

**Statement by Dr. Bimal Jalan, Governor,
Reserve Bank of India on Monetary and Credit
Policy for the year 2001-2002**

The Statement consists of three parts: (I) Review of Macroeconomic and Monetary Developments during 2000-01, (II) Stance of Monetary Policy for 2001-02, and (III) Financial Sector Reforms and Monetary Policy Measures.

2. This year's Policy is being presented at a time when serious lacunae have emerged in the functioning of certain segments of the financial system. It is important to take necessary remedial measures urgently to remove the weaknesses that have been noticed so that India's financial sector continues to remain strong and safe. Certain prudential measures to further strengthen the system are dealt with in Part III.

3. Like last year, a technical and analytical review of macroeconomic and monetary developments is being issued as a separate document. This document provides the necessary macroeconomic and other information in somewhat greater detail with the help of simple charts and tables.

**I. Review of Macroeconomic and Monetary
Developments: 2000-01**

Domestic Developments

4. According to the latest estimates of the Central Statistical Organisation (CSO), the GDP growth in 2000-01 is likely to be about 6.0 per cent as compared with 6.4 per cent and 6.6 per cent in the previous two years. The growth in agricultural sector was at 0.9 per cent during 2000-01 as against 0.7 per cent in the previous year. The growth in mining and quarrying sector was expected to be significantly higher at 4.5 per cent as compared with 1.7 per cent a year ago. The overall growth performance of the industrial sector during 2000-01 is estimated to be somewhat lower than that in the previous year. Combined with the continued good performance of the services sector, particularly of information technology related services, the economy is expected to show a growth rate of 6.0 per cent or very close to it, despite low agricultural growth.

5. The Gujarat earthquake has caused considerable damage. While the immediate loss of production may not be sizeable, the cost of restoration of infrastructure is expected to cause a fiscal strain on the state reflecting loss of revenue

and financing of relief and rehabilitation. Production of principal agricultural commodities from the state such as oilseeds, cotton and tobacco may suffer. While there has not been major damage to large industrial installations, industrial environment could be affected because of infrastructural constraints. Despite these negative factors, on an overall reckoning, the impact of the quake on GDP growth is estimated to be small. In order to enable the state government to deal with the situation, the Reserve Bank has taken several initiatives which are reviewed in the Part III of this Statement.

6. The annual rate of inflation on a point-to-point basis as measured by variations in the wholesale price index (base 1993-94 = 100) worked out to 4.9 per cent in 2000-01 as against 6.8 per cent a year ago. While inflation on account of manufactured products (weight 63.7) at 3.7 per cent was modest, primary articles (weight 22.0) showed a marginal decline of 0.3 per cent. The rise in WPI was mainly due to increase in prices of 'fuel, power, light and lubricants' sub-group (weight 14.2) which recorded a substantial increase of 15.3 per cent on top of an increase of 26.9 per cent a year ago. Inflation as reflected in consumer price index (CPI) was much lower at 3.0 per cent (on a point-to-point basis) and 4.0 per cent (on an average basis) up to end-February 2001.

7. During 2000-01, the annual growth in money supply (M_3) on a point-to-point basis, was higher at 16.2 per cent as against 14.6 per cent a year ago. This overall monetary expansion captured large inflows amounting to about Rs.26,000 crore of India Millennium Deposits (IMDs). Net of IMD inflows, the annual growth in M_3 would work out to 13.9 per cent. Among the components, the growth in aggregate deposits of the scheduled commercial banks at 17.8 per cent was higher than that of 13.9 per cent in the previous year. The expansion in currency with the public was lower at 10.8 per cent (about Rs.20,400 crore) as against 11.7 per cent (about Rs.19,800 crore) in the previous year. This could partly be attributed to lower agricultural activity and partly to the larger base in the previous year on account of Y2K uncertainties.

8. The increase in reserve money during 2000-01 at 8.3 per cent (about Rs.23,200 crore) was comparable to that of 8.1 per cent (about Rs.21,000 crore) in the previous year. While the monetisation of Central Government deficit was about

Rs.9,000 crore, the expansion in reserve money largely emanated from increase in net foreign exchange assets (NFEA). On the other hand, claims on banks and commercial sector showed a decline of about Rs.5,800 crore reflecting easy liquidity conditions.

9. The year-on-year growth of non-food credit in the range of 19 - 22 per cent during the first three quarters of the year (April-December 2000) was significantly higher than that in the previous year. Expansion in credit during this period partly reflected the increase in stocks of fertilizers, sugar, petroleum and automobiles. Moreover, credit flow to infrastructure sector and retail segment was relatively high. Consumer credit had also expanded in line with accelerated production of consumer durables. The pace of credit growth has, however, decelerated since December 2000 which is in line with subdued industrial activity. For the year as a whole, non-food credit has registered a lower growth of 14.3 per cent (Rs.58,800 crore) as against an increase of 16.5 per cent (Rs.58,200 crore) in the previous year.

10. The total flow of funds from scheduled commercial banks to the commercial sector including banks' investments in bonds/debentures/shares of public sector undertakings and private corporate sector, commercial paper, etc., are estimated at about Rs.71,500 crore (15.1 per cent) as against Rs.71,600 crore (17.9 per cent) in the corresponding period of the previous year. Total flow of resources to the commercial sector, including capital issues, global depository receipts (GDRs) and borrowing from financial institutions are placed at about Rs.1,49,000 crore as compared with Rs.1,38,000 crore in the previous year.

11. The increase in food credit was much higher at Rs.14,300 crore as compared with Rs.8,900 crore in the corresponding period of the previous year reflecting larger scale of procurement operations. The buffer stock of foodgrains peaked to 46.8 million tonnes at end-February 2001. The opportunity costs arising from fiscal and monetary perspectives of such large buffer stock operations need to be carefully considered. As the gap between the procurement and issue prices widen, the large buffer stock tends to result in the food subsidy assuming the nature of producers' subsidy rather than benefiting the targeted consumers. In this context, the reforms in the management of the food economy announced in the Union Budget 2001-02 such as enlarging the role of state governments in both procurement and distribution of foodgrains for Public Distribution System (PDS), review of the operations of the

Essential Commodities Act (1955) to facilitate free inter-state movement of foodgrains and reduction in the list of essential commodities are meant to enhance the efficiency of the food procurement and distribution system.

12. As per the revised estimates in the Union Budget, the fiscal deficit of the Central Government for 2000-01 was placed at Rs.1,11,972 crore as against budget estimate of Rs.1,11,275 crore. This containment of fiscal deficit facilitated the task of monetary and debt management as the market borrowing programme of the Central Government (Rs.1,15,183 crore gross and Rs.73,787 crore net) could be put through without undue pressure on interest rates. The state governments' net market borrowings of Rs.12,880 crore were almost the same as Rs.12,886 crore in the previous year. The estimated reduction in fiscal deficit to 4.7 per cent of GDP for 2001-02 and the promise of the Fiscal Responsibility Legislation should provide an enabling environment for smooth conduct of debt management.

13. As emphasised in the previous policy statements, the overall monetary management becomes difficult when a large and growing borrowing programme of the government, year after year, puts pressure on the absorptive capacity of the market. The banking system even now holds government securities of around 35.0 per cent of its net demand and time liabilities as against the minimum statutory requirement of 25.0 per cent. In terms of volume, such holdings above the statutory liquidity ratio (SLR) amounted to as much as Rs.1,00,000 crore, which is substantially higher than the net annual borrowings of the government. In this context, the effort towards fiscal consolidation aimed at in the Union Budget for 2001-02 is a very welcome development. The reduction in fiscal deficit coupled with lowering of interest rates on contractual savings would facilitate a move towards a favourable interest rate regime. This should also help in releasing government resources for much needed investment in physical and social infrastructure, which in turn could stimulate private investment. Further gains from a sustained fiscal consolidation will be realised over a period of time through stabilisation of inflationary expectations in the economy.

14. The average cost of primary issuance of Government of India (GOI) dated securities came down to 10.95 per cent during 2000-01 from 11.77 per cent in the previous year, a decline in interest cost of over 80 basis points. There was also a

perceptible downward shift in secondary market yields on government securities across the maturity spectrum during the second half of the year. The yield on government securities with one-year residual maturity which had peaked to 10.82 per cent in August 2000 from 9.23 per cent in April 2000 has subsequently moderated to 9.05 per cent by March 2001. Thus, there has been a reduction in yield of as much as 180 basis points (or 1.8 percentage points) in these securities since August 2000. Similarly, the yield on government securities with 10-year residual maturity which had risen from 10.37 per cent in April 2000 to 11.57 per cent in September 2000 fell to 10.36 per cent by March 2001.

15. In view of the easy liquidity conditions and softer interest rate environment, the overall monetary conditions are at present reasonably comfortable. However, last year's experience once again confirms that monetary management has now become much more complex than was the case even a few years ago. This is because of several factors, such as the on-going integration of financial markets across the world, the phenomenal increase in financial turnover, liberalization of the economy, and the rapidity with which unanticipated domestic and international tremors get transmitted to financial markets across the world because of the new technology. It will be recalled that at the beginning of the last financial year, the Reserve Bank had taken steps to ease monetary policy. However, these measures had to be quickly reversed (in July 2000), in view of unfavourable international developments, particularly successive increases in interest rates in major industrial economies. The need to quickly change the policy stance in the light of emerging situation has also been the experience of other monetary authorities including the US and European central banks. It is important to emphasise this, as, in case the present economic circumstances change, it may again become necessary to take appropriate monetary measures which may not be in consonance with the present easy conditions. Keeping these realities in view, it is particularly important for banks and financial institutions to make adequate allowances for unforeseen contingencies in their business plans, and fully take into account the implications of changes in the monetary and external environment on their operations.

16. A factor which further complicates the conduct of monetary policy during certain periods is the difficulty in the correct assessment of the potential inflationary

pressures based on the latest available data for the current period. While the WPI and CPI inflation rates generally move in tandem, there were periods in which one rate widely differed from the other in opposite directions. For instance, during the period 1995-96 to 1998-99, the CPI inflation ruled significantly higher than the WPI, while during 1999-2000 and 2000-01, the reverse is true. Secondly, while there is little disagreement that in the medium to long-run, inflation is largely caused by monetary expansion, in the short-run inflation could be affected by non-monetary and supply side factors. It may be recalled that during the early part of 1998-99, the headline inflation rate as measured by variations in WPI had shown a sharp increase following substantial rise in prices of certain food items such as fruits and vegetables and in October 1998, a conscious decision was taken, not to tighten the reins of monetary policy, since such an increase in prices emanated from temporary supply problems. The inflation rate reversed itself as the supply situation improved, and the monetary policy stance taken earlier proved to be correct. (However, the position could have turned out to be different if inflationary pressures had persisted or accelerated due to emergence of unexpected demand or supply side pressures.)

17. We faced a similar situation in most part of 2000-01 when the increase in the overall inflation rate emanated from the sharp increase in international crude prices. If the increase in prices on account of petroleum related sub-group is excluded from the WPI, the inflation rate which peaked to 4.8 per cent in mid-January 2001, has since come down to 2.6 per cent by end-March 2001. It, therefore, becomes extremely important to appreciate the underlying inflation rate from different angles before building up an appropriate policy stance. The Reserve Bank will continue its on-going work on further refinement of the methodology for assessment of the inflationary outlook based on different indices and a set of monetary indicators which could best guide the formulation of monetary policy in a changing environment.

18. In the Statement of April 1999, a mention was made about the need for developing a robust short-term operational model for better understanding of the transmission mechanism of the monetary policy. In line with this, a liquidity assessment model is being structured, on the basis of available data, so as to assess both the mechanism and inter-linkages among different segments of the financial system.

External Developments

19. There were significant changes in the external environment after April 2000 when the last annual Policy Statement was presented. It may be recalled that during the year 1999-2000, despite a sharp increase in oil prices, foreign currency assets of India had increased by US \$ 5.5 billion and forex market was generally stable. This position changed markedly during the first half of the year 2000-01, particularly during the period mid-May to mid-August 2000. In view of the continued high oil prices, combined with successive increases in interest rates in the US and Europe and lower capital inflows, there was a decline in India's foreign currency assets by US \$ 2.5 billion in the first six months of the year. Forex markets also witnessed considerable instability with rupee depreciating against US dollar by 5.3 per cent between April and September 2000. During this period, US dollar also appreciated against other major currencies, such as the Euro and the Pound Sterling.

20. The second half of the year, however, saw a sharp turnaround in the forex market. India's foreign currency assets increased by about US \$ 7.0 billion, and exchange rate movements were generally orderly and range-bound. This favourable development was largely due to restoration of confidence in India's external prospects in view of the highly successful launch of the India Millennium Deposits (IMD) scheme by the State Bank of India, which attracted deposits of US \$ 5.5 billion. It is significant that, excluding the effect of IMD scheme, there was actually an increase of US \$ 1.5 billion in India's foreign currency assets during the second half of the year (as against a decline of US \$ 2.5 billion during the first half of the year on a comparable basis).

21. The sharp turnaround in the foreign exchange situation and the behaviour of forex markets during the previous year is highly instructive for management of the external sector. As mentioned above, the behaviour of the forex market was sharply different during the two halves of the year, even though there was no significant change in the 'real' economy or important economic variables, such as, the growth rate, trade deficit or oil prices. Reserves in the first half of the year averaged US \$ 36.7 billion, which was several times higher than the additional cost of oil imports or even the size of anticipated current account deficit. Exports also did well throughout

the year with an average growth (in US dollar terms) of 20.1 per cent in the first half and 16.3 per cent in the second half (up to February 2001). In May 2000, the Reserve Bank had also announced that, as and when necessary, it would directly meet the foreign exchange requirements for imports by the Indian Oil Corporation as well as government debt service payments in order to meet the temporary demand-supply gaps. Yet, forex markets showed considerable instability and anxiety during the first half as compared with the second half of the year. An analysis of the behaviour of the market during these two periods, leads to following broad conclusions.

- The day-to-day movements, in the short-run, in foreign exchange markets have little to do with the so-called ‘fundamentals’ or country’s capacity to meet its payments obligations, including debt service. Any adverse news, and ‘expectations’ generated by it tend to play a paramount role. Adverse expectations are also generally self-fulfilling because of their adverse effect on “leads and lags” in export/import receipts and payments, remittances and inter-bank positions.
- In view of inter-bank activity, which sets the pace in forex markets, transaction volumes in “gross” terms are several times higher, and more variable, than “net” flows. Exchange rates are more sensitive to “gross” flows, and variability in “gross” flows in turn is sensitive to exchange rate expectations.
- Any initial adverse movement, following bad news or unfavourable development may get exacerbated because of greater inter-bank activity. Given the “bandwagon” effect of any adverse movement and the herd behaviour of market participants, the situation can lead to further buying or hedging activity among non-bank participants. The “Daily Earnings At Risk” (DEAR) strategies of risk management tends to reinforce herd behaviour. There is a natural tendency to do what everyone else is doing in the event of any adverse development rather than taking a contra position, particularly in thin and underdeveloped markets dominated by a few leading operators.
- Developing countries generally have smaller and localised forex markets where nominal domestic currency values are expected to show a depreciating trend, particularly if relative inflation rates are higher than those of major industrial countries. In this situation, there is a greater tendency among market participants to hold long positions in foreign currencies and to hold back sales when expectations are adverse and currencies are depreciating, than the other way round when currencies are appreciating and expectations are favourable. Thus, market behaviour is not symmetrical in both directions.
- The tendency of importers/exporters and other end-users to look at exchange rate movements as a source of return without adopting appropriate risk management strategies, at times, creates severe uneven supply-demand

conditions, often based on “news and views”. A self-sustaining triangle of supply demand mismatch, increased inter-bank activity to take advantage of it and accentuated volatility triggered by negative sentiments, not in tune with fundamentals can be set in motion, requiring quick intervention/response by authorities.

22. The above realities of the foreign exchange markets make the task of determining appropriate exchange rate and market intervention policies extremely difficult for central banks all over the world. In principle, and in theory, there is a strong case for either freely floating exchange rates (without intervention) or a currency board type arrangement of fixed rates. In practice, however, because of the operational realities of foreign exchange markets, empirical research shows that most countries have adopted intermediate regimes of various types including fixed pegs, crawling pegs, fixed rates within bands, managed floats with no pre-announced path, and independent floats with foreign exchange intervention moderating the rate of change and preventing undue fluctuations. By and large, barring a few, most countries have some variety of “managed” floats and central banks intervene in the market periodically.

23. Part of the reason for concern with exchange rate is also the likely effect of adverse developments in forex market on the real economy, as has been seen in East Asia, Russia, Mexico and Brazil a couple of years ago, and Turkey and Argentina currently. The “contagion” effect is quick, and a sharp change in the currency value can affect the real economy more than proportionately. Exporters may suffer if there is unanticipated sharp appreciation and debtors or other corporates may be affected badly if there is a sharp depreciation, which can also lead to bank failures and bankruptcies.

24. Against this background, India’s exchange rate policy of focusing on managing volatility with no fixed rate target while allowing the underlying demand and supply conditions to determine the exchange rate movements over a period in an orderly way has stood the test of time. Despite several unexpected external and domestic developments, India’s external situation continues to remain satisfactory. RBI will continue to follow the same approach of watchfulness, caution and flexibility in regard to forex market in the current year also.

25. Our own experience last year, has highlighted the importance of building up foreign exchange reserves to take care of unforeseen contingencies, volatile capital flows and other developments which can affect expectations adversely. The emerging economies have to rely largely on their own resources during external exigencies (or contagion) as there is no international “lender of last resort” to provide additional liquidity at short notice on acceptable terms. Thus, the need for adequate reserves is unlikely to be eliminated or reduced even if exchange rates are allowed to float freely. Sharp exchange rate movements can be highly disequilibrating and costly for the economy during periods of uncertainty or adverse expectations, whether real or imaginary. These economic costs are likely to be substantially higher than the net financial cost, if any, of holding reserves. The success of the IMD scheme last year, and the confidence generated by it was a crucial factor in stabilizing India’s forex markets and containing risks to the real economy in the second half of the year.

26. The overall approach to the management of India’s foreign exchange reserves in recent years has reflected the changing composition of balance of payments, and has endeavoured to reflect the “liquidity risks” associated with different types of flows and other requirements. The policy for reserve management is thus judiciously built upon a host of identifiable factors and other contingencies. Such factors, *inter alia*, include: the size of the current account deficit; the size of short-term liabilities (including current repayment obligations on long-term loans); the possible variability in portfolio investments and other types of capital flows; the unanticipated pressures on the balance of payments arising out of external shocks (such as the impact of the East Asian crisis in 1997-98 or increase in oil prices in 1999-2000); and movements in the repatriable foreign currency deposits of non-resident Indians. Taking these factors into account, India’s foreign exchange reserves are at present comfortable. However, there can be no cause for complacency. We must continue to ensure that, leaving aside short-term variations in reserve levels, the quantum of reserves in the long-run is in line with the growth in the economy and the size of risk-adjusted capital flows. This will provide us with greater security against unfavourable or unanticipated developments, which can occur quite suddenly.

27. The developments in respect of India’s balance of payments, particularly exports, also require continuous vigilance. Fortunately, in 2000-01, exports have

done well and it is essential to keep up the momentum to ensure that balance of payments do not become a constraint on economic growth. In the past, several measures were introduced to ensure timely delivery of credit to exporters and remove procedural hassles. As indicated in the Mid-term Review of October 2000, the suggestions received from exporters and export trade organisations were examined by RBI and the Bankers' Group and guidelines were issued to banks to further simplify procedures for export credit. These include adopting a flexible approach in negotiating bills drawn against LCs over and above the sanctioned limits, delegating discretionary/higher sanctioning powers to branches, authorisation to branches for disbursing a certain percentage of enhanced/ad-hoc limits pending sanction, to incorporate all sanctions including waiver of submission of order/LC for every disbursement and export credit and submission of a statement of orders/LCs in hand at periodical intervals in the sanction letter and advise ECGC immediately about the terms of sanction to facilitate faster claim settlement.

28. RBI has been arranging seminars at major exporting centres for the benefit of exporters and branch level bank officials for resolving the problems relating to export credit and meeting foreign currency requirements. RBI has also been holding meetings of All India Export Advisory Committee (AIEAC) at quarterly intervals for deliberating on the issues raised by exporter organisations and taking appropriate action. Further, exporters have also been advised that they can call on concerned senior officials of RBI on any working day during a designated time-slot without prior appointment for redressal of their grievances. In order to have a feedback on simplification of procedures by RBI for export credit delivery as also the level of exporters' satisfaction with bank services, it is proposed to conduct a survey with the help of an independent outside agency.

29. As a step towards simplification of procedures in the field of exports, all status holders (export/trading/super trading houses) and manufacturer exporters who are exporting more than one-half of their production and recognised as such by the Directorate General of Foreign Trade (DGFT), have recently been extended a simplified facility to write off their export outstandings to the extent of 5.0 per cent of their average annual export realisation in the preceding three years.

30. For mitigating the problems of exporters due to the severe earthquake, guidelines have been issued to banks for providing relief/concessions. These include extending the period of packing credit, conversion of dues into short-term loans repayable in suitable instalments and relaxation in NPA classification norms.

31. In the recent period, procedure of financial transactions such as remittances, investments and maintenance of bank accounts, etc., for non-resident Indians (NRIs) has been considerably simplified and the feedback from the NRIs on this count has been very positive. The Reserve Bank would continue to welcome suggestions for further improving various facilities pertaining to NRIs.

32. Foreign Institutional Investors (FIIs) can invest in a company under the portfolio investment route up to 24.0 per cent of the paid-up capital of the company which could now be increased to 49.0 per cent (40.0 per cent earlier) by the concerned Indian company by passing a resolution by its Board of Directors followed by passing of a special resolution to that effect by its General Body.

33. In order to encourage foreign investment, foreign direct investment (FDI) is permitted under the automatic route for most activities except in certain circumstances and for a very small negative list. New foreign investment proposals in the IT sector have been allowed automatic approval irrespective of whether the investor has an existing joint venture or technical collaboration in the country. No monetary ceilings have been placed on investment under the automatic route. Foreign Investment Promotion Board (FIPB) now considers applications for FDI up to 100 per cent for oil refining sector, business-to-business e-commerce and internet service providers (ISPs) subject to certain conditions. FDI under the automatic route has been permitted up to 100 per cent for all manufacturing activities (with certain exceptions) in Special Economic Zones (SEZs). As announced in the Union Budget, FDI in Non-Banking Financial Companies (NBFCs) will be put on the automatic route. Foreign equity participation up to 26 per cent has been allowed in the insurance sector subject to issue of necessary licence by the Insurance Regulatory and Development Authority (IRDA). The Reserve Bank has given general permission to Indian companies which are eligible under the automatic route or have SIA/FIPB approval to issue shares to their foreign collaborators, subject only to certain reporting requirements.

34. Continuing with the policy of liberalisation of the capital account following the announcement made in the Union Budget in March 2001, a number of steps have been taken to improve liquidity in the ADR/GDR market and to give opportunity to Indian shareholders to divest their shareholding in the ADR/GDR market abroad. Thus, two-way fungibility in ADR/GDR issues of Indian companies has been introduced, subject to sectoral caps, wherever applicable. Stockbrokers in India have now been allowed to purchase shares and deposit these with the Indian custodians for issue of ADRs/GDRs by the overseas depository to the extent of those being converted into underlying shares. Indian companies have been permitted to sponsor ADR/GDR issues with an overseas depository against shares held by a shareholder, who wish to use this option subject to compliance with Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993 and guidelines issued by the Government.

35. Indian companies wishing to make acquisitions of foreign companies or direct investment abroad in Joint Ventures/Wholly Owned Subsidiaries can now invest up to US \$ 50 million on an annual basis through automatic route without being subject to the three year profitability condition. Additional block allocation of foreign exchange over the limit of US \$ 50 million is available to companies with proven track record, subject to certain conditions. Companies may invest 100 per cent of the proceeds of their ADR/GDR issues for acquisitions of foreign companies and direct investments in Joint Ventures and Wholly Owned Subsidiaries. Any Indian company that has issued ADRs/GDRs may now acquire shares of foreign companies engaged in the same area of core activity up to an amount of US dollar 100 million or an amount equivalent to ten times of their exports in the previous year, whichever is higher. Earlier, such stock swap facility was available only to Indian companies in certain sectors. Partnership firms providing certain specified professional services, viz., chartered accountancy, legal services, medical and health care services, information technology and entertainment software related services are allowed to invest abroad in foreign concerns in the same line of activity subject to certain criteria.

36. In order to provide stimulus to the growth of the venture capital industry in India, Securities and Exchange Board of India (SEBI) has been made the single point nodal agency for registration of both domestic and overseas venture capital funds

which are allowed to invest through the automatic route, subject to SEBI regulations. General permission has been granted to SEBI registered Foreign Venture Capital Investments (FVCIs) to invest in Indian Venture Capital Undertakings (IVCUs) or in a Venture Capital Fund (VCF) and divest its investments at any price mutually acceptable to the buyer and the seller.

37. In order to provide appropriate information, “Frequently Asked Questions” (FAQs) on various topics relating to foreign exchange matters have also been made available on RBI’s website (www.fema.rbi.org.in). In addition, for queries from public relating to specific transactions, eight dedicated e-mail addresses have been provided on RBI’s website covering different types of transactions.

38. The Reserve Bank will continue with its efforts to simplify procedure, reduce documentation requirements and further liberalise opportunities for productive investment in India by NRIs and others and by Indian corporates abroad. Further suggestions by experts, corporates and market participants in these areas would be welcome.

II. Stance of Monetary Policy for 2001-02

39. During March 2001, the equity markets experienced considerable turbulence and uncertainty leading to problems in certain stock exchanges as well as liquidity/insolvency problems in some co-operative banks, which in turn affected certain commercial banks also. An important priority of the Reserve Bank during this difficult period was to try and minimise the “contagion” spreading from equity markets to money and government securities markets or to the banking system as a whole. In order to achieve this objective, it was necessary to provide assurance of sufficient collateralised liquidity to banks, and to take early action to prevent the problem affecting particular co-operative banks in one region from spreading to other financial institutions. By and large, so far, money market as well as government securities market have continued to function normally. Further, there has been no reduction in market liquidity in spite of some cases of payment delays/defaults. There has also been no immediate adverse impact of stock market turbulence on interest rates.

40. The recent experience in equity markets, and its aftermath, have thrown up new challenges for the regulatory system as well as for the conduct of monetary policy. It has become evident that certain banks in the co-operative sector did not adhere to their prudential norms nor to the well-defined regulatory guidelines for asset-liability management nor even to the requirement of meeting their inter-bank payment obligations. Even though such behaviour was confined to a few relatively small banks, by national standards, in two or three locations, it caused losses to some correspondent banks in addition to severe problems for depositors. In the interest of financial stability, it is important to take measures to strengthen the regulatory framework for the co-operative sector by removing “dual” control by laying down clear-cut guidelines for their management structure and by enforcing further prudential standards in respect of access to uncollateralised funds and their lending against volatile assets. In the light of recent experience, some corrective steps to prevent commercial banks from taking undue risks in their portfolio management are also outlined in Part III of this Statement.

41. The overall macroeconomic indicators, despite recent developments in the equity market, continue to be favourable for growth with price stability. As mentioned earlier, GDP growth is likely to be about 6.0 per cent in 2000-01 in line with the projection indicated in the Mid-term Review. The “headline” inflation rate at 4.9 per cent turned out to be lower than expected in the Mid-term Review. Excluding the petroleum sub-group, the inflation rate was 2.6 per cent as on March 31, 2001. The external sector was also comfortable during the year as a whole with exports doing well and current account deficit expected to be considerably lower than 2.0 per cent of GDP. Money supply growth was also by and large in line with projected trajectory and the recent Budget has signalled a firm commitment towards fiscal consolidation and reduction in fiscal deficit. The interest rates, after some hardening in mid-year, had softened in the later part of 2000-01. The primary yields in Treasury Bills of various maturities which had risen from a range of 7.0-9.2 per cent in April 2000 to close to 11.0 per cent in August 2000 have since declined to a range of 8.8-9.1 per cent by March 2001. The primary yield on 10-year government securities has fallen from a peak of 11.7 per cent in October 2000 to 10.7 per cent in January 2001. The secondary market yields have also moved in tandem with the primary market.

42. While there is still considerable uncertainty, it is widely expected that the world GDP growth would be substantially lower in 2001 compared with a high growth of about 5.0 per cent in the previous year, driven by the slowdown of the US economy. A favourable factor this year is that the international inflationary environment is reasonably benign. Low inflationary expectations have facilitated substantial reduction in international interest rates in order to revive economic activity in major industrial countries. India cannot but reckon the impact of these global developments though for several reasons, including its relatively small share of trade, GDP growth in India is unlikely to be as seriously affected by these developments, as in many other countries. While merchandise exports growth may slightly moderate, software exports with more diversified destinations and private remittances may still be maintained. The size of current account deficit is, therefore, expected to continue to be well within 2.0 per cent of GDP.

43. The fiscal deficit of the Central Government is budgeted at 4.7 per cent of GDP for 2001-02 and the borrowing programme of the Centre at Rs.1,18,852 crore (gross) and Rs.77,353 crore (net). While the borrowing programme in respect of some States has come under stress, RBI expects to conduct debt management without serious pressure on overall liquidity and interest rates.

44. Against this background, the Reserve Bank proposes to continue to ensure that all legitimate requirements for credit are met consistent with price stability. Towards this objective, the Reserve Bank will continue its policy of active demand management of liquidity through OMO, including two-way sale/purchase of Treasury Bills, and further reduction in CRR as and when required. Unless circumstances change unexpectedly, or current problems in some segments of the market are not resolved soon, on the present reckoning, it should also be possible to maintain the current interest rate environment, and explore the possibility of some further softening in medium and long-term rates over time, following the stance of interest rate flexibility announced in the recent Budget. However, as emphasized last year as well as in Part I of this Statement, in formulating their business plans, banks and financial institutions should be prepared for a reversal or tightening of monetary policy in case the underlying inflationary situation turns adverse or there are unfavourable and unexpected external developments.

45. A realistic projection of the overall growth rate for the current year 2001-2002 is presently difficult in view of uncertainties pertaining to the outlook for industrial growth. As mentioned above, the objective conditions for revival of growth are favourable, but the trend in growth of output and investment demand in the last quarter of the previous year has not been very encouraging. Assuming revival of the industrial sector from the next quarter, reasonable monsoon, and good performance of exports, for purposes of monetary policy formulation, for the year as a whole, growth rate of real GDP may be placed at 6.0 to 6.5 per cent. The rate of inflation is assumed to be close to that in the previous year, i.e., within 5.0 per cent; the projected expansion in broad money (M_3) for 2001-02 is about 14.5 per cent. Consistent with prevailing elasticities, this order of growth in M_3 would lead to an increase in aggregate deposits of scheduled commercial banks at about the same rate (or about Rs.1,34,000 crore). Non-food bank credit adjusted for investment in commercial paper, shares/debentures/bonds of PSUs and private corporate sector is projected to increase by 16.0 to 17.0 per cent. This magnitude of credit expansion is expected to adequately meet the credit needs of the productive sectors of the economy.

46. The Mid-term Review of October 1999 underlined the need to undertake concrete steps to remove certain inherent rigidities so that the interest rate structure can be made more flexible during different phases of the business cycle. Since then, there has been some easing of constraints on the flexibility of interest rates in the financial system as a whole. Assuming a continued positive outlook for inflationary expectations, further flexibility would be facilitated if consistent progress is made in certain directions. As emphasised in the Budget, there is urgent need for consistent and credible fiscal adjustment combined with flexibility in administered interest rates. The financial system should also improve its operational efficiency and aim at further reduction in cost of intermediation. In this regard, there is a need to improve the debt recovery system so that the burden of NPAs on the financial system is eased. Although banks have been given the freedom to quote flexible and variable rates on deposits, the bulk of the deposits are still at fixed rates which become unsustainable when lending rates are lowered. It is necessary for banks to undertake further improvements in operational efficiency and active liability management for interest rate flexibility in line with changes in the inflationary outlook. A reduction in fiscal

deficit and overall government borrowing programme could facilitate easing the regulatory burden in the banking system by reducing the relatively high level of CRR. There is also a need to rationalise the tax regime so that tax-induced distortions in effective rates of return between different instruments and markets are avoided.

47. The Bank Rate changes by RBI combined with CRR and repo rate changes have emerged as signalling devices for interest rate changes and important tools of liquidity and monetary management. The Liquidity Adjustment Facility (LAF) introduced since June 2000 has proved to be an effective mechanism for absorbing and/or injecting liquidity on a day-to-day basis in a more flexible manner and, in the process, providing a corridor for the call money market. The experience with LAF has been satisfactory and RBI's endeavour will be to make it more efficient, by removing some of the existing institutional, procedural and technological constraints. The Reserve Bank will also continue with its effort to bring about orderly development and smooth functioning of financial markets and takes further steps in financial sector reforms.

48. In sum, under normal circumstances and barring emergence of any adverse and unexpected developments in domestic or external sectors, the overall stance of monetary policy for 2001-02 will be:

- Provision of adequate liquidity to meet credit growth and support revival of investment demand while continuing a vigil on movements in the price level.
- Within the overall framework of imparting greater flexibility to the interest rate regime in the medium-term, to continue the present stable interest rate environment with a preference for softening to the extent the evolving situation warrants.

III. Financial Sector Reforms and Monetary Policy Measures

49. The recent annual Policy Statements as well as Mid-term Reviews have focussed on the structural measures to strengthen the financial system and to improve the functioning of the various segments of financial markets. The main objectives of these measures have been to increase operational effectiveness of monetary policy, redefine the regulatory role of the Reserve Bank, strengthen the prudential and supervisory norms, improve the credit delivery system and develop the technological

and institutional infrastructure of the financial sector. In this year's Policy also, it is proposed to make further progress in these areas. As far as possible, changes of structural nature being proposed have been decided after extensive consultations with experts and market participants.

50. As announced before, the short-term credit and regulatory measures, like changes in the Bank Rate or CRR, do not necessarily form a part of bi-annual Policy Statements. These short-term measures are announced, from time to time, in the light of emerging developments in the domestic and international financial markets. Thus, recently after a review of developments in the international and domestic financial markets, Reserve Bank lowered the Bank Rate and CRR on February 16, 2001. A further reduction in the Bank Rate was announced after the Budget on March 1, 2001. No further changes in CRR or the Bank Rate are being proposed just now. These will be announced as and when considered necessary in the light of overall monetary and other developments.

Review of Liquidity Adjustment Facility - Stage II

51. As indicated in April 2000 Policy Statement, the scheme of Liquidity Adjustment Facility (LAF) is being introduced progressively in three convenient stages in order to ensure smooth transition. In the first stage, with effect from June 5, 2000, the Additional Collateralised Lending Facility (ACLF) and Level II support to Primary Dealers (PDs) were replaced by variable rate repo auctions with the same day settlement. The second stage of LAF envisages replacement of Collateralised Lending Facility (CLF) and Level I support to PDs by variable rate repo auctions. It was indicated that the effective date for the second stage would be decided in consultation with banks and PDs. On the basis of experience gained and wide ranging consultations, it has been decided to move forward to implement the second stage in well defined steps, as described below. The third stage envisages multiple auctions intra-day, which will become feasible with the proposed introduction of electronic transfers of funds and securities.

52. An internal Group has reviewed the scheme taking into account feedback received from the market participants and have made several suggestions to make the LAF more effective. The working of the LAF was also considered by the Technical

Advisory Committee on Money and Government Securities Markets. A seminar was also organised sometime ago by Fixed Income Money Market and Derivatives Association (FIMMDA) on the subject. By and large, it has been observed that LAF has been working satisfactorily as a flexible instrument for injecting/absorbing liquidity and also as an interest rate signal for the short-term money market. The suggestions emerging from these consultations broadly relate to the procedural aspects relating to the auctions, the need for a second level support, etc., so as to make the LAF operationally more flexible and hassle free.

53. The experience with the LAF has also shown that the LAF can be made fully effective only when it becomes the primary instrument of liquidity adjustment and the other forms of liquidity support to the system, viz., collateralised lending facility and export credit refinance to banks and liquidity support to PDs are gradually replaced with the LAF. However, these facilities were granted on certain specific considerations in the past. The replacement of these facilities has, therefore, to be structured and staggered over a reasonable period so that the transition to LAF as a primary instrument does not cause any serious operational problems for banks and PDs to adjust their asset-liability positions smoothly.

54. Yet another requirement for the LAF to become fully effective is the need to move towards a pure inter-bank call/notice money market and the need to create opportunities for activating the repo market with adequate safeguards and for other alternative short-term investment options to the non-bank participants, which are at present allowed to lend in the call/notice money market.

55. Taking into account the above considerations, it is proposed to announce a package of measures encompassing changes in operating procedures of LAF including auction methods and periods, a strategy for smooth transition of call money market to pure inter-bank market and a comprehensive and coherent programme for rationalisation of liquidity support available to the system at present, through various facilities for different requirements of the market. It is also proposed to announce certain complementary and associated measures in money and government securities markets. The package as a whole is expected to provide considerable operational flexibility to the market participants enhancing smooth flow of funds across

instruments and participants resulting in further integration of money market, thereby improving it as a more effective transmission channel of monetary policy.

56. The scheme will, as usual be constantly under review in consultation with the market participants and the Technical Advisory Committee on Money and Government Securities Markets with a view to refining and improving procedural and operational aspects.

(a) Changes in Standing Liquidity Facilities Available to the System and Introduction of Back-stop Facility

57. At present, banks are provided with liquidity support at the Bank Rate under two schemes, viz., (i) Collateralised Lending Facility (CLF) which is available to each scheduled commercial bank at a level of 0.125 per cent of its average aggregate deposits during the year 1997-98 and (ii) export credit refinance to the extent of 50.0 per cent of the increase in its outstanding export credit eligible for refinance over the level of such outstanding as on February 16, 1996. The PDs are provided at present with collateralised liquidity support, and PD-wise limits are based on certain norms relating to their commitments to RBI.

58. When the LAF was reviewed, it was felt that for a smooth transition to full-fledged operation of LAF, the system would need a back-stop facility at a variable rate of interest, as a cushion, over and above the support available through standing liquidity facilities at the Bank Rate and through the LAF operations in daily auctions.

59. Taking the above features into account and the need for a gradual switchover to the subsequent stage of LAF, the following modifications to the present standing liquidity facilities are announced:

- It is proposed to split the standing liquidity facilities available from RBI into two parts, viz., (i) normal facility and (ii) back-stop facility. Accordingly, the total quantum of support available to banks under CLF and export credit refinance, and the quantum of support available for PDs will be split into two components, i.e., normal facility and back-stop facility.
- The normal facility will be provided at the Bank Rate. The back-stop facility will be provided at a variable daily rate. The variable rate would be linked to cut-off rates emerging in regular LAF auctions and in the absence of such

rates, to National Stock Exchange – Mumbai – Inter-bank Offer Rate (NSE-MIBOR) as detailed below:

- (i) The variable rate for the back-stop facility, to be fixed on a daily basis would be 1.0 percentage point over the reverse repo cut-off rate at which funds were injected earlier during the day in the regular LAF repos auctions.
 - (ii) Where no reverse repo bid was accepted as part of LAF auction, the rate will be 2.0 to 3.0 percentage points over the repo cut-off rate of the day emerged in LAF auction as may be decided by RBI.
 - (iii) In case no bids were accepted earlier during the day at either repo or reverse repo auctions, the rate will be 2.0 to 3.0 percentage points over NSE-MIBOR as may be decided by RBI.
- Back-stop facility would be operated till close of banking hours.
 - Of the total limits of liquidity support available to PDs and banks, the normal facility would initially constitute about two-thirds and the back-stop facility about one-third. PD-wise and bank-wise limits will be announced separately.

60. At present, banks are provided export credit refinance on the basis of outstanding export credit eligible for refinance on an incremental basis over a base date. It has been observed that some banks which had large exposure to the export sector on the base date are either unable to get any refinance from RBI or they have very small entitlements. For instance, a bank, which had an outstanding credit, say, 30.0 per cent of total advances as on February 16, 1996 and an outstanding credit of the same absolute amount in a recent period, does not get any refinance facility as per the current formula even though as a percentage of total advances, export credit may constitute a very high proportion. It has, therefore, been decided to rationalize the export credit refinance facility so that the facility reflects more closely the extent of total credit support being provided by banks to exporters. Now, the limits would be fixed on the basis of total outstanding export credit eligible instead of the incremental export credit eligible over a base date.

61. It has accordingly been decided that with effect from the fortnight beginning May 5, 2001, scheduled commercial banks would be provided export credit refinance to the extent of 15.0 per cent of the outstanding export credit eligible for refinance as at the end of the second preceding fortnight. With the change in formula, the

illustrative bank mentioned above will continue to remain entitled to a certain percentage of refinance. In case the volume of export credit by these banks increases, their refinance facility will also correspondingly increase.

62. As a matter of further comfort to all banks, the existing refinance limit as on May 4, 2001 as per the current formula will constitute the minimum limit available for a bank up to March 31, 2002.

63. All the above revisions will be effective from the fortnight beginning May 5, 2001.

(b) Changes in LAF Operating Procedures

64. The following measures relate to LAF operating procedures:

- The minimum bid size for LAF is being reduced from the existing Rs.10 crore to Rs.5 crore to add further operational flexibility to the scheme and enable small level operators to participate.
- The LAF timing is being advanced by 30 minutes - 10.30 a.m. for receipt of bids and for announcement of results to 12.00 noon.
- With a view to stabilising market expectations and arresting volatility in call rates, it has been decided to provide the market with additional information. The market would be provided with information on the scheduled commercial banks' aggregate cash balances maintained with RBI on a cumulative basis during the fortnight with a lag of two days.
- At present, repo auctions are conducted without any pre-announced rate and bids are accepted on the basis of uniform price method. With a view to providing quick interest rate signals, when necessary, in order to meet unexpected domestic or external developments, RBI will henceforth have an additional option to switchover to fixed rate repos on overnight basis; but this option is expected to be sparingly used. For the purpose of such repos, the rates of interest intended to be offered would be announced as part of auction announcement on the previous evening or before 10.00 a.m. on the day of auction, if necessary.
- In addition to overnight repos, RBI will also have the discretion to introduce longer-term repos up to 14 day period as and when required.

65. At present, auctions under LAF are conducted on uniform price basis. Uniform price auction has the advantage of setting a single repo rate for absorption or injection of funds. Further, unlike multiple price auction, there is no problem of so

called “winner’s curse”, as all the successful bidders get the same rate. However, an important disadvantage of the uniform price system is that, as bidders are sure to succeed at the most favourable rate, there is a possibility of indiscriminate or irresponsible bidding out of alignment with the market. Under multiple price auction, on the other hand, as bidders get differential rates in accordance to their need and assessment of cost, greater commitment to bidding is likely to be ensured and the intensity of demand in the market is clearly reflected in the bidding pattern. While there is no conclusive evidence about the superiority of one method over the other, country experience shows that both the methods are used for different instruments and at different times, depending upon the circumstances. The issue between the two auction methods under LAF was discussed recently in a FIMMDA Seminar and a view had emerged that RBI should at this stage switchover to multiple price auction system. It has, therefore, been decided to introduce multiple price auction (in place of existing uniform price auction) on an experimental basis for one month period during May 2001. The system would be evaluated on the basis of experience. The weighted average cut-off yield in case of multiple price auction would be released to the public which along with cut-off rates will provide a band for call money market to operate.

66. The medium-term objective is to move over gradually to liquidity adjustment only through LAF combined with back-stop facility at variable rates as mentioned earlier and to do away with various specific standing liquidity facilities available now at the Bank Rate.

(c) Rationalisation of Interest Rates on Export Credit

67. At present, export credit is provided by prescribing specific rates of interest on pre-shipment credit and mostly as a ceiling in the case of post-shipment credit. Henceforth, it is proposed to make interest rate on export credit extended by banks to be indicated as a ceiling rate in respect of all categories so that interest rate charged by the banks can actually be lower than the prescribed rate. Along with this, it is also proposed to link such ceiling rates to the Prime Lending Rates (PLRs) of respective banks available to their other domestic borrowers. Accordingly, in respect of pre-shipment credit up to 180 days, the ceiling rate applicable will be 1.5 percentage points below the PLR (Details are in Annexure-1); banks would be free to charge interest rate below the ceiling rate prescribed, viz., 1.5 percentage points below PLR.

68. At present, banks prescribe PLR for short-term and also on tenor-linked basis for different maturity periods. The application of interest rates on export credit by banks will be on the basis of the relevant PLR prescribed by the bank. Currently, the tenor-linked PLR up to 180 days by three major public sector banks is in the range of 10.0-10.5 per cent. Thus, the ceiling rates prescribed as above would result in the major public sector banks effectively reducing the interest rates on export credit by about 1.0-1.5 percentage points to 8.5-9.0 per cent compared to the present prescribed lending rate of 10.0 per cent for pre-shipment credit up to 180 days (and as a ceiling for post-shipment credit up to 90 days). This is expected to introduce healthy competition and provide exporters a greater choice to avail of banking services in terms of interest rate, quality of service and transaction costs.

69. It may be mentioned that at present, the forward premium for US dollars in the Indian market is around 4.5 per cent for 6 months. An exporter can thus avail of rupee export credit at 8.5-9.0 per cent interest rate and sell the expected export earnings in the forward market, effectively reducing the interest cost to only around 4.0-4.5 per cent, which is internationally highly competitive.

70. Exporters now also have the option to avail of pre- and post-shipment credit in foreign currency which is available at a ceiling rate of LIBOR plus 1.5 percentage points. With the ceiling rate on FCNR (B) deposits being changed to LIBOR (instead of LIBOR plus 0.5 percentage point – covered later in this Statement), it has been decided to revise the ceiling rate on foreign currency loans for exports by banks to LIBOR plus 1.0 percentage point which will make this rate even more competitive.

(d) Complementary Measures Associated with Money and Government Securities Markets

71. As part of streamlining the LAF and improving the transmission channel of monetary policy, the following complementary and associated measures in respect of money and government securities markets are announced:

(i) Moving towards Pure Inter-bank Call Money Market

72. In addition to select corporates, which route calls transactions through PDs, there are several non-banks such as financial institutions and mutual funds, which are permitted to lend directly in the call/notice money market. Following the recommendations of Narasimham Committee II, it was decided to move towards a pure inter-bank (including PDs) call/notice money market. With a view to planning a smooth phasing out of these institutions from call/notice money market, as indicated in the Mid-term Review of October 2000, a Technical Group, which included representatives from RBI, non-banks and banks was constituted. The Group has since submitted its report. This report was placed on RBI website (www.rbi.org.in) on March 29, 2001 for further comments and suggestions from experts and other market participants. The Group has, *inter alia*, recommended a strategy for gradually phasing out non-bank participation. In the light of the recommendations of the Group and the feedback received on the recommendations, following steps are being taken:

- Permission to corporates to route their call transactions through PDs would be available up to June 30, 2001, as announced in the Mid-term Review of October 2000.
- Access to other non-bank institutions (including financial institutions, mutual funds and insurance companies) to operate in call/notice money market would be gradually reduced in four stages:
 - In stage I, with effect from May 5, 2001 non-banks would be allowed to lend up to 85.0 per cent of their average daily lendings in call market during 2000-01.
 - In stage II, with effect from the date of operationalisation of Clearing Corporation, non-banks would be allowed to lend up to 70.0 per cent of their average daily lendings in call market during 2000-01.
 - In stage III, with effect from three months after stage II, access of non-banks to call/notice money market would be equivalent to 40.0 per cent of their average daily lendings in call market during 2000-01.
 - In stage IV, with effect from three months after stage III, access of non-banks to call/notice money market would be equivalent to 10.0 per cent of their average daily lendings in call market during 2000-01.
- From a date to be notified by RBI, after the on-set of stage IV, non-banks will not be permitted to lend in call/notice money market.

73. The above measures would allow sufficient time for market participants on both lending and borrowing side to adjust their portfolios without any disruption in

the market as the programme will be implemented in four stages indicated, in line with the recommendations of the Technical Group. With the proposed establishment of the Clearing Corporation, repo operations would not only become more efficient, it would also be possible to undertake repo transactions in non-government securities. It is envisaged that eventually both call money market and repo/reverse repo market combined with market for other money market instruments like term money, Commercial Paper (CP), Certificates of Deposit (CDs) and Treasury Bills would constitute an integrated market for equilibrating short-term funds for both banks and non-banks. Also such an integration is expected to make the money market an effective transmission channel for monetary policy.

**(ii) Shortening of Minimum Maturity
Period of Term Deposits**

74. Interest rates on all term deposits are currently free and banks now offer an array of rates across maturities above 15 days, which is the minimum maturity for term deposits. With a view to moving further towards deregulation, providing opportunities for non-banks to invest short-term surplus funds in a more flexible manner when they are phased out from call money market and to enable banks to have more flexibility in their Asset Liability Management (ALM), it has been decided to reduce the minimum maturity period for term deposits to 7 days from the present 15 days at the discretion of individual banks. But, this facility will be available only in respect of wholesale deposits of Rs.15 lakh and above where banks have the freedom to offer differential rates according to size of deposits. However, the stipulation of minimum maturity of 15 days for CDs and CP will continue.

**(iii) Relaxation in Daily Minimum
Cash Reserve Ratio Maintenance
Requirement**

75. As per the Reserve Bank of India Act, Cash Reserve Ratio (CRR) has to be maintained on an average daily basis during a reporting fortnight by all scheduled banks. Along with lagged reserve maintenance, the minimum daily requirement was reduced to 65.0 per cent from the earlier 85.0 per cent to improve the cash management of banks and for smooth inter-bank adjustment of liquidity. The minimum requirement is not, however, applicable to the reporting Friday of the fortnight. It is now proposed to reduce the maintenance of daily minimum

requirement of 65.0 per cent to 50.0 per cent for the first seven days of the reporting fortnight while continuing with the minimum requirement of 65.0 per cent for the rest of the fortnight; this minimum requirement, however, will be applicable to all seven days including the reporting Friday without any exception. This will come into force with effect from the fortnight beginning August 11, 2001. This will enable banks to have further flexibility of holding reserves depending upon their intra-period cash flows. This measure is expected to reduce volatility in the call money market.

(iv) Interest on Cash Balances Maintained with Reserve Bank of India under Cash Reserve Ratio

76. At present, all scheduled commercial banks (excluding Regional Rural Banks) are paid interest on eligible cash balances maintained with RBI under CRR requirement at the rate of 4.0 per cent per annum. While the medium-term objective will continue to be to reduce CRR to the statutory minimum, as an intermediate measure, interest rate on eligible balances will be aligned with the Bank Rate in two stages. In the first stage, with effect from the fortnight beginning April 21, 2001, the interest paid on eligible balances will be increased to 6.0 per cent. At a subsequent stage, to be announced later, interest paid will be at the Bank Rate.

(v) Exemption of Inter-bank Term Liability from Minimum Cash Reserve Requirement

77. At present, inter-bank liabilities are exempt from CRR prescription subject to the minimum requirement of 3.0 per cent. As inter-bank borrowings are of short-term nature and do not cause any secondary deposit expansion, it is proposed to exempt the inter-bank term liabilities of maturity of 15 days and above from the prescription of minimum CRR requirement of 3.0 per cent. Besides a marginal saving on cost to banks, this measure is expected to help in developing inter-bank term money market. This measure will be effective from the fortnight beginning August 11, 2001.

(vi) Treasury Bill Market

78. The present 14 day Treasury Bill and 182 day Treasury Bill auctions are proposed to be discontinued and instead, the notified amount in the 91 day Treasury Bill auctions will be increased to Rs.250 crore. The notified amount in the 364 day

Treasury Bill auction will remain at Rs.750 crore. It is proposed to synchronise the dates of payment for both 91 day and 364 day Treasury Bills. As such, both the 91 day and 364 day Bills will mature on same dates and together they can provide adequate fungible stock of Treasury Bills of varying maturities in the secondary market. The market clearing yields and the increased floating stock which are fungible are expected to activate the secondary market in Treasury Bills.

(vii) T plus 1 Settlement for SGL Settled Transactions

79. Currently, transactions in government securities are required to be settled on the trade date or next working day unless the transaction is through a broker of a permitted stock exchange in which case settlement can be on T plus 5 basis. With the progress made in computerization of Public Debt Office (PDO), it is possible to have pooled terminal facility located at Regional Offices across the country and member-terminals paving the way for a Negotiated Dealing System (NDS) (Annexure-3). In the proposed NDS, all trades between members of NDS will have to be reported on the NDS which will be directly linked to the settlement system. In order that the market participants prepare themselves for the NDS, it is proposed that with effect from June 2, 2001, all transactions settled through the Delivery versus Payment (DVP) system of RBI will be on T plus 1 basis. As this will provide certainty to market participants in respect of demand for settlement funds for securities transactions on the day of settlement, it is expected to improve cash and liquidity management among money market participants. This will also have a stabilising influence on call money market.

Interest Rate Policy

(a) Review of Norms Relating to Prime Lending Rate

80. As a step towards deregulation of interest rates and providing more operational flexibility to banks, Prime Lending Rate (PLR) was introduced in April 1997. Since then, the norms relating to the operation of PLR by banks has been substantially rationalised and liberalised. Banks were given freedom to declare their own PLRs along with a maximum spread. Later, the Prime Term Lending Rate (PTLR) was introduced and subsequently banks were provided with the freedom to

offer tenor-linked PLRs. Banks also have now the flexibility to offer lending rates on a fixed rate or on a floating rate basis.

81. At present, PLR serves as the ceiling rate for credit limits of up to Rs.2 lakh and as a floor for loans or credit limits above Rs.2 lakh. The rationale for this policy is that PLR being the rate chargeable to the best borrower of the bank, transparency and objectivity requires that it should be the minimum rate chargeable to a borrower. However, based on requests from the banking system, banks were given the flexibility to charge interest rates without reference to the PLR in respect of certain categories of loans/credit like discounting of bills, lending to intermediary agencies, etc., in the Mid-term Review of October 1999.

82. In recent meetings with bankers, a request was made that the PLR should be converted into a reference or benchmark rate for banks rather than treating it as the minimum rate chargeable to the borrowers. In this context, a review of the international practices also shows that while the PLR was traditionally the lowest rate charged to the prime borrowers with highest credit rating, in recent years, the practice of providing loans even below the PLR by banks has become common.

83. Keeping in view the international practice and to provide further operational flexibility to commercial banks in deciding their lending rates, it has been decided to relax the requirement of PLR being the floor rate for loans above Rs.2 lakh. Banks will be able to offer loans at below-PLR rates to exporters or other creditworthy borrowers including public enterprises on the lines of a transparent and objective policy approved by their Boards. Banks will continue to declare the maximum spread of interest rates over PLR. However, given the prevailing credit market in India and the need to continue with concessionality for small borrowers, the practice of treating PLR as the ceiling for loans up to Rs.2 lakh will continue.

(b) Deposit Schemes for Senior Citizens

84. As per present regulations, banks are prohibited to discriminate in the matter of rates of interest paid on deposits except in respect of single term deposits exceeding Rs.15 lakh. Based on the requests received from several senior citizens and their organisations, it has been decided to permit banks to formulate fixed deposit schemes specifically meant for senior citizens offering higher and fixed rates of interest as

compared to normal deposits of any size. These schemes should also incorporate simplified procedures for automatic transfer of deposits to nominees of such depositors in the event of death.

(c) Term Deposits – Flexibility to Banks

85. Banks have been given the freedom to offer fixed/floating rates on term deposits and allow pre-mature withdrawal of such deposits. On the basis of suggestions received from banks, in order to facilitate better ALM, the following changes in the existing provisions are proposed:

- As per the extant guidelines on domestic/NRE deposits, it is mandatory for banks to allow premature withdrawals, if requested by the depositors. However, banks are free to prescribe penal rate of interest for allowing premature withdrawal except in the case of reinvestment in term deposits with the same bank. However, premature withdrawal of large sums may impact the ALM function of the banks. It is, therefore, proposed that banks will be given freedom to exercise their discretion to disallow premature withdrawal of large deposits held by entities other than individuals and Hindu Undivided Families. Banks would, however, have to inform such depositors of their policy of disallowing premature withdrawals in advance, i.e., at the time of accepting such deposits. In regard to existing deposits, present provision will continue until the time of renewal of individual deposits.
- At present, banks are free to renew overdue domestic term deposits at an interest rate applicable on the date of maturity. In order to facilitate better ALM, it is proposed that renewal of overdue deposits at the rate of interest prevailing on the date of maturity be allowed only for an overdue period of 14 days. In case the overdue period exceeds 14 days, the deposits should be treated like term deposits and banks may prescribe their own interest rate for the overdue period. Banks, however, have to inform the depositors in advance of their policy for renewal of overdue deposits.

(d) Interest Rate on FCNR(B) Deposits

86. At present, banks are free to accept FCNR(B) deposits for a maturity period of 1-3 years and to offer fixed or floating rates, the latter with a interest reset period of six months, subject to the ceiling of LIBOR/SWAP rates plus 50 basis points for the corresponding maturity. Based on the feedback received from the banks, it has been decided to revise the above ceiling downward to LIBOR/SWAP rates for the corresponding maturity.

Development of Government Securities Market

87. Following the announcement made in the Union Budget for 2001-02, the Reserve Bank has already taken the following measures:

- A Clearing Corporation with State Bank of India as chief promoter with five other banks and financial institutions is expected to commence its operations by June 2001. The Corporation is expected to facilitate clearing and settlement of money, government securities and forex transactions. Annexure-2 provides more details on the proposals relating to the Clearing Corporation.
- It was mentioned in the Mid-term Review of October 2000 that in order to promote retail access to government securities, an order driven screen-based trading in government securities on the stock exchanges would be introduced in consultation with the Securities and Exchange Board of India (SEBI). The progress in implementation is being continuously reviewed.
- It has been decided to introduce an electronic Negotiated Dealing System (NDS) by June 2001 with a view to facilitating transparent electronic bidding in auctions and secondary market transactions in government securities on a real-time basis. Annexure-3 provides more details about the proposed NDS.
- The Public Debt Act is proposed to be replaced by the Government Securities Act. The enactment will provide flexibility in undertaking transactions in government securities and facilitate retailing.

88. In order to strengthen the institutional mechanism in government securities market, taking into account market risk faced by PDs, capital adequacy guidelines were issued to them in December 2000 based on the accepted international standards. The following measures are being announced for further development of government securities market:

- In order to encourage retail participation in the primary market for government securities, it is proposed to allocate up to a maximum of 5.0 per cent of the notified amount in each auction of dated securities for allotment to retail investors on a non-competitive basis at the weighted average cut-off yield. The scheme will be operated only through the PDs and SDs. Individuals, and provident funds will be allowed to participate and entitled for allotment under this scheme and such allotment will be outside the notified amount. This scheme will be on an experimental basis after which it will be reviewed and modified, if necessary.
- Presently, the uniform price auction format is used for the issuance of 91 day Treasury Bills. It is proposed to extend the format to the auctions of dated securities, on a selective and experimental basis, in order to assess the benefits of such format. The notification for the respective auctions will specify the format to be used, viz., uniform price or multiple price.

- The scheme of Satellite Dealers (SDs) was established in December 1996 to develop supporting infrastructure as a second tier to the PDs in government securities. The facilities extended to SDs include entitlement for current and SGL accounts with RBI and access to liquidity support through repos to the extent of 50.0 per cent of the outstanding stock at the end of the previous day. On a review of the scheme, it has been decided that while the current eligibility criteria for accreditation as a SD would continue, the existing liquidity support available from RBI will be discontinued. The SDs will be able to fund themselves in the repo market as with the setting up of the Clearing Corporation, transactions in the repo market by SDs will be facilitated.

89. It may be mentioned that the proposed NDS and the Clearing Corporation will result in more transparent and efficient trading in the money, government securities and forex markets. Simultaneously, it will ensure efficient and secure settlement by having electronic links among the trading system, clearing corporation and the Public Debt Office (PDO) and payment system.

Progress towards Separation of Debt Management

90. A Working Group on Separation of Debt Management from Monetary Management set up in the RBI in November 1997 submitted its Report in December 1997. The Working Group recommended, *inter alia*, separation of debt management from monetary management and establishment of an independent company under Companies Act, 1956 to take over the debt management function. In that context, while no view was taken on the details of implementation, a decision to separate the two functions was considered desirable in principle. It was, however felt that separation of the two functions would be dependent on the fulfilment of three pre-conditions, viz., development of financial markets, reasonable control over fiscal deficit and necessary legislative changes.

91. Subsequent developments demonstrate substantial progress on all the fronts:

- First, significant progress has been made in the development and integration of financial markets with the introduction of new instruments and participants, strengthening of the institutional infrastructure and greater clarity in the regulatory structure. Notably, the recent amendment to the Securities Contracts (Regulation) Act, 1956 demarcated the regulatory roles of the RBI and SEBI over the financial markets.

- Second, in the Budget Speech of 2000-01, the Finance Minister expressed the need to accord greater operational flexibility to the RBI for conduct of monetary policy and regulation of the financial system. Accordingly, RBI has proposed amendments to various Acts, which is under active consideration.
- Third, RBI has already proposed amendment to the Reserve Bank of India Act to take away the mandatory nature of management of public debt by the RBI and vesting the discretion with the Central Government to undertake the management of the public debt either by itself or to assign it to some other independent body, if it so desires.
- Fourth, the proposed Fiscal Responsibility Bill when passed is expected to bring in reasonable control over the fiscal deficit. Apart from elimination of revenue deficit by March 31, 2006 and bringing down the fiscal deficit to 2.0 per cent of GDP in the same period, the proposed Bill envisages prohibition of direct borrowings by the Central Government from RBI after three years except by way of advances to meet temporary cash needs.
- Fifth, with the setting up of the Clearing Corporation and the operation of the full-fledged LAF and the other technological infrastructure being put in place, RBI will be able to operate its instruments of monetary policy with greater flexibility and the proposed separation of debt management will greatly facilitate the independence of RBI in performing its monetary management function.

92. In the above context, once legislative actions with regard to Fiscal Responsibility Bill and amendments with regard to the Reserve Bank of India Act are accomplished, it is proposed to take up with the Government the feasibility of and further steps for separation of government debt management function from RBI.

Prudential Measures

(a) Adoption of 90 days Norm for Recognition of Loan Impairment

93. At present, a loan is classified as non-performing when the interest and/or instalment of principal remain overdue for a period of more than 180 days as against the international best practice of 90 days payment delinquency. With a view to moving towards international best practices and to ensure greater transparency, it has been decided to adopt the 90 days norm from the year ending March 31, 2004.

94. The banks are, therefore, required to chalk out an appropriate transition path for smoothly moving over to the 90 days norm. As a facilitating measure, banks

should move over to charging of interest at monthly rests by April 1, 2002. Banks would have to substantially upgrade their existing Management Information System (MIS) for collecting data on loans, where the interest and/or instalment of principal remain overdue for a period of more than 90 days in order to crystallise NPAs on a 90 days norm. Banks should commence making additional provisions for such loans, starting from the year ending March 31, 2002, which would strengthen their balance sheets and ensure smooth transition to the 90 days norm by March 31, 2004. Banks are, therefore, advised to work out necessary modalities and submit their action plans after approval by their Boards to RBI. The implementation of the plans will be monitored by RBI on a half-yearly basis.

95. RBI is constantly reviewing the regulatory requirements in respect of prudential provisions and it is proposed to gradually enhance provisioning requirements in future. Considering that higher loan loss provisioning adds to the overall financial strength of the banks and the stability of the financial sector, banks are urged to voluntarily set apart provisions much above the minimum prudential levels prescribed by RBI as a desirable practice.

(b) Prudential Norms for Financial Institutions

96. As per the extant guidelines, financial institutions (FIs) are required to treat a credit facility as non-performing if interest is overdue for more than 180 days and/or the principal is overdue for more than 365 days. Over the years, a number of steps have been taken by Government of India to improve the legal framework governing recovery of dues of banks and FIs. The Reserve Bank has already circulated to banks and FIs the ground-rules on certain areas requiring co-ordination, particularly in respect of large value projects jointly financed by banks and FIs, with a view to avoiding delays and facilitating better solution to the common problems for implementation. Since the banking system is moving towards 90 days norm for recognition of loan impairment, it has been decided to bring in convergence in the norms for asset classification between FIs and banks over a reasonable period. Accordingly, to start with, the asset of a financial institution would be treated as non-performing if interest and/or principal remain overdue for 180 days instead of the present 365 days, with effect from the year ending March 31, 2002.

**(c) Norms for Statutory Central Auditors
in respect of Private Sector Banks**

97. Of late, it was observed by RBI that there was no uniformity amongst private sector banks in regard to the appointment of their Statutory Central Auditors (SCAs). Many banks were appointing audit firms of a smaller size and proprietary concerns with comparatively less experience. Considering the fast changes that are taking place in the financial sector in general and in the field of banking in particular as also the use of latest technology by some of the new private sector banks in their day-to-day operations, RBI had examined the issue of prescribing minimum eligibility standards for the audit firms before approving their names as statutory auditors for Indian private sector banks. Accordingly, with effect from the year 2001-02, the audit firms recommended by Indian private sector banks for appointment as their SCAs will have to satisfy the prescribed standards in this regard such as minimum standing, minimum number of full time partners associated with the firm for a period of at least 3 years, minimum number of chartered accountants exclusively associated with the firm, number of professional audit staff as well as minimum statutory central audit experience for the auditors. With a view to applying the prescribed minimum standards, Indian private sector banks have been classified into two categories on the basis of their asset size as at end-March of the previous year, i.e., banks with an asset size up to Rs.5,000 crore and those with above Rs.5,000 crore.

(d) Revised Guidelines for Recovery of NPAs

98. As announced in the Union Budget for 1999-2000, guidelines for constitution of Settlement Advisory Committees (SACs) for compromise settlement of chronic Non-Performing Assets (NPAs) of small sector were framed. While banks were required to take effective measures to strengthen the credit appraisal and post credit monitoring to arrest the incidence of fresh NPAs, a more realistic approach was needed to reduce the stock of existing and chronic NPAs in all categories. The guidelines were, therefore, modified in July 2000 which provided a simplified, non-discretionary and non-discriminatory mechanism for recovery of NPAs. The guidelines are in RBI website www.rbi.org.in. The Government and RBI have received a number of representations from industry/trade associations, individual borrowers as also from banks that the period of the guidelines should be extended.

Accordingly, the revised guidelines, operative till March 31, 2001 were extended up to June 30, 2001; for processing these applications/cases, banks have been given time up to September 30, 2001. All public sector banks are required to uniformly follow these guidelines, so that they maximise recovery of NPAs within the stipulated time.

(e) Credit Exposure to Individual/Group Borrowers

99. It was announced in the Mid-term Review of October 2000 that a review of current practices regarding credit exposure limits vis-à-vis international practices shows that there are certain issues which require further consideration. The first relates to the concept of 'capital funds'; second relates to the scope of the measurement of credit exposure, in particular, the coverage of non-fund and other off-balance sheet exposures; and the third relates to the level of exposure limit itself. Taking into account the complexities involved, a discussion paper on the subject was prepared and circulated among a few public sector, private sector and foreign banks. Based on the comments and suggestions received from the banks on the issues, following measures are announced:

- Internationally, exposure ceilings are computed in relation to total capital as defined under capital adequacy standards (Tier I and Tier II Capital). Taking into account the best international practices, it has been decided to adopt the concept of capital funds as defined under capital adequacy standards for determining exposure ceiling uniformly both by domestic and foreign banks, effective from March 31, 2002.
- In line with international best practices, it has been decided that non-fund based exposures should be reckoned at 100 per cent and in addition, banks should include forward contracts in foreign exchange and other derivative products like currency swaps and options, at their replacement cost value in determining individual/group borrower exposure ceiling, effective from April 1, 2003.
- As the concept of capital funds has been broadened to represent total capital (Tier I and Tier II), it has been decided to adjust the exposure ceiling for single borrower from the existing 20.0 per cent to 15.0 per cent effective from March 31, 2002. Similarly, the group exposure limits will be adjusted effective from March 31, 2002 to 40.0 per cent of capital funds. In case of financing for infrastructure projects, the limit is extendable by another 10.0 per cent, i.e., up to 50.0 per cent.

(f) Debt Recovery Tribunals

100. It has been announced in the Union Budget for 2001-02 that the Government has decided to set up 7 more Debt Recovery Tribunals (DRTs) during 2001-02 in addition to the existing 22 DRTs and 5 Appellate Tribunals to facilitate banks to quickly recover their dues from borrowers. Besides, the Government has proposed to bring in legislation for facilitating foreclosure and enforcement of securities in case of default so as to enable banks and financial institutions to realise their dues.

(g) Defaulters' List – Widening the Coverage

101. The RBI annual publication of the list of defaulters to banks and financial institutions of Rs.1 crore and above, introduced in 1995, is confined to suit filed cases due to the secrecy provisions enshrined in the banking laws. The coverage of the scheme was widened by bi-annual circulation of the names of defaulters of Rs.1 crore and above in the doubtful or loss category as well. A scheme for collection and dissemination of information on willful defaulters with outstanding balance of Rs.25 lakh and above, on quarterly basis, was also introduced in February 1999. Pending appropriate amendments in banking laws, RBI has also advised banks to incorporate a condition in the loan agreement for obtaining consent of the borrowers to disclose their names in the event of their becoming defaulters. Banks, which have not yet put in place the system of obtaining consent of the borrowers, are advised to complete the process by September 30, 2001.

(h) Revised Guidelines on Exposure of Banks to Stock Market

102. As announced in the Mid-term Review of October 2000, the RBI-SEBI Technical Committee has reviewed the RBI guidelines on banks' investments in shares as also advances against shares and other connected exposures. In making its recommendations, the Committee has taken into account the recent experiences of the banks and the exposures taken by them by way of advances against shares and financial guarantees. The report of the RBI-SEBI Technical Committee, which was submitted to RBI on April 12, 2001 was released on the same day by RBI for comments/suggestions by experts/market participants and others. The report is available on RBI website.

103. The Technical Committee has found that the overall exposure of banks in capital markets (both in terms of funded and non-funded credit facilities) continues to be modest at 1.76 per cent of total advances of banks in February 2001. Banking system as a whole and public sector banks, accounting for the overwhelming proportion of deposits and advances in the economy, have currently an exposure of 1.76 per cent and 0.49 per cent of total advances, respectively, compared to 1.88 per cent and 0.53 per cent, respectively, in March 2000, showing overall, a negligible impact of the guidelines issued last year. However, some relatively small banks (in terms of their share in total advances) do not seem to have observed appropriate risk management guidelines, particularly in respect of advances against shares and non-funded guarantees to a few stock broking entities (including their associated and inter-connected companies). This concentration of exposure on a few entities by these few banks was unjustified on prudential grounds and substantially increased the risks attached to such advances/guarantees, besides raising serious ethical concerns.

104. The Technical Committee's recommendations are expected to minimise the possibility of such unwarranted and unethical "nexus" emerging between some inter-connected stock broking entities and promoters/managers of some private sector or co-operative banks. At the same time, the Technical Committee's recommendations provide head-room for growth of banks' financial support to capital market with appropriate disbursement of funds by multiplicity of banks among the customers.

105. In the light of the recommendations of the Technical Committee, RBI proposes to revise the guidelines issued earlier in November 2000 on banks' investments in shares as also advances against shares and other connected exposures. It is proposed to issue the final guidelines in this regard in early May 2001 after taking into account further comments/suggestions received by RBI.

106. It is also proposed to review the actual working of the revised guidelines again after six months. Financing of assets backed by equity is a relatively new activity for most banks. It was anticipated by RBI, when the present guidelines were issued in November 2000, after intensive and open consultations with all concerned, that some revisions in these guidelines might be required in the light of actual experience. Banks were also requested to keep a close watch on their operations and monitor data relating to this sector. All banks, large and small, are once again advised to carefully

monitor their operations in this sensitive sector in order to minimize risk and maximize transparency.

(i) Reliance on Call Money Market

107. With the progressive deregulation, it is essential that banks adopt asset-liability management technique for scientific management of balance sheets. Accordingly, RBI issued comprehensive guidelines on Asset-Liability Management System in February 1999, advising banks to put in place a scientific system with effect from April 1, 1999. As a prudent measure, banks were, *inter alia*, advised that mismatches in cash flows during the first two time-buckets, viz., 1-14 days and 15-28 days should not, in any case, exceed 20 per cent of the cash outflows. Further, to contain short-term funding, banks were advised to set caps on inter-bank borrowings, especially call borrowings.

108. Narasimham Committee II has also recommended that there must be clearly defined prudent limits beyond which banks should not be allowed to rely on the call money market and that access to the call market should essentially be for meeting unforeseen swings and not as a regular means of financing banks' lending operations. Recognising, however, that the money and fixed income securities markets were not well-developed and that banks had been advised to comply with the prudential limits on mismatches, it was decided to move away from placing product-specific limit. However, a review undertaken by RBI had revealed that a few banks were overly exposed to the call money market. These banks were specifically advised to chart definite plans to reduce maturity mismatches and avoid excessive reliance on call money market. A recent assessment has indicated that some of the banks have taken concrete steps in building core deposit base, arranging committed lines of credit, etc., in order to reduce their dependence on call money borrowings. If, however, any bank continues to rely excessively on call money market for carrying out their banking operations, after discussion with such bank, RBI will lay down specific ceilings to reduce its long-term dependence on call money.

(j) Commercial Paper

(i) Preference for Dematerialised holding

109. As part of the new guidelines for issue of CP released in October 2000, banks, FIs, PDs and SDs were advised to invest and hold CP only in dematerialised form, as soon as arrangements for such dematerialisation are put in place. As the existing arrangements for dematerialised holding of CP are now considered adequate and satisfactory, it has been decided that with effect from June 30, 2001, banks, FIs, PDs and SDs will be permitted to make fresh investments and hold CP only in dematerialised form. Outstanding investments in scrip form should also be converted into dematerialised form by October 31, 2001.

110. As a corollary, it is also considered expedient to extend the demat form of holding to other investments like bonds, debentures and equities. Accordingly, with effect from October 31, 2001 banks, FIs, PDs and SDs will be permitted to make fresh investments and hold bonds and debentures, privately placed or otherwise, only in dematerialised form. Outstanding investments in scrip form, should also be converted into dematerialised form by June 30, 2002. As regards equity instruments, they will be permitted to be held by the above mentioned institutions only in dematerialised form, from a date to be notified in consultation with SEBI.

(ii) Documentation and Procedure

111. As part of the new guidelines on issue of CP released in October 2000, FIMMDA was entrusted with the task of prescribing standard procedures and documentations that are to be followed by the participants, in consonance with the international best practices. In this regard, FIMMDA has been in dialogue with RBI and in the process of devising such standard procedures and documentation. Before finalisation, FIMMDA would circulate a draft of these guidelines among its members and other market participants.

(k) New Basel Capital Accord

112. The Basel Committee on Banking Supervision has recently released the second set of consultative documents on a new Capital Accord. The new Accord provides a range of options of increasing sophistication for providing explicit capital for credit, market and operational risks. It is envisioned that the new Accord will be implemented in member jurisdictions in 2004. In RBI, an internal Working Group is currently examining the implications of the new Accord.

113. While the 1988 Accord could be easily adopted on account of its simplicity and flexibility, the more sophisticated provisions incorporated in the new Accord pose significant implementation challenges for banks and supervisors. The feedback received from a few banks indicates that they would have to substantially upgrade their existing MIS, risk management practices and procedures and technical skills of staff. Banks should, therefore, initiate necessary steps to ensure that they are geared to adopt the new Accord, as and when approved. In this context, banks are advised to assess their preparedness to adopt the new Accord, and formulate a plan for implementation.

(l) Consolidated Accounting and Supervision

114. The Board for Financial Supervision has evolved an approach for consolidated supervision as appropriate in the Indian context based on which, a set of measures was announced last year. A multi-disciplinary Working Group has been set up to look into the introduction of consolidated accounting and quantitative techniques for consolidated supervision, in line with international best practice. The Group is expected to submit its report before July 2001.

(m) Move towards Risk-based Supervision

115. As indicated in April 2000 Policy Statement, there is a growing acceptance that risk based supervision (RBS) approach would be more efficient than the traditional transaction based approach. Accordingly, following the recommendations of an international consultant, appointed to advise on a proper structuring of the RBS approach, a dedicated Group has been set up within RBI for project implementation and to drive the change management implication. To meet the requirements of RBS, banks would have to take immediate measures to improve the reliability and robustness of their risk management, management information, and supervisory reporting systems.

(n) Credit Information Bureau

116. A mention was made in the April 2000 Policy Statement regarding State Bank of India entering into a Memorandum of Understanding with HDFC Ltd. and other

foreign technology partners to set up a Credit Information Bureau (CIB) which would provide an institutional mechanism for sharing of credit information among banks and FIs. CIB has since been set up with a paid up capital of Rs.25 crore. The Bureau will collect, process and share credit information on the borrowers of credit institutions. As per the existing legislative framework, success of CIB would largely depend on the banks' efforts to obtain consent of borrowers for disclosure and make available the information to the Bureau. While CIB can be functional within the existing framework, to strengthen the legal mechanism for making the functioning of CIB effective, a draft master legislation covering responsibilities of the Bureau, rights and obligations of the member credit institutions, safeguarding of the privacy rights, has been forwarded to Government of India.

(o) Prompt Corrective Action

117. As indicated in the Mid-term Review of October 2000, a framework for Prompt Corrective Action (PCA) was prepared with various trigger points for prompt responses by the supervisors. The draft scheme was posted on the RBI website, and sent to select banks. Based on the suggestions received, the scheme has been modified. The scheme will be finalised in consultation with banks and the Government.

(p) Macro-Prudential Indicators

118. The Mid-term Review of October 2000 indicated that a half-yearly financial stability review using Macro-Prudential Indicators (MPIs) would be prepared for internal circulation. In this regard, an inter-departmental Group was constituted and a pilot review of MPIs for the half-year ended March 2000 was finalised and a review for September 2000 has since been prepared. While the initial reviews are likely to be largely compilations of MPIs, over time, these reviews are expected to act as the foundation of an early warning system by highlighting potential vulnerabilities in the financial system. They would also show linkages between the macroeconomic indicators and the balance sheets of individual institutions with the eventual objective of building appropriate models in the Indian context. These periodical reviews would also identify issues for further examination or internal research and suggest

improvements in the data collection/ compilation process through constant analysis of emerging literature in this area.

Urban Co-operative Banks

(i) Prudential Measures

119. It has to be recognised that the present prudential norms and the regulatory system prescribed for Urban Co-operative Banks (UCBs) are relatively soft in comparison with those for commercial banks. This is partly on account of historical reasons, and partly due to their size being generally small and the preferential treatment of co-operative structure in general. At present, three authorities are involved in regulatory and promotional aspects concerning the UCBs – the Central Government (in case of banks having multi-state presence), State Governments and RBI. At times, this results in overlapping jurisdiction and difficulties in carrying out administrative/prudential measures with the required speed and stringency. The recent experience has also shown that irresponsible and unethical behaviour on the part of even a few co-operative banks in the country can have some contagion effect beyond the particular area or the state concerned and may cause severe harm to depositors, including smaller co-operative banks, and impair the confidence in the system. It is necessary to ensure that immediate interim measures are taken to ward off such contingencies with serious adverse consequences without continuing to wait for legal and institutional reform. The following measures are proposed:

- Even at present, co-operative banks are not permitted to invest directly in stock markets or lend to stock brokers. They can, however, lend to individuals against pledge of shares up to Rs.10 lakh per borrower, if the shares are in the physical form, and up to Rs.20 lakh if they are in demat form. Available information shows that a few UCBs have ignored the present guidelines and established a nexus with certain stock brokers in order to operate in the stock market. In order to prevent any possible misuse in the future, it is necessary to stop lending by UCBs directly or indirectly to individuals or corporates against security of stocks. With immediate effect, UCBs are being advised not to entertain any fresh proposals for lending directly or indirectly against security of shares either to individuals or any other entity. They are also advised to unwind existing lending to stock-brokers or direct investment in shares, which were not permissible, at the earliest. Advances to individuals against security of stocks that have already been disbursed, up to permissible amounts, may however, continue till the contracted date. The managements of co-operative banks should immediately communicate above measures to the

concerned members and the steps being taken by the bank to implement the new guidelines.

- In order to reduce the excessive reliance of some UCBs in the call money market, it is being provided that their borrowings in the call/notice money market on a daily basis should not exceed 2.0 per cent of their aggregate deposits as at end March of the previous financial year. The existing freedom to lend in the call/notice money market will continue.
- As parking of funds by UCBs with other UCBs may pose a systemic risk, as a safety precaution, UCBs are advised not to increase their term deposits with other UCBs. While UCBs will not be permitted to increase their term deposit balances with other UCBs, the outstanding deposits with other UCBs as on April 19, 2000, could be unwound before end of June 2002. UCBs may maintain current account balances at their discretion with other UCBs to meet their day-to-day clearing and remittance requirements.
- UCBs are allowed to maintain their SLR (25.0 per cent of NDTL) in the form of investments in government and other approved securities or as deposits with District Central Co-operative Banks/State Co-operative Banks. As per extant guidelines, the scheduled UCBs are required to maintain at least 15.0 per cent of NDTL in government and other approved securities; non-scheduled UCBs with deposits of Rs.25 crore and above are required to maintain at least 10.0 per cent of their NDTL in government and other approved securities; and in respect of non-scheduled UCBs with deposits of less than Rs.25 crore there is no stipulation regarding maintenance of SLR in the form of government and other approved securities. It is now proposed to increase the proportion of SLR holding in the form of government and other approved securities as percentage of NDTL in the following manner, which should be achieved by end-March 2002:

| <u>Category of UCBs</u> | <u>SLR holding in Government and other approved securities as per cent of NDTL</u> | |
|---|--|-----------------|
| | <u>Present</u> | <u>Proposed</u> |
| | Non-Scheduled UCBs | |
| i) UCBs with deposits of Rs.25 crore and above | 10.0 per cent | 15.0 per cent |
| ii) UCBs with deposits of less than Rs.25 crore | Nil | 10.0 per cent |
| Scheduled UCBs | 15.0 per cent | 20.0 per cent |

- With effect from April 1, 2003, the scheduled UCBs will need to maintain their entire SLR assets of 25.0 per cent of NDTL only in government and other approved securities. Further, compliance with CRR requirements on par with scheduled commercial banks would be prescribed in due course.

- All the scheduled UCBs and non-scheduled UCBs with deposits of Rs.25 crore and above would henceforth be required to maintain investments in government securities only in SGL Accounts with RBI or in constituent SGL Accounts of public sector banks and PDs. Non-scheduled UCBs with deposits of less than Rs.25 crore will have the facility of maintaining government securities in physical or scrip form.
- UCBs should, in their operations, take note of the fact that commercial banks may establish appropriate inter-bank monetary limits for discounting of pay-orders issued by scheduled co-operative banks, taking into account the size of their deposits/net worth, etc.

120. It may be noted that, in order to minimize any immediate financial impact on UCBs, all the measures are either “prospective” in nature or sufficient time has been allowed for UCBs to implement them in the interest of their members. The above measures should provide greater security for depositors and members of UCBs and contribute to the development of the UCB sector on sound lines.

(ii) A New Supervisory Structure for UCBs?

121. As mentioned earlier, three authorities (Central and State Governments and RBI) are presently involved in regulating, supervising and/or administering UCBs. There are as many as 2,084 UCBs of which 51 are scheduled UCBs and the rest are unscheduled. In view of the large number as well as their dispersed and local character, their supervision and inspection pose special problems. At present, while accounts of UCBs are required to be audited by state governments, there has been substantial delay in completing audit of a large number of UCBs. RBI conducts statutory inspections normally once in two years in respect of scheduled UCBs, once in two to three years in respect of non-scheduled UCBs, while the identified weak banks are inspected on annual basis.

122. Concerned about the potential consequences of the present multiplicity of authorities involved in supervising and regulating the UCBs and other problems that had been observed, RBI had set up a high level committee in May 1999 under the Chairmanship of Shri K.Madhava Rao. The Committee also had representatives of the co-operative banking sector and RBI as well as other experts as members. The Committee submitted its Report in November 1999 and this report was also sent to

Central and State Governments for consideration. The Committee made wide-ranging recommendations for improving the functioning of the co-operative banks. These recommendations, *inter alia*, included proposals to substantially improve the entry-point norms, induction of professional management, abolition of dual supervisory control, and stiffer prudential and other parameters. Most of the recommendations of the Committee have been accepted by RBI, but recommendations requiring legislative action at the level of State Governments have yet to be implemented. RBI is following up with State Governments to implement the recommendations of the Committee as early as possible.

123. In the light of the recent experience, one of the options that deserves to be seriously considered is the setting up of a new apex supervisory body which can take over the entire inspection/supervisory functions in relation to scheduled and non-scheduled UCBs. This apex body could be under the control of a separate high-level supervisory board consisting of representatives of the Central Government, State Governments, RBI as well as experts and it may be given the responsibility of inspection/and supervision of UCBs and ensuring their conformity with prudential, capital adequacy and risk-management norms laid down by RBI.

124. RBI proposes to consult the Central Government on the above suggestion, and if found acceptable in principle, the proposal could be pursued further in consultation with State Governments and others concerned. RBI will be prepared to provide manpower and other assistance to the new apex supervisory body as necessary.

Ownership Functions of Reserve Bank of India

125. The Reserve Bank holds at present shares in State Bank of India (SBI), National Housing Bank (NHB), Infrastructure Development Finance Company (IDFC), Deposit Insurance and Credit Guarantee Corporation (DICGC), National Bank for Agriculture and Rural Development (NABARD), Bharatiya Reserve Bank Note Mudran Ltd. (BRBNML), Discount and Finance House of India (DFHI) and Securities Trading Corporation of India (STCI).

126. It may be recalled that Narasimham Committee II was of the view that appropriately, RBI should not own the institutions it regulates. In the Discussion

Paper prepared by RBI on Harmonising the Role and Operations of Development Financial Institutions and Banks (January 1999), it was suggested that in order to enable RBI to concentrate its regulatory and supervisory functions, the ownership of financing institutions could ideally be delinked from RBI through transfer of such ownership to the Government. It was stated indeed that RBI should desist from continuing with its ownership functions in both commercial banking and refinance or development finance segments.

127. RBI has accepted the recommendation for transfer of ownership of its shares in SBI, NHB and NABARD to the Central Government, and is in touch with the Government in this regard. The matter has to be examined further by the Government and RBI in detail, and a view taken by the Government since policy decisions and legislative actions are involved.

128. RBI also plans to initiate the process in respect of IDFC at an appropriate time in future. In respect of BRBNML, there is no intention to divest RBI's shareholding at this stage since RBI is a captive customer and there are no regulatory implications. In respect of DICGC, RBI had already submitted proposals to the Government for framing a new Act to make it consistent with financial sector liberalization.

129. RBI has, consistent with the above approach, already divested most of its shareholding in DFHI and STCI. Currently, RBI holds only 10.50 per cent of the shares in DFHI and 14.40 per cent of the shares in STCI. It has been decided to completely divest these shareholdings in the current year.

Credit Delivery Mechanism

Relief Measures for Gujarat

130. In view of the devastating effect of earthquake in the state of Gujarat in January 2001 resulting in wide-spread damage to the properties and heavy loss of life, RBI announced a package of relief measures for the State. These measures cover:

- The loan classification status in case of borrowers affected by the earthquake is frozen on an 'as-is-where-is' basis up to March 31, 2003 at concessional interest rate of 10.0 per cent without application of penalty provisions.

- Notwithstanding the present loan classification status, the affected small traders, small business, self-employed and small road transporters, etc., would be sanctioned fresh loans up to Rs.1 lakh for the purpose of restoration/rehabilitation of their business at interest rates not exceeding PLR.
- Banks are advised to grant loans up to Rs.2 lakh at interest rate not exceeding PLR for repairs/reconstruction of houses/shops damaged by the earthquake.
- Provision of additional limits/rescheduling of existing limits for affected small scale industries (SSI), business, trade and industry under a need based approach at PLR up to Rs.10 lakh and at banks' discretion beyond Rs.10 lakh.
- Loans for repair/construction of houses and shops and to small traders, small business, self-employed and small road transport operators, etc., will be reckoned as priority sector lending.
- Waiving of processing fee for the affected beneficiaries.
- In respect of agricultural loans, banks are not to recover principal or interest from the affected farmers for a period of two years with a provision for reschedulement up to 7 years.
- For purposes of interest rate on loans to affected borrowers, PLR of the SBI will be uniformly applied by all banks.
- On the request from National Housing Bank (NHB), RBI has sanctioned a long-term loan of Rs.1,000 crore at 6.0 per cent rate of interest per annum repayable over 18 years to enable NHB to provide refinance assistance to housing finance companies, banks, etc., providing loans for reconstruction of houses, etc., to the affected people.
- Relief/concessions for affected exporters include extending the period of packing credit, conversion of dues into short-term loans repayable in suitable instalments and relaxation in NPA classification norms.

Non-Banking Financial Companies

131. In recent years, the Reserve Bank has taken a number of initiatives and steps to speed up the reform process in the functioning of Non-Banking Financial Companies (NBFCs). In terms of the extant Regulations (Section 45-IA of the amended RBI Act, 1934), NBFCs are not permitted to commence/carry on financial business as defined in the Act without a Certificate of Registration (CoR) from RBI. The Bank has received applications for CoR from 36,870 NBFCs, of which 12,690 applications were approved and 17,736 were rejected as at end-February 2001. Out of the total approvals of 12,690 applications, only 734 have been permitted to accept

public deposits. It may be mentioned that, of these, only 25 NBFCs have public deposits of over Rs.50 crore. It may be reiterated that NBFCs not registered with RBI, and those institutions which are not permitted to accept public deposits, should not raise public deposits. Further, NBFCs are advised to repay public deposits as per the terms of their acceptance and continue to adhere to the provisions of RBI Act and other directives issued from time to time.

132. With a view to further strengthening the regulatory/supervisory framework on NBFCs, the following measures are proposed:

(a) Separate Act for Non-Banking Financial Companies

133. In order to facilitate NBFCs to effectively perform their role in the economic development of the country, the Government has proposed a separate legislation to provide for enhanced protection to the depositors of NBFCs. The Bill is under consideration of the Government.

(b) Draft Guidelines for Asset Liability Management for Non-Banking Financial Companies

134. The Reserve Bank has concluded its consultations with NBFCs and other concerned institutions on the draft guidelines for asset-liability management for NBFCs. The final guidelines would be issued shortly.

Technology Upgradation

135. Improvement in payment system has been one of the priority areas of financial sector reform. In this direction, the following further steps are being taken:

(a) Payments System Vision Document

136. The Mid-term Review of October 2000 mentioned about the preparation of a "Payments System Vision Document" focussing on the implementation of the systemically important payment system applications having impact on large value inter-bank funds transfers. The draft Vision Document was prepared and widely circulated. RBI has received feedback from banks and comments from the members of apex bodies such as the National Payments Council. The Reserve Bank is

examining these comments/feedback and the final version of the Vision Document would be published shortly. The Vision Document would provide a road map of important developments in the payment system project. This would facilitate banks in getting themselves fully prepared to participate effectively in the new products aimed at better payment and settlement services.

(b) 'Imaging' as Pre-cursor for Cheque Truncation

137. As part of the Mid-term Review of October 2000, stages of development relating to introduction of imaging to serve as pre-cursor for cheque truncation were mentioned. A Working Group constituted by the Ministry of Finance, Government of India is examining the legal requirements for cheque truncation under the Negotiable Instruments Act.

(c) Internet Banking

138. As indicated in the Mid-term Review of October 2000, the Working Group on Internet Banking has since submitted its report which has been accepted for implementation. As a part of this process, a staggered approach, based on the levels of technology usage in different banks is being prepared covering the conduct of internet based transactions in a highly secured environment with appropriate risk control measures and risk management techniques.

(d) Indian Financial Network

139. In addition to the extensive use of Indian Financial Network (INFINET) for information flow and funds movements, further steps have been taken in improving the infrastructure for facilitating efficient funds management. Accordingly, it has been decided to set up a structured financial messaging backbone system for which SWIFT like message formats have been finalised and circulated to the banks to encompass various types of intra and inter-bank applications including those of government transactions and debt-related transactions.

140. The other technology related infrastructure such as the Securities Settlement System, the Negotiated Dealing System, the Centralised Funds Management System and the Real Time Gross Settlement System are all slated for completion shortly.

Banks, therefore, need to take suitable measures by ensuring intra-city connectivity and networking of branches and setting up of gateways at major cities. The 21 centres where RBI has a presence have been identified for network connectivity by the National Payments Council. However, intra-city and intra-bank networking within these 21 centres will have to be done by individual banks.

Legal Reforms

141. The major legal reforms initiated in the banking sector in the recent months encompass areas such as security laws, Negotiable Instruments Act, fraud on banks and regulatory framework of banking. RBI has forwarded its recommendations to Government of India for comprehensive amendments to the Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949, which are under consideration by the Government. Government of India has constituted a Working Group for suggesting changes in the provisions of Negotiable Instruments Act, 1881, to bring it in conformity with the Information Technology Act, 2000 and also to examine the incorporation of electronic cheque, securitised certificate and other evolving products within the ambit of Negotiable Instruments Act. Further, with the increasing level and complexity of frauds and the difficulties being faced by banks in recovering the financial loss by recourse to legal process, RBI has constituted a Committee on legal aspects of bank frauds to define financial frauds, lay down procedural laws, examine the process of investigation of bank frauds and prosecution of persons involved.

142. Government of India constituted an Expert Committee under the chairmanship of Shri T.R.Andhyarujina for the purpose of formulating specific proposals to give effect to the suggestions made by Narasimham Committee II relating to changes needed in the legal framework. The Committee submitted its report in February 2000. As a follow-up, Government of India constituted a Working Group (Chairman: Shri S.H.Bhojani, with Shri M.R.Umarji, as a member from RBI) on asset securitisation in July 2000 to examine the Expert Committee's recommendations for implementation. This Working Group has drafted a Bill on asset securitisation for enactment and submitted to the Government.

143. Another Working Group was constituted by the Government in July 2000 (Chairman: Shri M.R.Umarji), to examine the vesting of powers with banks and FIs

for taking possession and sale of securities without intervention of the courts and to draft a Bill for consideration of the Government. The report of the Group is expected to be submitted shortly.

International Financial Standards and Codes

144. In the Mid-term Review of October 2000, it was mentioned that some of the Advisory Groups on International Standards and Codes had submitted their reports in part/full to the Standing Committee, constituted by RBI in consultation with the Government. Advisory Groups, which consist of non-official experts, have since made significant progress in firming up their views in various subject areas. As of now, the reports/part of reports in respect of the following subjects have already been received by the Standing Committee: (i) Transparency of Monetary and Financial Policies (Final), (ii) Payment and Settlement System, (iii) Insurance Regulation, (iv) Banking Supervision (Part I), (v) Accounting and Auditing, (vi) Bankruptcy Laws (Interim) and (vii) Corporate Governance. The remaining reports on three subjects, viz., Data Dissemination, Fiscal Transparency and Securities Market Regulation are expected by May 2001. All the reports of the Advisory Groups have been put on the RBI website www.rbi.org.in for debate and discussion. These reports are also being printed for wider dissemination. The Standing Committee also plans to help the Groups in organising Seminars/Workshops to enhance awareness and concretise views on the recommendations and seek comments/feedback from both private and public sector organisations, international institutions and experts. The work of the Standing Committee and non-official advisory groups in this important area has been commended internationally.

Regulations Review Authority

145. The Regulations Review Authority (RRA), which was constituted on April 1, 1999 for reviewing the Reserve Bank's rules, regulations and reporting system based on the suggestions received from general public at large, market participants and other users of services of RBI, has ceased its operations from March 31, 2001 on expiry of its term. During two years of its operations, RRA received a number of suggestions, many of which were implemented. This helped in removal of redundancies in the reporting system, simplification of rules and internal procedures in various functional

areas within RBI and also brought about some improvement in operational efficiency in commercial banks which enabled better customer service. An important outcome of RRA's initiative was the arrangement for preparation of master circulars in many regulatory areas, incorporating RBI's instructions/ guidelines at one place.

146. Though the RRA has ceased its operations, in view of the favourable response to the Scheme, RBI has decided to make the review exercise an integral part of its internal system and accordingly, has put in place an alternate mechanism under the charge of an Executive Director for dealing with such applications from April 1, 2001. This will help RBI to further simplify procedures, reduce paper work and improve customer service, on an on-going basis.

Mid-term Review

147. A review of credit and monetary developments in the first half of the current year will be undertaken in October 2001. The Mid-term Review will be confined to a review of monetary developments and to such changes as may be necessary in monetary policy and projections for the second half of the year.

Mumbai

April 19, 2001

Annexure-1

Current and Revised Interest Rate Structure on Export Credit

| Category | Existing | Revised* (With effect from May 5, 2001) |
|---|-----------------------------|--|
| Pre-shipment Credit | | |
| (i) Up to 180 days | 10.0 per cent | Not exceeding PLR <u>minus</u> 1.5 percentage points |
| (ii) Beyond 180 days and up to 270 days | 13.0 per cent | Not exceeding PLR <u>plus</u> 1.5 percentage points |
| Post-shipment Credit | | |
| a) On demand bills for transit period (as specified by FEDAI) | Not exceeding 10.0 per cent | Not exceeding PLR <u>minus</u> 1.5 percentage |

points

b) Usance Bills

| | | |
|---|--------------------------------|---|
| (i) Up to 90 days | Not exceeding 10.0 per cent | Not exceeding PLR minus 1.5 percentage points |
| (ii) Beyond 90 days and up to 6 months from date of shipment | 12.0 per cent | Not exceeding PLR plus 1.5 percentage points |

* Note : 1. Since these are ceiling rates, banks would be free to charge any rate below the ceiling rates.

2. Interest rates on other miscellaneous categories of export credit will stand revised in accordance with the above restriction. Detailed instructions are being issued separately.

Annexure-2

Clearing Corporation

The main features of the proposed Clearing Corporation for clearing of money, government securities and forex markets transactions are:

- The Clearing Corporation will be constituted as a limited liability Company under the Indian Companies Act 1956 and will be known as “The Clearing Corporation of India Ltd.”
- The Company will have an authorised capital of Rs.50 crore.
- The Clearing Corporation will be owned by the market participants and promoted by State Bank of India. The other core promoters of the company will be Bank of Baroda, HDFC Bank, ICICI, IDBI and LIC.
- The proposed Clearing Corporation will be managed by a Board of Directors headed by a non-executive Chairman.
- The Clearing Corporation will address the need for efficient securities settlement system covering money, government securities and forex markets.
- The Clearing Corporation will:
 - Facilitate extension of repos market to non-Government securities and enlargement of market participants.
 - Act as a tri-party agent for efficient management of collateral in consonance with internationally accepted best practices.

- Act as a central counter-party through novation thereby minimising counter-party risk.
- The Corporation will also manage a Settlement Guarantee Fund thereby minimising settlement risk.

Annexure-3

Negotiated Dealing System

The salient features of the Negotiated Dealing System (NDS) are:

- Banks, Primary Dealers and Financial Institutions having Subsidiary General Ledger and Current Accounts with RBI will be eligible to become members of the system.
- The system will facilitate submission of bids/applications for auctions/ floatations of government securities through pooled terminal facility located at regional offices of Public Debt Office (PDO) across the country and through 'member-terminals.
- The system can be used for daily Repo and Reverse Repo auctions under Liquidity Adjustment Facility (LAF).
- It will provide an electronic dealing platform for primary and secondary market participants in government securities and also facilitate reporting of trades executed through exchanges for information dissemination and settlement in addition to deals done through the system.
- Government dated securities, Treasury Bills, Repurchase Agreements (Repos), Call/Notice/Term Money, Commercial Paper, Certificates of Deposit, Forward Rate Agreements/Interest Rate Swaps, etc., will be the eligible instruments.
- NDS will be integrated with Securities Settlement System (SSS) of PDO of RBI to facilitate settlement of deals done in government securities and treasury bills.
- It will facilitate dissemination of information relating to primary issuance through auction/sale on tap and underwriting apart from secondary market trade details to participants.