host of new measures were introduced to further deepen the foreign exchange market. Liberalisation of foreign exchange transactions was extended to residents, non-residents and corporates. The thrust of liberalisation was on greater transparency, data monitoring and information dissemination and a regulatory shift from micro management of foreign exchange transactions to macro management of foreign exchange flows. Reflecting this, the Exchange Control

Department (ECD) of the Reserve Bank was renamed as the Foreign Exchange Department (FED) effective January 31, 2004. Simultaneously, procedural formalities are being minimised to avoid paper work and to reduce compliance burden, while ensuring that Know-Your-Customer (KYC) guidelines are in place. 9.13 Capital account transactions were further liberalised during 2003-04. Relaxations were allowed for overseas investments and remittances abroad by banks, corporates, resident and nonresident individuals. Policy initiatives to improve the inflows of foreign direct investment, foreign portfolio investment and external commercial borrowings were also carried forward during the year. Resident individuals were allowed to remit up to US
$ 25,000 freely per calendar year for any permitted purposes under the current and the capital account. Steps were taken to encourage outflows that would enhance the strategic presence of Indian corporates overseas. They were allowed to invest in overseas joint ventures (JVs)/wholly owned subsidiaries (WOSs) up to 100 per cent of their net worth.

Outlook

9.14 The Reserve Bank would continue to calibrate the process of building various segments of the financial market with overall macroeconomic developments with a view to improving allocative efficiency and ensuring financial stability. In the near term, the reintroduction of Capital Indexed Bonds (CIBs) with modified features would improve the width of the Government securities market. Harmonisation of the regulatory prescriptions for OTC and exchange traded interest rate derivatives with clearing arrangements through the CCIL is under consideration. Enhancements in hardware and software systems and functionalities including introduction of anonymous, screen-based and order matching in the NDS are also underway. The operationalisation of the RTGS would bring speed and efficiency to financial transactions. The ongoing upgradation of the CCIL-NDS and the other elements of technological infrastructure, introduction of new instruments, the sequenced process of developing the call/notice money market into a pure inter-bank market, the concurrent development of other market segments and the gathering pace of exchange and payments liberalisation are all expected to deepen financial markets and ensure stability and vibrancy.

X FINANCIAL REGULATION AND SUPERVISION

10.1 The blurring of the distinction between financial intermediaries under the combined effect of domestic and cross-border integration, innovations in instruments and processes, advances in technology and the massive volumes of capital intermediated by the financial system has necessitated a pro-active strengthening of the regulatory and supervisory framework. Recent international experience has highlighted the critical role played by the regulatory and supervisory system in ensuring the stability of the financial system. This has made the upgradation and refinement of the regulatory and supervisory function of the Reserve Bank a concurrent priority. The approach of the Reserve Bank in this context has been to pursue a progressive upgrading of prudential norms and benchmarking of these norms against international best practices, although there has been a strong emphasis on adapting these standards to the country-specific situation.

REGULATORY FRAMEWORK FOR THE INDIAN FINANCIAL SYSTEM

10.2 The Reserve Bank regulates commercial and urban co-operative banks, development finance institutions (DFIs) and non-banking financial companies (NBFCs). The main objective of regulation and supervision has been to maintain confidence in the financial system by enhancing its soundness and efficiency. For this purpose, the Reserve Bank evaluates system-wide risks and promotes sound business and financial practices. It also conducts analyses of institution-wise risks to detect deficiencies in their operations, if any, in a timely manner and ensures that institution-specific problems do not spread to the system as a whole. The Board for Financial Supervision (BFS), constituted as a Committee of the Central Board of the Reserve Bank in November 1994 and headed by the Governor with a Deputy Governor as Vice Chairperson and other Deputy Governors and four Directors of the Central Board as members, held 12 meetings during the period July 2003 to June 2004. During this period, it examined 105 inspection reports. While State and district co-operative banks are supervised by the NABARD, certain problem cases are reviewed by the BFS. The Reserve Bank closely monitors these banks to enforce regulatory provisions and takes corrective action in respect of problem banks.

REGULATORY AND SUPERVISORY INITIATIVES

10.3 As the financial sector matures and becomes more complex, the process of deregulation must continue, but in such a manner that all types of financial institutions are strengthened and financial stability of the overall system is safeguarded. As deregulation gathers momentum, the emphasis of regulatory practice has to shift towards effective monitoring and implementation of regulations. To ensure this shift in regulatory practice, corporate governance within financial institutions must be strengthened and internal systems must be developed. Furthermore, as financial institutions expand and grow more complex, it is also necessary to ensure that the quality of service to customers is focused upon and improved.

Scheduled Commercial Banks

10.4 Corporate governance has assumed crucial significance for ensuring the stability and soundness of the financial system in recent years. The Reserve Bank provided guidelines for acknowledgment for transfer of shares of private sector banks in February 2004. The guidelines set out the factors that would be taken into account by the Reserve Bank for permitting acquisition of 5 per cent or more of the paid-up capital of banks. The Reserve Bank advised banks in June 2004 that they should undertake due diligence to ensure that persons appointed as directors satisfy 'fit and proper' criteria upfront. The BFS formulated a draft comprehensive policy framework with regard to ownership of and governance in private sector banks and placed it in the public domain on July 2, 2004 for wider consultation and feedback before it is finalised. In terms of mergers between banking companies and non-banking companies the Reserve Bank advised banks in June 2004 that banks should obtain prior approval of the Reserve Bank for any merger with a non-banking financial company.

10.5 In order to minimise cross holding of equity and other instruments eligible for capital status within the financial system, banks/DFIs were advised in July 2004 to restrict their investments in these instruments issued by other entities in the financial system to 10 per cent of the investing bank's capital funds. Furthermore, the equity holding in any other bank/DFI is required to be restricted to 5 per cent of the capital of the investee bank. Banks/DFIs are required to indicate to the Reserve Bank the time frame for reducing the equity holding where such holding exceeds 5 per cent.

10.6 Banks were advised to ensure that the building up of the Investment Fluctuation Reserve (IFR) to 5 per cent of their investments in 'Held for Trading' (HFT) and 'Available for Sale' (AFS) categories is achieved earlier, though they have time up to March 2006. In order to ensure that the internationally accepted norms for capital charge for market risk under Basel I are adopted, banks were also advised in June 2004 to maintain an explicit capital charge for market risks on the lines of the standardised duration method prescribed under the 1996 Amendment to the Capital Accord issued by the Basel Committee on Banking Supervision (BCBS). This would apply to the trading portfolio by March 2005 and to the AFS category by March 2006.

10.7 Banks were advised to examine the soundness of their risk management systems and draw up a road map by end-December 2004 for migration to Basel II. They were also advised to review the progress made thereunder at quarterly intervals. The Reserve Bank is closely monitoring the progress made by banks in this direction.

10.8 Banks were advised to increase the provisioning on the secured portion of doubtful assets which have remained in that category for over three years from 50 to 100 per cent. In the case of existing assets in this category, a time period of three years is allowed. It is expected that this will facilitate speedy resolution of doubtful assets including through transfer to asset reconstruction companies (ARCs).

10.9 As banks have been putting in place risk management systems and considering the requirement of banks to cater to the evolving requirements of their clientele, the Reserve Bank permitted banks to consider enhancement of the exposure up to a further 5 per cent of capital funds to 20 per cent of capital funds for a single borrower and 45 per cent of capital funds for group borrowers. The additional limits to be sanctioned are subject to approval by banks' boards and the borrower consenting to the banks making appropriate disclosures in their annual reports.

10.10 During the year, the Reserve Bank strengthened the existing mechanisms for NPA management and initiated some new measures to strengthen the efforts of banks to recover their dues. A recent addition to the menu of options available to banks for resolving NPAs is the establishment of ARCs. In terms of the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 the Reserve Bank prescribed guidelines for the formation and functioning of securitisation companies (SC) and reconstruction companies (RC).

10.11 The Reserve Bank announced in November 2003 that it would set up a monitoring system in respect of systemically important financial intermediaries. A Working Group (Chairperson : Smt. Shyamala Gopinath) to recommend a framework for monitoring financial conglomerates recommended the introduction of a framework for the complementary supervision of financial conglomerates.

10.12 The High Level Co-ordination Committee on Financial and Capital Markets (HLCCFCM), set up in 1992 with the Governor of the Reserve Bank as its Chairman constituted three Standing Technical Committees in order to provide a more focused inter-agency forum for sharing of information and intelligence.

10.13 As a part of the move towards greater deregulation, banks fulfilling certain minimum criteria regarding CRAR and net NPAs have been given the discretion to pay dividend without the prior approval of the Reserve Bank, provided the dividend payout ratio does not exceed 33.3 per cent. 10.14 In recent years, banks have turned out to be the major investors in bonds issued on a private placement basis. In view of the fact that issuance of such bonds lacked transparency, banks were advised in November 2003 to restrict their fresh investments in unlisted securities to 10 per cent of their overall non-SLR portfolio. A time period was also prescribed for getting the existing outstanding bonds listed. Simultaneously, the SEBI also prescribed guidelines requiring all debt issuances, including private placements, to be rated and listed within a specified time period.

10.15 With a view to aligning standards adopted by the Indian banking system with global standards, the Reserve Bank issued detailed guidelines relating to several Accounting Standards (AS) in March 2003. In April 2004, guidelines for compliance with three more standards, *viz.*, AS 24 (discontinuing operations), AS 26 (intangible assets) and AS 28 (impairment of assets) were issued. Banks are required to ensure that there are no qualifications by the auditors in their financial statements for non-compliance with any of the accounting standards.

10.16 Preventing misuse of the financial system and preserving its integrity is vital for orderly development of the financial system. Prevention of frauds and implementation of anti money laundering (AML) measures are two important aspects of the efforts being made by the Reserve Bank to prevent misuse of the financial system by criminals whose transactions threaten the stability of financial transactions worldwide.

10.17 The Reserve Bank set up a Committee on Procedures and Performance Audit on Public Services (Chairman : Shri S.S.Tarapore) to advise it on improving the quality of such services. Based on the reports of the Committee on personal transactions of individuals in foreign exchange, government transactions, banking operations and currency management, a number of guidelines have been issued with a view to improving the customer service rendered by banks and the Reserve Bank.

10.18 Keeping in view the emerging scenario under the Basel II accord and the need to use supervisory resources more productively, a beginning towards risk-based supervision (RBS) of banks was made. The Risk-Based Supervision Manual (RBS Manual), customising the international best practices to Indian conditions, was finalised during the year.

Co-operative Banks

10.19 The focus of supervision of urban co-operative banks by the Reserve Bank has been on strengthening the prudential norms, resolving the issue of dual control, addressing the lack of professionalism, use of unscientific loan policy and increasing incidence of financial weakness.

10.20 A system of gradation of UCBs, based on critical financial parameters, *viz*., capital adequacy, net non-performing advances and profitability was introduced as a framework for initiating prompt corrective action. The period for recognition of loan impairment was reduced from 180 days to 90 days with effect from March 31, 2004 in line with the international best practice and to ensure greater transparency. Gold loans and small loans up to Rs. one lakh, however, continue to be governed by the 180-day impairment norm. The Registrars of Co-operative Societies of all States were advised to issue suitable instructions enabling UCBs to take recourse to the SARFAESI Act for recovery of NPAs. UCBs were also advised to build up Investment Fluctuation Reserves (IFR) out of realised gains on sale of investments of a minimum of 5 per cent of the investment portfolio within a period of 5 years, subject to available net profit, in order to mitigate interest rate risk.

10.21 In 2003-04, licence applications of two DCCBs were rejected by the Reserve Bank in view of their precarious financial position. Besides, show cause notices were issued to 3 DCCBs as to why their licence applications should not be rejected. As on June 30, 2004 seven DCCBs were placed under the Reserve Bank’s directions prohibiting them from granting any loans and advances and/or accepting fresh deposits.

Development Finance Institutions (DFIs)

10.22 With the change in the operating environment, DFIs have been facing difficulties in sustaining their operations. Several policy initiatives have been taken to facilitate the process of transition of DFIs opting for conversion into banks through a series of measures aimed at financial restructuring, provision of regulatory relaxation for restructured investments of creditor banks or providing Government support, transfer of stressed assets of DFIs to asset reconstruction companies/asset management trusts for managing the NPA level and harmonisation of prudential norms between banks and DFIs.

10.23 A Working Group on DFIs (Chairman : Shri N. Sadasivan) was set up by the Reserve Bank. The Working Group, which submitted its Report in May 2004, has suggested a road map for development financing and the future role of DFIs.

Non-Banking Financial Companies (NBFCs)

10. 24 The policy initiatives in respect of NBFCs related to measures for protecting depositors, aligning interest rates offered by NBFCs with those of banks in respect of NRI deposits on a repatriable basis, issuance of KYC guidelines and allowing diversification into insurance business.

10.25 The maximum rate of interest that NBFCs (including *Nidhi* companies and Chit Fund companies) could pay on their public deposits was reduced from 12.5 per cent per annum to 11.0 per cent per annum with effect from March 4, 2003 in line with the general softening of interest rates. Similarly, the minimum rate of interest payable by the Residuary Non-Banking Companies (RNBCs) was reduced from 4 per cent per annum to 3.5 per cent per annum on daily deposit schemes and from 6 per cent per annum to 5 per cent per annum on other types of deposits. The rate of interest which NBFCs and Miscellaneous Non-Banking Companies (MNBCs) could pay on NRI deposits was also aligned with that payable by scheduled commercial banks on such deposits. It was clarified that NBFCs were not allowed to accept such deposits for a period less than one year (with a maximum period of three years).

10.26 The KYC guidelines, akin to those issued for commercial banks, were prescribed for NBFCs, including MNBCs (Chit Fund Companies) and RNBCs in January 2004.

10.27 In June 2004, the Reserve Bank rationalised the investment pattern of RNBCs for imparting greater liquidity and safety to their investments, enhancing the protection available to the depositors and reducing the overall systemic risk.

MACRO-PRUDENTIAL INDICATORS REVIEW

10.28 Macro-prudential indicators (MPIs), which comprise both aggregated micro-prudential indicators of the health of individual financial institutions (FIs) and macroeconomic variables associated with financial system soundness, are a useful tool to assess the health and stability of the financial system.

Capital Adequacy

10.29 The capital position of financial intermediaries was generally above the minimum requirement. The Capital to Risk-weighted Assets Ratio (CRAR) of the majority of banks as also major bank groups was well above the regulatory stipulation, except for two banks.

Asset Quality

10.30 A sharp decline in the gross and net NPAs of scheduled commercial banks, in spite of the change over to 90-day delinquency norm, reflects the impact of various initiatives undertaken for resolution of NPAs.

Earnings and Profitability Indicators

10.31 The earnings and profitability indicators for the financial system as a whole were positive, except in the case of DFIs. The ROA of scheduled commercial banks has been improving steadily even after making substantial provisions. Continued higher income from securities trading, profits from foreign exchange operations and decline in interest expenses are some of the reasons for the buoyancy in banks’ profitability.

Liquidity

10.32 The ratio of liquid assets to total assets of banks declined to 42.6 per cent at end-March 2004 from 44.2 per cent at end-September 2003. This was indicative of the increased credit offtake from the banking system during the last half year.

10.33 MPIs also include key indicators of the global economic outlook, prospects for the domestic economy, financial markets, corporate profitability and credit offtake. These have been covered extensively elsewhere in the Report.

10.34 The response of the financial sector to the Reserve Bank's initiatives has been encouraging. This has resulted in improvement in key banking parameters, especially in increased capital adequacy and reduced net NPA ratios. The improved macroeconomic outlook and the pick-up in industrial activity have also resulted in an improved credit offtake. The financial sector has acquired greater strength, efficiency and stability. The performance of the banking sector is noteworthy considering the legacy of past NPAs and progressive tightening of prudential norms. Overall rigidity in lending rates as well as inadequacy in quality of service to some sections continue to be matters of concern.

Outlook

10.35 The process of financial liberalisation has exposed financial institutions to a wide range of market risks than before. This has necessitated an ongoing restructuring of the regulatory framework, adaptation to the changing landscape of the financial system and a continuous sharpening of the focus of monitoring. Furthermore, recent events have brought issues relating to corporate governance and internal control systems to the centre-stage of the responsibility for financial stability. It also calls for watchfulness among all stakeholders.

10.36 The Reserve Bank would continue to strengthen its supervisory initiatives. Risk-based supervision and the PCA framework would be strengthened further. Consolidated supervision would be complemented by a supervisory framework for financial conglomerates. Regulators and regulated entities would have to enhance their risk detection and management systems in order to prepare themselves for the eventual adoption of the new capital adequacy norms under the Basel II process. The improvement in the asset quality in spite of the adoption of the 90-day delinquency norm is indeed a noteworthy development. The Reserve Bank would continue to ensure a sustained reduction in the non-performing assets to levels comparable with those of industrial countries and even below.

XI PUBLIC DEBT MANAGEMENT

11.1 The conduct of public debt management by the Reserve Bank in 2003-04 was marked by significant gains in terms of its objectives of minimisation of cost and elongation of maturity profile for limiting the rollover risk. Lower net market borrowings by the Central Government considerably strengthened debt management operations in an environment characterised by large capital inflows, easy liquidity and generally stable inflation expectations. Innovative efforts were directed towards restructuring and consolidating States' debt and lowering the debt servicing burden. The borrowing programme of the Central Government was completed successfully in 2003-04 without any devolvement on the Reserve Bank for the first time since the introduction of auctions in primary issuances in 1992-93. Market borrowings by the States also elicited good response.

CENTRAL GOVERNMENT

11.2 The Ways and Means Advance (WMA) limits of the Centre were kept unchanged at Rs.10,000 crore for the first half (April-September) and Rs.6,000 crore for the second half (October-March) of 2003-04. The Central Government was in overdraft for only 43 days and on 10 occasions during the year. A noteworthy development was the absence of recourse to WMA in the second half of the year, which was unprecedented.

11.3 Beginning August 8, 2003 (and up to April 29, 2004), the Central Government continuously maintained surplus cash balances in its current account with the Reserve Bank mainly due to substantial inflows on account of the debt swap scheme and increased issuance of 91-day Treasury Bills. The Central Government had an investment balance of Rs.26,669 crore at end-March 2004.

11.4 The Central Government raised a gross amount of Rs.1,21,500 crore (a net amount of Rs.88,807 crore) through issuances of dated securities during the year. Of this, Rs.1,00,000 crore was raised through auctions (28 auctions comprising 19 reissues and 9 new issues) and Rs.21,500 crore by way of private placements (mainly for the prepayment of external debt). Taking into account the four dated securities issued on July 22, 2003 under the debt buy-back scheme amounting to Rs.14,434 crore, issuances of dated securities aggregated Rs.1,35,934 crore. The conversion of Government of India Treasury Bills (Conversion) Special Securities amounting to Rs.61,818 crore into dated securities added to the stock of marketable securities of the Reserve Bank. Of the 124 outstanding marketable securities amounting to Rs.8,24,314 crore as on March 31, 2004, 41 securities with outstanding amount of Rs.10,000 crore or more accounted for 63 per cent.

11.5 Private placements of the Centre's dated securities with the Reserve Bank were restricted mainly to the prepayment of external debt. Out of Rs.21,500 crore (17.7 per cent of the gross borrowings through dated securities) placed privately with the Reserve Bank, Rs.16,500 crore was for the purpose of prepayment of external debt. Although this arrangement was reserve money neutral, it added to the stock of marketable securities with the Reserve Bank. Securities amounting to Rs.5,000 crore were placed privately with the Reserve Bank on April 23, 2003 outside the calendar for market borrowing and these, together with Rs.7,000 crore raised through auctions as per the borrowing calendar on the same day, wiped out the Central Government's overdraft, which had peaked at Rs.9,656 crore on April 22, 2003.

11.6 The calendar of dated securities issuance for the first half (April-September) of 2003-04 covering 50.6 per cent (*i.e.*, Rs.71,000 crore) of the budgeted amount was mostly adhered to even as the actual mobilisation by the Government was somewhat higher at Rs.80,000 crore (excluding Rs.14,434 crore issued under the debt buyback scheme). After adjusting for the amounts received from the State Governments towards prepayment of high cost loans and keeping in view trends in other receipts, the calendar for the second half of 2003-04 (October-March) was announced for an aggregate borrowing of Rs.25,000 crore. This had a softening impact on the market yields as market participants had anticipated an amount of Rs.60,000 crore. The weighted average yield of dated securities issued during the year and of the total outstanding stock declined by 163 and 114 basis points, respectively.

STATE GOVERNMENTS

11. 7 A majority of States reduced their recourse to normal WMA and overdrafts (OD) during 2003-04. The use of special WMA by the States increased by 52.7 per cent during 2003-04, mainly due to the change in provision that special WMA should be availed first before availing the normal WMA as recommended by the Ramachandran Committee (2003). The interest rate charged on Special WMA is one percentage point less than the rate on normal WMA. The buoyant proceeds from small savings and higher market borrowings (other than under the debt swap scheme) also contributed to the substantially lower recourse to the normal WMA *vis-à-vis* the aggregate limit of Rs.7,170 crore available for the year 2003-04.

11.8 Effective April 1, 2004 the formula-based aggregate normal WMA limit of the State Governments was revised upwards by 13.5 per cent to Rs.8,140 crore on the basis of higher average revenue receipts of the States in the preceding three years.

11.9 Gross market borrowings raised by the State Governments increased by 63.7 per cent during 2003-04. Of the total amount of Rs.29,000 crore allocated under the debt swap scheme (DSS), Rs.26,623 crore was utilised towards repayment of debt under the DSS. A part of market borrowings under the DSS was allowed to be retained by a few States for other purposes, while a small portion of the DSS remained unsubscribed. Of the total borrowings by the States during 2003-04, 94.3 per cent was through sale of securities on a tap basis. Interest rates on States' market borrowings softened during 2003-04 even as the maturity profile of select tap tranches was extended up to 13 years to minimise the rollover risk and bunching of repayments arising from the higher market borrowings under the DSS.

11.10 During 2004-05 (up to August 14, 2004), the State Governments raised gross amount of Rs.22,259 crore under the market borrowing programme (inclusive of Rs.13,782 crore under the DSS). On April 21, 2004 all the 28 States raised Rs.7,500 crore through tap issuances of 5.60 per cent 10-year State Development Loans 2014 under the market borrowing programme. On May 26-27, 2004, 19 States raised an amount of Rs.8,471 crore at a coupon of 5.70 per cent for a tenure of 10 years through tap sale, of which Rs.8,091 crore went towards the debt swap scheme. On July 28-29, 2004 19 States raised an amount of Rs.6,288 crore at a coupon rate of 6.35 per cent for a tenure of nine years through a tap sale, of which Rs.5,691 crore went towards the debt swap scheme.

11.11 Under the DSS, the Central Government permitted State Governments to prepay high cost debt from the Centre aggregating over Rs.1,00,000 crore (contracted at interest rates of 13 per cent or more) over a three-year period ending 2004-05. During 2003-04, the States repaid Rs.46,211 crore under the DSS. This included Rs.26,623 crore prepaid to the Centre out of fresh market borrowings. For the year 2004-05, the States would raise an additional Rs.24,000 crore from the market under the DSS.

Outlook

11.12 The lower market borrowings of the Central Government have provided some room for manoeuvre to the Reserve Bank and undertake innovative debt rescheduling /restructuring measures. These initiatives would be carried forward with a view to ensuring the sustainability of public debt. The Reserve Bank would also persevere with efforts towards development of financial markets, including new instruments and new participants, with an ongoing priority attached to modernising the technological infrastructure. These efforts, in turn, would help minimise debt servicing costs, transaction costs and volatility. The relaxation of regulations relating to sale of Government securities facilitating repo rollover, institution of delivery *versus* payment (D*v*P) III and the launching of screen based trading in Government securities would help in deepening the Government securities market and would facilitate the process of debt management. The reintroduction of capital indexed bonds (CIBs) would lower the cost of borrowings to the Government, while minimising the inflation risk to the investors. The lower cost of borrowing by way of CIBs would hinge on effective fiscal-monetary coordination. The enactment of Fiscal Responsibility and Budget Management Act, 2003 and the Fiscal Rules, 2004 effective July 5, 2004 would prohibit borrowings through subscription to primary issues of the Government by the Reserve Bank from April 1, 2006. This would impart greater flexibility and manoeuverability in the conduct of monetary policy. The Reserve Bank would pursue the debt management policy consistent with objectives of minimisation of cost and rollover risk taking into account market conditions. The liquidity in State Government securities is an issue that would need to be addressed. Besides, the States would need to adopt a prudent fiscal policy, with enabling fiscal responsibility legislations for fiscal consolidation.

XII CURRENCY MANAGEMENT

12.1 The note issue and currency management function vested in the Reserve Bank in terms of Section 22 of the Reserve Bank of India Act, 1934 was guided during 2003-04 by the objectives of ensuring adequate availability of notes and coins and improving the quality of notes in circulation. Initiatives were taken to improve customer service and enhance security features in currency notes with a strong drive towards computerisation of currency management information system.

CURRENCY OPERATIONS

12.2 Currency operations are performed by the Reserve Bank through its 19 regional offices/sub-offices and a wide network of currency chests and small coin depots spread across the country. The total number of currency chests declined during the year consequent to implementation of the policy to progressively convert and/or close currency chests held with the State Treasuries. Commercial banks expanded their currency chest operations. Foreign banks were permitted for the first time to operate currency chests.

12.3 With adequate availability of coins from the mints, the Reserve Bank undertook intensive efforts to ensure that the shortage of coins in the country in the recent past was mitigated and that the supply of coins to the interior parts of the country was sustained.

CLEAN NOTE POLICY

12.4 The Reserve Bank took various measures to improve the quality of notes in circulation. These measures included discontinuance of the practice of stapling of note packets, supply of adequate quantity of fresh notes to banks and mopping up of soiled and mutilated notes, particularly notes of lower denominations from circulation and acceleration in mechanised processing of notes at the offices of the Reserve Bank. During 2003-04 (April-March), 12,445 million pieces of soiled notes were processed and disposed off. The denomination-wise disposal of soiled notes indicates that Rs.10 constituted the largest share (40.2 per cent), followed by Rs.100 notes (31.8 per cent) and Rs.50 notes (21.0 per cent).

12.5 Mechanisation of processing and destruction of currency notes has been one of the major thrust areas of the Reserve Bank in currency management. The Reserve Bank has installed 48 Currency Verification and Processing Systems (CVPS) at 18 offices. The notes processed on these machines during 2003-04 aggregated 3,290 million pieces. Twenty-seven Shredding and Briquetting Systems (SBSs) were installed at 18 Issue Offices of the Reserve Bank. These environment-friendly machines provide shredding, granulation and briquetting of soiled currency notes in a secure and eco-friendly manner. These machines have replaced the conventional furnaces.

12.6 The Reserve Bank is putting in place an Integrated Computerised Currency Operations and Management S y s t e m (I C C O M S) i n t h e I s s u e Departments of the regional offices of the Reserve Bank and in the Department of Currency Management at the Central Office. The project includes computerisation and networking of the currency chests with the Reserve Bank's offices to facilitate prompt, efficient, error-free reporting and accounting of currency chest transactions in a secure manner. The system will provide a uniform computing platform across all the regional offices for transaction processing , accounting and management information system relating to currency.

12.7 The Reserve Bank stepped up efforts to improve customer services in the issue of coins, acceptance of coins from public and exchange of soiled and mutilated notes. The Reserve Bank introduced a single window customer service at its Issue Offices under which coins and notes of all denominations are either issued or accepted at one counter. Similarly, mutilated notes are accepted in a Drop Box (even beyond normal banking hours) without any limit.

12.8 The Reserve Bank is setting up a Monetary Museum in Mumbai to preserve the country's monetary heritage. The Museum is the first of its kind in the country and aims to depict the history of currency and the evolution of money in India. The Museum would exhibit representative collection of coinage, paper currency, financial instruments and curiosities across the Indian history.

Outlook

12.9 The Reserve Bank would continue to pursue the objective of meeting the currency demand of the economy and improving the quality of notes. Installation of additional Currency Verification and Processing Systems would be undertaken to ease the pressure of accumulation of soiled notes. Customer service would be upgraded further. A sustained campaign against counterfeiting is being devised along with greater emphasis on enhanced security features. The Reserve Bank would continue to facilitate the circulation of clean notes in the economy. It intends to implement the Integrated Computerised Currency Operations and Management System (ICCOMS) in all its offices and major currency chests during 2004. The process of design and development of software for the system is in progress. This will be followed by testing on a pilot basis at currency chests and select offices of the Reserve Bank. In view of the magnitude and spread, a process of dialogue with banks has been initiated to work out the modalities for testing, training, trial run and implementation. The Information Technology (IT) initiatives taken by banks for computerisation of branch operations, coupled with advances in the communication facilities in the country, would provide the necessary platform for successful implementation of the ICCOMS across all banks throughout the country. These measures would provide an enabling environment for smooth currency management.

XIII PAYMENT AND SETTLEMENT SYSTEMS AND INFORMATION TECHNOLOGY

13.1 The development of payment and settlement systems conforming to the best international standards has been a key objective of the Reserve Bank. A milestone was crossed during 2003-04 with the commencement of the Real Time Gross Settlement (RTGS) as a facility available for quick, safe and secure electronic mode of funds transfer. Preparation of the draft legislation relating to payment and settlement systems was another important development. The legislation aims at providing a sound legal basis to various payment and settlement systems operating in India and empowers the Reserve Bank to regulate and supervise such systems.

PAYMENT SYSTEMS

13.2 The overall turnover through the various payment and settlement systems rose by 1.4 per cent during 2003-04 to Rs.1,60,15,716 crore. This was mainly in the form of retail payment such as Electronic Clearing Services (ECS), Magnetic Ink Character Recognition (MICR) and Non-MICR clearing (Table 13.1). The substantial increase in repo transactions (outside the Reserve Bank's LAF) and the onset of foreign exchange clearing resulted in a sizeable increase in the value of turnover under the Negotiated Dealing System (NDS) and the foreign exchange clearing.

13.3 Retail payment systems constitute the bulk of the volume of payment transactions of the country. All the retail electronic payment modes have grown considerably during the year, reflecting their growing popularity. The Reserve Bank partnered a pilot project on smart cards in 1999 in order to provide for large scale usage of smart cards for financial transactions. With the spread of rapid technological developments and the potential of the usage of smart cards for many purposes, the Reserve Bank teamed up with the Government of India, the academia, banks and the card industry to conduct another pilot project for the use of smart cards for multiple purposes.

13.4 Large value payment systems in India comprise the Inter-Bank Cheque Clearing and the High Value Clearing for paper based systems; the Negotiated Dealing System (NDS), the Inter-Bank Foreign Exchange Transactions Clearing and Settlement System (Forex Clearing) and the Real Time Gross Settlement System (RTGS) for the electronic mode based systems. During the year, RTGS was introduced parallel with the existing Inter-Bank Cheques Clearing system with the ultimate objective of migrating to the RTGS completely. RTGS would be extended throughout the country covering around 3,000 bank branches in about 275 centres.

13.5 The RTGS system requires continuous funding for settling transactions. Internal funding by participants may, therefore, prove costly on account of opportunity costs, leading to delay in outgoing payment instructions. The provision of intra-day credit facilities extended either by the market or by the central bank is regarded as a circuit-breaker. Liquidity requirements for settlement of transactions under the RTGS system are met through intra-day liquidity support to the members by the Reserve Bank on a collateralised repo basis.

13.6 The RTGS has the capability to settle retail payments also. Along with the RTGS and the SEFT, banks in almost all the commercially important centres of the country have the capability to offer their customers country-wide electronic modes of fund transfer services.

13.7 The apex-level National Payments Council (NPC) has overseen the reforms in the payment and settlement systems since 1999. In order to create the appropriate regulatory and supervisory infrastructure for the payment and settlement systems in the country, a Board for Payment and Settlement Systems is proposed to be constituted. The Board, which would comprise members of the Central Board of Directors of the Reserve Bank, would oversee the overall functioning of the payment and settlement systems of the country. A Department of Payment and Settlement Systems within the Reserve Bank would assist the Board in carrying out its functions

SETTLEMENT SYSTEMS

13.8 Cheque clearing continued to be the most important retail settlement system in terms of volume, with its share being 81 per cent in total transactions recorded during 2003-04. MICR-based clearing operations, which commenced in 1986 at the four major metropolitan centres, is emerging as an efficient method for processing paper based funds movement. Expansion of the coverage of MICR technology is being pursued in a phased manner. During the year, 12 more centres (Rajkot, Allahabad, Gwalior, Jodhpur, Varanasi, Kozhikode, Thrissur, Bhubaneshwar, Nashik, Raipur, Jabalpur and Vishakapatnam) commenced MICR based clearing using state-of-the-art reader sorter-based processing capabilities, taking the total number of MICR Centres to 39. These centres account for about 70 per cent of the cheque volumes of the country.

INFORMATION TECHNOLOGY IN THE RESERVE BANK

13.9 The primary role of information technology (IT) within the Reserve Bank is to support its business objectives and to provide efficient customer services. A Strategic Information Technology Plan (SITP) is being prepared to provide the framework for effective management of information technology resources in the Reserve Bank. The plan is built on an IT management model based on both centralised and decentralised IT management, decision making and support.

13.10 Information security is a key requirement in a technology intensive environment. A comprehensive Information Security Policy (ISP) covering the various information assets of the Reserve Bank was prepared following international best practices and codes, including the ISO 17799 code on Information Security.

Outlook

13.11 The Reserve Bank is committed to providing a safe, secure, efficient and integrated payment and settlement system for the country. The operationalisation of the RTGS would greatly facilitate the optimum utilisation of funds. The draft bill on the constitution of the Board for Payment and Settlement Systems under the Reserve Bank of India Act, 1934 would provide an explicit legal sanction to the Reserve Bank's oversight of payment and settlement systems. The INFINET is emerging as the communication backbone for the banking and the financial sector. Cheque truncation is expected to reduce the delay in payment system considerably. Continuous efforts towards upgradation of technology within the Reserve Bank would help in improving its customer services. Initiatives for setting up disaster recovery management would gather momentum with comprehensive business continuity plans to anticipate disasters and cope with them.

XIV HUMAN RESOURCES DEVELOPMENT AND ORGANISATIONAL MATTERS

14.1 The focus of human resources development in the Reserve Bank has been changing in tune with the rapidly evolving external environment. A growing emphasis is being placed on facilitating performance improvement and personal growth within the overall institutional goals whereby personnel policies and practices are being increasingly integrated into the corporate strategy. A major challenge has been the building up of appropriate skills in an environment that fosters creativity, learning and efficiency. During 2003-04, the Reserve Bank continued with its efforts to upgrade its human resources to face the challenges arising out of globalisation and advances in technology. Concomitant measures were initiated to ensure transparency in operations and to improve customer service.

14.2 The goal of human resource (HR) initiatives in the Reserve Bank is to put in place robust human resource management systems that enhance efficiency and create an enabling work environment, which encourages individual responsibility. The endeavour is to foster an atmosphere of trust and integrity so as to keep the staff motivated and committed by adopting transparent personnel policies and keeping communication channels open by providing redressal windows.

14.3 These initiatives have assumed a new significance in the context of the Optional Early Retirement Scheme (OERS), whereby about 29 per cent of officers opted for voluntary retirement. In the post-OERS scenario, personnel policies are being reviewed and the existing initiatives are being reoriented, keeping in view the need for job realignment and consolidation. The new focus of HR policy in the Reserve Bank is essentially to create an environment which enhances efficiency and empowers the staff to draw out their latent potential. The emphasis of HR policies is on motivation, job involvement and commitment to the institution.

Organisational Climate Survey

14.4 The Reserve Bank conducted an organisational climate survey in mid-2003 amongst the staff in Classes I and III to gauge the impact of the policy initiatives and welfare measures undertaken in the last few years on the satisfaction level of the employees. The Bank had conducted similar satisfaction surveys in 1996 and 1998. The survey received a response level of approximately 40 per cent which was more than twice the response level in the previous surveys. The analysis of the responses showed a general improvement in the satisfaction levels, especially in areas such as job satisfaction, infrastructure support and personnel welfare. As compared with previous surveys, there was an improvement in the overall satisfaction levels as measured in terms of Net Satisfaction Factor (NSF which represents the overall difference between those replying to the questions as satisfied and dissatisfied) which went up from (-) 0.63 per cent in 1996 to 3.93 per cent in 1998 and further to 16.36 per cent in 2003. It implied that approximately 58 per cent of the respondents were generally satisfied. Certain areas of concern were also brought out by the survey such as performance appraisal and recognition of merit, organisational culture and internal communication.

Optional Early Retirement Scheme

14.5 The Reserve Bank introduced an Optional Early Retirement Scheme (OERS) on August 16, 2003. The OERS was closed on December 31, 2003 and the last group of employees who opted for the scheme was relieved on March 31, 2004. A total of 4,468 employees representing 15.8 per cent of the workforce as on June 30, 2003 availed of the Scheme. The age profile of officers who opted for OERS indicates a concentration in the age group of 54 to 57.

14.6 An exit survey conducted among the officers who opted for OERS indicated that the predominant reasons for opting for OERS by officers were personal reasons and poor health conditions.

Customer Service Measures

14.7 Efforts were made to further improving customer service, especially in the areas of currency management, foreign exchange and banking matters. Publicity was given to the Customer Redressal Mechanism, which provides a forum to the public to seek redressal of their complaints against any department of the Reserve Bank. Advertisements were issued in newspapers informing members of the public that they could seek redressal of their grievances by contacting a designated officer in each regional office. Tele-banking was introduced with a view to providing better customer service to the Government departments. In addition, a new facility called the Easy Term Remote Terminal Facility was also introduced in most offices.

X V THE RESERVE BANK'S ACCOUNTS FOR 2003-04

Income

15.1 The gross income of the Reserve Bank for the year 2003-04 was Rs.14,323.70 crore which was lower by Rs.8,861.94 crore (38.2 per cent) as compared with the previous year's total income of Rs.23,185.64 crore. There was a decline in income from both domestic and foreign sources. The surplus transferable to the Central Government for the year 2003-04 amounted to Rs.5,400.00 crore, inclusive of Rs.2,331.00 crore towards interest differential on special securities converted into marketable securities.

15.2 The Reserve Bank's earnings from the deployment of foreign currency assets and gold decreased by Rs.723.15 crore from Rs.9,826.65 crore in 2002-03 to Rs.9,103.50 crore in 2003-04. This was mainly on account of lower money market interest rates in major countries, on the one hand, and a fall in prices of securities due to rise in longer term yields, on the other. The rate of earnings on foreign currency assets and gold, after accounting for depreciation, decreased from 3.1 per cent in 2002-03 to 2.1 per cent in 2003-04.

15.3 Domestic income decreased by Rs.8,138.79 crore (60.9 per cent) from Rs.13,358.99 crore in 2002-03 to Rs.5,220.20 crore in 2003-04. This decline in income was mainly due to (a) reduction in profit from sale of rupee securities under open market operations and booking of substantially higher depreciation in the value of rupee securities, (b) substantial rise in cost of monetary operations under the Liquidity Adjustment Facility (LAF), (c) reduction in interest income due to decline in the size of the portfolio and (d) investment of Government of India surplus balances in rupee securities held by the Reserve Bank.

15.4 Profits booked on sale of securities amounted to Rs.2,322.62 crore in 2003-04, representing a decrease of Rs.2,475.41 crore over the previous year. The interest income on ways and means advances declined by Rs.241.98 crore from Rs.612.50 crore in 2002-03 to Rs.370.52 crore in 2003-04, reflecting decreased recourse by the Central Government to this facility and also the lower Bank Rate. Interest earnings from loans and advances to banks/financial institutions declined by Rs.395.01 crore from Rs.401.13 crore in 2002-03 to Rs.6.12 crore in 2003-04 due to lower utilisation of the refinance facility by primary dealers/scheduled commercial banks combined with lower interest rates applicable on these advances.

Expenditure

15.5 Total expenditure of the Reserve Bank increased by Rs.1,038.73 crore (15.5 per cent) from Rs.6,723.41 crore in 2002-03 to Rs.7,762.14 crore in 2003-04.

15.6 Interest payment decreased by Rs.181.61 crore (9.1 per cent) from

Rs.1,990.09 crore in 2002-03 to Rs.1,808.48 crore in 2003-04 due to a reduction in the cash reserve ratio and lower interest rates payable on eligible CRR balances.

15.7 Establishment expenditure increased by Rs.744.13 crore (49.9 per cent) from Rs.1,488.86 crore in 2002-03 to Rs.2,232.99 crore in 2003-04 as a result of increased provisioning in respect of gratuity and superannuation funds and payment of *ex-gratia* of Rs.408.00 crore to staff who opted for Optional Early Retirement Scheme (OERS). As per the actuarial valuation, the appropriation to the Gratuity and Superannuation Fund was to the extent of Rs.1,010.00 crore during 2003-04 as against Rs.616.67 crore during the previous year. The establishment expenditure during 2003-04 comprised of salary (14.5 per cent), allowances (25.7 per cent), funds (47.2 per cent) and miscellaneous expenditures (12.6 per cent).

15.8 Expenditure on security printing comprising, *inter alia*, cost of printing currency notes and cheque forms, increased by Rs.276.47 crore (19.3 per cent) from Rs.1,433.09 crore in 2002-03 to Rs.1,709.56 crore in 2003-04 mainly due to higher indent and supply of notes by more than 150 crore pieces.

BALANCE SHEET

Liabilities

15.9 There were no operations in the National Industrial Credit (Long Term Operations) Fund (established under Section 46C of the Reserve Bank of India Act, 1934) during 2003-04 except the credit of Rs.1.00 crore to the Fund out of the Reserve Bank's income.

15.10 The National Housing Credit (Long Term Operations) Fund was established by the Reserve Bank in terms of Section 46 D(l) of the Reserve Bank of India Act, 1934 in January 1989. A token contribution of Rs.1.00 crore was made to the Fund out of the Reserve Bank's income during 2003-04.

15.11 'Deposits - Banks' represent balances maintained by banks in current accounts with the Reserve Bank mainly for maintaining Cash Reserve Ratio (CRR) and as working funds for clearing adjustments.

15.12 'Deposits - Others' include deposits from financial institutions, employees' provident fund deposits, surplus earmarked pending transfer to the Government and sundry deposits.

15.13 'Other Liabilities' include the internal reserves and provisions of the Reserve Bank and net credit balance in the RBI General Account. These liabilities have increased by Rs.11,573.48 crore (9.8 per cent) from Rs.1,18,356.01 crore as on June 30, 2003 to Rs.1,29,929.49 crore as on June 30, 2004 mainly on account of increase in the levels of the Currency and Gold Revaluation Account (CGRA).

15.14 The reserves, *viz.* Contingency Reserve, Asset Development Reserve, Currency and Gold Revaluation Account and Exchange Equalisation Account reflected in 'Other Liabilities' are in addition to the 'Reserve Fund' of Rs.6,500.00 crore held by the Reserve Bank as a distinct balance sheet head.

15.15 Gains/losses on valuation of foreign currency assets and gold due to movements in the exchange rates and/ or prices of gold are not taken to the Profit and Loss Account but instead booked under a balance sheet head named as CGRA. The balance represents accumulated net gain on valuation of foreign currency assets and gold. During 2003-04, there was an accretion of Rs 11,006.63 crore to the CGRA, thus increasing its balance from Rs.51,276.41 crore as on June 30, 2003 to Rs.62,283.04 crore as on June 30, 2004. The balance in the CGRA at the end of June 2004 was equivalent to 11.5 per cent of foreign currency assets and gold holdings of the Reserve Bank, as compared with 13.4 per cent at the end of June 2003. The decline was mainly on account of increase in the level of foreign currency assets on the one hand, and appreciation of the rupee against the US dollar during 2003-04, on the other. The balance in the Exchange Equalisation Account (EEA) represents provision made for exchange losses arising out of forward commitments. The balance in the EEA as on June 30, 2004 stood at Rs 5.65 crore. The balances in the CGRA and the EEA are grouped under 'Other Liabilities' in the balance sheet.

15. 16 The Reserve Bank maintains a Contingency Reserve (CR) to enable it to absorb unexpected and unforeseen contingencies. The Reserve Bank has set an indicative target for the CR at 12 per cent of the Reserve Bank's total assets to be achieved in phases by the year 2005, subject to review if considered necessary. The balance in the CR has increased from Rs.55,249.29 crore as on June 30, 2003 to Rs.56,218.76 crore as on June 30, 2004. A transfer of Rs.969.47 crore was made to the CR during 2003-04 from the Reserve Bank's income. The balance in the CR is sufficient to meet contingent liabilities.

15. 17 In order to meet the internal capital expenditure and make investments in its subsidiaries and associate institutions, the Reserve Bank had created a separate Asset Development Reserve (ADR) in 1997-98, with the aim of reaching one per cent of the Reserve Bank's total assets within the overall target of 12 per cent set for the CR. In the year 2003-04, an amount of Rs.188.09 crore was transferred from income to the ADR raising its level from Rs.5,590.85 crore as on June 30, 2003 to Rs.5,778.94 crore as on June 30, 2004. The CR and ADR together constituted 10.2 per cent of total assets of the Reserve Bank as on June 30, 2004.

Assets

15.18 The foreign currency assets comprise foreign securities held in the Issue Department and balances held abroad and investments in foreign securities held in the Banking Department. Such assets rose from Rs.3,65,000.98 crore as on June 30, 2003 to Rs.5,24,865.01 crore as on June 30, 2004. The increase in the level of foreign currency assets was mainly on account of net purchases of US dollars from the market, interest and discount received and revaluation gains.

15. 19 Investment in Government of India Rupee Securities which stood at Rs.1,05,144.04 crore as on June 30, 2003 decreased by Rs.64,964.30 crore (61.8 per cent) to Rs.40,179.74 crore as on June 30, 2004.

15.20 There was no change in the Reserve Bank's investments in the shares of its subsidiaries and associate institutions during 2003-04.

15.21 'Other Assets' comprise mainly fixed assets, gold holdings in the Banking Department, amounts spent on projects pending completion and staff advances. The level of 'Other Assets' increased by Rs.2,035.21 crore (16.4 per cent) from Rs.12,424.56 crore as on June 30, 2003 to Rs.14,459.77 crore as on June 30, 2004.

RESERVE BANK OF INDIA
BALANCE SHEET AS AT 30TH JUNE 2004
ISSUE DEPARTMENT

(Rupees Thousands)

2002 - 03	LIABILITIES		2003 - 04	2002 - 03	ASSETS		2003 - 04
	Notes held in the				**Gold Coin and Bullion:**		
28,16,95	**Banking Department**	**23,89,70**		14036,76,55	(a) Held in India	**15240,39,42**	
292509,85,82	**Notes in circulation**	**332654,21,56**		–	(b) Held outside India	**–**	
				255000,00,00	**Foreign Securities**	**313709,35,44**	
292538,02,77	**Total Notes issued**		**332678,11,26**	269036,76,55	**Total**		**328949,74,86**
				228,78,36	**Rupee Coin**		**261,59,80**
				23272,47,86	**Government of India Rupee Securities**		**3466,76,60**
				–	**Internal Bills of Exchange and other Commercial Paper**		**–**
292538,02,77	**Total Liabilities**		**332678,11,26**	292538,02,77	**Total Assets**		**332678,11,26**

BANKING DEPARTMENT

2002- 03	LIABILITIES	2003- 04	2002- 03	ASSETS	2003- 04
5,00,00	**Capital paid-up**	**5,00,00**	28,16,95	**Notes**	**23,89,70**
6500,00,00	**Reserve Fund**	**6500,00,00**	29,02	**Rupee Coin**	**6,94**
			25,25	**Small Coin**	**2,21,73**
12,00,00	**National Industrial Credit (Long Term Operations) Fund**	**13,00,00**			
				Bills Purchased and Discounted :	
186,00,00	**National Housing Credit (Long Term Operations) Fund**	**187,00,00**	–	(a) Internal	–
			–	(b) External	–
			–	(c) Government Treasury Bills	–
	Deposits		109831,26,17	**Balances Held Abroad**	**194673,18,21**
	(a) Government				
100,16,22	(i) Central Government	**37912,22,37**			
41,15,13	(ii) State Governments	**41,15,30**			
	(b) Banks		86514,01,14	**Investments**	**57668,22,25**
78614,08,82	(i) Scheduled Commercial Banks	**80069,04,70**			
1643,02,50	(ii) Scheduled State Co-operative Banks	**2034,54,55**			
1548,21,00	(iii) Other Scheduled Co-operative Banks	**1667,74,11**			

47,07,61	(iv) Non-Scheduled State Co-operative Banks	**81,83,91**			
2748,21,23	(v) Other Banks	**3043,39,61**			
17454,27,45	**(c) Others**	**15521,74,89**		**Loans and Advances to :**	
			9783,00,00	(i) Central Government	**3272,00,00**
			3058,92,35	(ii) State Governments	**4159,80,49**
48,81,69	**Bills Payable**	**77,34,78**		**Loans and Advances to:**	
			1,05,48	(i) Scheduled Commercial Banks	**–**
			7,06,97	(ii) Scheduled State Co-operative Banks	**2,78,00**
			–	(iii) Other Scheduled Co-operative Banks	**–**
			–	(iv) Non-Scheduled State Co-operative Banks	**–**
			4475,64,84	(v) NABARD	**2732,09,05**
			1004,78,34	(vi) Others	**39,50,00**
118356,01,11	**Other Liabilities**	**129929,49,45**		**Loans, Advances and Investments from National Industrial Credit (Long Term Operations) Fund:**	
				(a) Loans and Advances to:	
			–	(i) Industrial Development Bank of India	**–**
			–	(ii) Export Import Bank of India	**–**
			–	(iii) Industrial Investment Bank of India Ltd.	**–**
			–	(iv) Others	**–**
				(b) Investments in bonds/debentures issued by:	
			–	(i) Industrial Development Bank of India	**–**
			–	(ii) Export Import Bank of India	**–**
			–	(iii) Industrial Investment Bank of India Ltd.	**–**
			–	(iv) Others	**–**
				Loans, Advances and Investments from National Housing Credit (Long Term Operations) Fund:	
				(a) Loans and Advances to	
			175,00,00	National Housing Bank	**50,00,00**
				(b) Investments in bonds/ debentures issued by	
			–	National Housing Bank	–
			12424,56,25	**Other Assets**	**14459,77,30**
227304,02,76	**Total Liabilities**	**277083,53,67**	227304,02,76	**Total Assets**	**277083,53,67**

Significant Accounting Policies and Notes to the Accounts as per Annex.

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 30TH JUNE 2004

(Rupees Thousands)

2002- 03	INCOME		2003- 04
15561,40,98	**Interest, Discount, Exchange, Commission *etc.*** [1]		**13166,13,55**
15561,40,98	**Total**		**13166,13,55**
	EXPENDITURE		
1990,08,87	**Interest**		**1808,48,34**
1488,85,85	**Establishment**		**2232,99,22**
55,14	**Directors' and Local Board Members' Fees and Expenses**		**93,14**
28,09,43	**Remittance of Treasure**		**21,09,23**
1352,40,66	**Agency Charges**		**1539,12,19**
1433,08,53	**Security Printing (Cheque, Note forms etc.)**		**1709,56,01**
26,15,85	**Printing and Stationery**		**51,81,29**
17,86,79	**Postage and Telecommunication Charges**		**23,01,90**
59,88,44	**Rent, Taxes, Insurance, Lighting etc.**		**58,80,81**
1,00,39	**Auditors' Fees and Expenses**		**1,28,87**
1,63,67	**Law Charges**		**1,90,60**
125,52,79	**Depreciation and Repairs to Bank's Property**		**154,34,33**
198,24,57	**Miscellaneous Expenses**		**158,77,62**
6723,40,98	**Total**		**7762,13,55**
8838,00,00	**Available Balance**		**5404,00,00**
	Less: Contribution To:		
	National Industrial Credit (Long Term Operations) Fund	1,00,00	
	National Rural Credit (Long Term Operations) Fund [2]	1,00,00	
	National Rural Credit (Stabilisation) Fund [2]	1,00,00	
	National Housing Credit (Long Term Operations) Fund	1,00,00	
4,00,00			**4,00,00**

8834,00,00	**Surplus Payable to Central Government**	**5400,00,00**

1. After making the usual or necessary provisions in terms of Section 47 of the Reserve Bank of India Act, 1934.
2. These funds are maintained by National Bank for Agriculture and Rural Development (NABARD).

V. S. Das	**K. J. Udeshi**	**Rakesh Mohan**	**Y.V. Reddy**
Chief General Manager	Deputy Governor	Deputy Governor	Governor

REPORT OF THE AUDITIORS TO THE PRESIDENT OF INDIA

We, the undersigned auditors of the Reserve Bank of India, do hereby report to the Central Government upon the Balance Sheet of the Bank as at 30th June, 2004 and the Profit and Loss Account for the year ended on that date.
We have examined the above Balance Sheet of the Reserve Bank of India as at 30th June, 2004 and the Profit and Loss Account of the Bank for the year ended on that date and report that where we have called for information and explanations from the Bank, such information and explanations have been given and have been satisfactory.

These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in India. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion and according to the best of our information and explanations given to us and as shown by the books of account of the Bank, the Balance Sheet read with Significant Accounting Policies and Notes to the Accounts is a full and fair Balance Sheet containing all necessary particulars and is properly drawn up in accordance with the Reserve Bank of India Act, 1934 and Regulations framed thereunder so as to exhibit a true and correct view of the state of the Bank's affairs, in conformity with the accounting principles generally accepted in India.

P. B. Santhanakrishnan	S. N. Nanda	P. Parthasarathy	Shivji K. Vikamsey	R. K. Goel	A. D. Shenoy
(M. No. 20309)	(M. No. 5909)	(M. No. 19410)	(M. No. 2242)	(M. No. 6154)	(M. No. 11549)
M/s. P.B.Vijayaraghavan & Co.,	**M/s. S.N. Nanda & Co.,**	**M/s. J.L.Sengupta & Co.,**	**M/s. Khimji Kunverji & Co.,**	**M/s.Rajendra Co., K.Goel &**	**M/s. Ford, Rhodes, Parks & Co.,**
Auditors	Auditors	Auditors	Auditors	Auditors	Auditors

ANNEX

RESERVE BANK OF INDIA

SIGNIFICANT ACCOUNTING POLICIES AND NOTES TO THE ACCOUNTS FOR 2003-04

SIGNIFICANT ACCOUNTING POLICIES

1. CONVENTION

The financial statements are prepared in accordance with the Reserve Bank of India Act, 1934 and the notifications issued thereunder and in the form prescribed by the Reserve Bank of India General Regulations, 1949.

Historical cost basis of accounting is used except where it is modified to reflect revaluation.The accounting practices and policies followed in the statements, unless otherwise stated, are consistent with those followed in the previous year.

2. REVENUE RECOGNITION

Income and expenditure are recognised on accrual basis except penal interest and dividend which are accounted for on receipt basis. Only realised gains are recognised. Provision for outstanding expenditure is made for unpaid bills in each case of Rs. 1 lakh and above. Balances unclaimed and outstanding for more than three consecutive years in certain transitory accounts including Drafts Payable Account, Payment Orders Account, Sundry Deposits Account, Remittance Clearance Account and Earnest Money Deposit Account are reviewed and written back to the Reserve Bank's income. Claims in this respect are considered and charged against the Reserve Bank's income as and when paid.

Income and expenditure in foreign currency are translated on the basis ofexchange rates prevailing on the last business day of the preceding week.

3. GOLD AND FOREIGN CURRENCY ASSETS AND LIABILITIES

(a) Gold

Gold is valued at the end of the month at 90 per cent of the daily average price quoted at London for the month. The rupee equivalent is determined on the basis of the exchange rate prevailing on the last business day of the month. Unrealised gains/losses are adjusted to the Currency and Gold Revaluation Account.

(b) Foreign Currency Assets and Liabilities

All foreign currency assets and liabilities are translated at the exchange rates prevailing on the last business day of the week and also on the last business day of the month.

At the year-end, assets and liabilities in foreign currencies are translated at the exchange rates prevailing on the last business day except in cases where rates are contractually fixed. Foreign securities other than Treasury Bills are valued at lower of book value or market price prevailing on the last business day of each month. The depreciation is adjusted against current income. Foreign Treasury Bills are valued at cost. Forward exchange contracts are evaluated half-yearly and net loss, if any, is provided for. Profit/loss on sale of foreign currency assets is recognised with respect to the book value. Exchange gains and losses arising from translation of foreign currency assets and liabilities are accounted for in Currency and Gold Revaluation Account and remain adjusted therein.

4. RUPEE SECURITIES

Rupee securities, other than Treasury Bills, held in the Issue and Banking Departments, are valued at lower of book value or market price or rates based on the yield curve prevailing on the last business day of the month where the market price for such securities is not available. The depreciation in the value is adjusted against current income. Treasury Bills are valued at cost.

5. SHARES

Investments in shares are valued at cost.

6. FIXED ASSETS

Fixed Assets are stated at cost less depreciation. Depreciation on computers, motor vehicles, office equipments, furniture and electrical fittings, *etc*., is charged on a straight-line basis. Depreciation on other assets including premises and fixtures is charged on written-down value basis.

Depreciation on fixed assets is charged only if held for a period of more than six months as at the year-end.

7. RETIREMENT BENEFITS

The liability on account of retirement benefits and leave encashment to employees is estimated based on an actuarial valuation.

8. CONTINGENCY RESERVE AND ASSET DEVELOPMENT RESERVE

Contingency Reserve represents the amount provided on a year-to-year basis for meeting unexpected and unforeseen contingencies including depreciation in value of securities, exchange guarantees and risks arising out of monetary/ exchange rate policy compulsions.

In order to meet the internal capital expenditure and make investments in subsidiaries and associate institutions, a further specified sum is provided and credited to the Asset Development Reserve.

NOTES TO THE ACCOUNTS

1. SURPLUS TRANSFER TO THE GOVERNMENT OF INDIA

Surplus transferable to the Government includes an amount of Rs.2,331 crore representing interest differential pertaining to the period April 1, 2003 –March 31, 2004 on account of conversion of Special Securities into marketable securities.

2. RESERVE FUND

The Reserve Fund comprises initial contribution of Rs. 5 crore made by the Government of India and appreciation of Rs. 6,495 crore on account of revaluation of gold up to October 1990. Subsequent gains/losses on monthly revaluation of gold are taken to Currency and Gold Revaluation Account.

3. DEPOSITS

a. Deposits of the Central Government include an amount of Rs. 37,812.01 crore on account of operations under the Market Stablisation Scheme.

b.Deposits - Others :

(Rupees crore)

	Particulars	As at June 30	
		2004	2003
	1	2	3
I.	Rupee Deposits from Foreign Central Banks and Foreign Financial Institutions	4,087.	3,311.34
II.	Deposits from Indian Financial Institutions	453.50	538.73
III.	Accumulated Retirement Benefits	5,152.	4,447.63
IV.	Surplus transferable to Government of India	5,400.	8,834.00
V.	Miscellaneous	428.52	322.57

4. OTHER LIABILITIES

(Rupees crore)

Particulars	As at June 30	
	2004	**2003**
1	**2**	**3**
I. Contingency Reserve		
Balance at the beginning of the year	55,249.29	48,434.17
Add : Accretion during the year	969.47	6,733.92
Add : Transfer from unresolved items of credit	–	81.20
Balance at the end of the year	**56,218.76**	**55,249.29**
II. Asset Development Reserve		
Balance at the beginning of the year	5,590.85	4,700.54
Add : Accretion during the year	188.09	890.31
Balance at the end of the year	**5,778.94**	**5,590.85**
III. Currency and Gold Revaluation Account		
Balance at the beginning of the year	51,276.41	51,010.77
Add : Net Accretion during the year	11,006.63	265.64
Balance at the end of the year	**62,283.04**	**51,276.41**
IV. ExchangeEqualisation Account		
Balance at the beginning of the year	567.25	51.50
Transfer from Exchange Account	763.65	1,123.92
Add : Net Accretion(+)/ Net Utilisation(-) during the year	(-)1,325.25	(-)608.17
Balance at the end of the year	**5.65**	**567.25**
V. Provision for net debit entries in RBI General Account	**63.15**	**63.15**
VI. Provision for Outstanding Expenses	**1,153.86**	**1,239.12**
VII. Miscellaneous	**4,426.09**	**4,369.94**
Total (I to VII)	**1,29,929.49**	**1,18,356.01**

5. RBI GENERAL ACCOUNT

Miscellaneous under “Other Liabilities” includes Rs.517.39 crore in respect of inter-office transactions and balances under reconciliation. Reconciliation of entries is in progress and necessary adjustments are being effected as and when ascertained.

6. RUPEE INVESTMENTS

Securities sold under LAF repos have been reduced from *‘ I n v e s t m e n t s ’* Accordingly, the Reserve Bank has absorbed the liquidity in the market the tune of Rs.61,885.00 crore as on June 30, 2004 for which securities amounting to Rs.64,979.25 crore were provided as collateral. These securities were repurchased in July 2004 Depreciation on these securities is parked in a separate account called Depreciation Adjustment Account and reversed in the month of July at the time of repurchase.

7. FOREIGN CURRENCY ASSETS

(Rupees crore)

	Particulars	**As at June 30**	
		2004	**2003**
	1	**2**	**3**
I.	Held in Issue Department	3,13,709.35	2,55,000.00
II.	Held in Banking Department -		
	a) Included in Investments	16,482.48	169.72
	b) Balances Held Abroad	1,94,673.18	1,09,831.26
	Total	**5,24,865.01**	**3,65,000.98**

Note: (i) As on June 30, 2004, there were outstanding US$/ Rupee forward exchange purchase contracts to the tune of Rs. 524.66 crore as against Rs.

18,634.03 crore outstanding as at June 30, 2003. There were no outstanding forward sale contracts as at June 30, 2004.

(ii) Uncalled amount on partly paid shares of the Bank for International Settlement as at June 30, 2004 was Rs 75.80 crore.

8. OTHER ASSETS

(Rupees crore)

	Particulars	**As at June 30**	
		2004	**2003**
	1	**2**	**3**
I.	Fixed Assets (net of accumulated depreciation)	520.17	550.74
II.	Gold	3,415.09	3,145.63
III.	Income accrued but not received	6,339.20	6,621.92
IV.	Miscellaneous	4,185.31	2,106.27
	Total	**14,459.77**	**12,424.56**

9. INTEREST, DISCOUNT, EXCHANGE, COMMISSION, *ETC.*

Interest, Discount, Exchange, Commission, *etc.* include the following items.

	Particulars	(Rupees crore) Yearended June 30, 2004	June 30, 2003
	1	2	3
i.	Profit on sale of Foreign and Rupee Securities	3,022.85	6,127.32
ii.	Rent realised	9.17	11.98
iii.	Net profit on sale of Bank's property	0.73	2.65

10. RETIREMENT BENEFITS

The Bank has made a provision of Rs. 1,010.00 crore (including additional provision on account of Optional Early Retirement Scheme) towards Gratuity and Superannuation Fund during the year based on actuarial valuation.

11. ESTABLISHMENT EXPENDITURE

Establishment expenditure includes payment of Ex-gratia of Rs. 408.00 crore to staff who opted for Optional Early Retirement Scheme.