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5.1 Introduction

The process of financial reforms, which began in the wee of the economic reforms in early 1990, has been carried forward through various credit policy announcements. The conduct of monetary management has undergone significant changes in the 1990s in terms of objectives, framework and instruments, reflecting broadly the progressive liberalization of the Indian economy. Monetary policies pursued mark a significant departure from the past and became an essentially market oriented policy. To quote the RBI Annual Report 2000-01,

The macroeconomic environment since the second half of the 1990s have rendered the conduct of monetary policy complex and subject to conflicting pulls. While output considerations may warrant monetary easing, it has been necessary to guard against monetary expansion turning excessive in a situation of slowing down of output growth, which could cause the emergence of inflationary pressures and expectations. Moreover, the policy setting has been complicated by the impact of brief, yet significant, supply shocks to the price level within the general ebbing of demand-pull factors, structural rigidities resulting in the downward inflexibility of interest rates, the continuous pressure of the Government’s market borrowing programme and sporadic episodes of volatility in the financial markets. The on-going integration of financial markets across the world, the phenomenal increase in financial turnover, the 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 have added additional dimensions to the conduct of monetary policy.

This gives the clear thinking of the RBI during the past ten years and how the RBI enforced the implementation of the monetary policy.

A factor that complicated the conduct of monetary policy during certain periods is the difficulty of an appropriate assessment of the potential inflationary pressures. While there is little disagreement that in the medium to long-run, inflation was largely caused by monetary expansion, in the short-run, price fluctuations could be affected by non-monetary and supply side factors. Under these conditions, monetary and credit policies have been deployed in support of the overall macroeconomic policy objectives, albeit, with a flexible approach under which tightening or easing of monetary conditions can be swiftly undertaken.

The Reserve Bank announced a multiple indicator approach in 1996-99, which accords the necessary flexibility to respond to changes in domestic and international economic and financial market conditions more effectively. While
the growth in broad money ($M_3$) continues to be used as an important indicator of monetary policy, interest rates along with information on currency and credit extended by banks and financial institutions, the fiscal position, trade, capital flows, the inflation rate, the exchange rate and transactions in foreign exchange available on high frequency basis are juxtaposed with output data for drawing policy perspectives. This shift has been a gradual and a logical outcome of measures taken over the period of structural reforms.

A major transformation has also taken place in the operating procedures of monetary policy. The reform of monetary and financial sectors has enabled the Reserve Bank to expand the array of instruments of indirect monetary control and at the same time reduce reliance on reserve requirements. The liquidity management in the system is carried out through open market (including repo) operations (OMO), supplemented by access to the Reserve Bank's standing facilities. The Liquidity Adjustment Facility (LAF) operations combined with strategic OMO have evolved as the principal operating procedure of monetary policy.

It may be recalled that the traditional objective of growth was practically dethroned during the financial sector reforms phase. The credit policy has moved away from being agriculture-centric to being primarily market-centric. The effort has been to gradually shed the development garb and adorn the garb of a regulator and play maker. The stance of monetary policy is to create liquidity and make interest rate regime more flexible in medium term. This is a bold break from the pre-reform policy stance and it deserves to be commended. It will be clear from the following how the objectives of the monetary policies changed during the past ten-year period of Economic Reforms beginning 1991 to 2001 and how the RBI used the monetary policy to strengthen the financial system of the country, in tune with the global economy.

5.2 Objectives

Retaining the traditional objectives of price stability, growth and regulation of the economy, the stance of monetary policy is being changed in keeping with the prevailing economic conditions and the requirements. The monetary policy concentrated more on effective functioning of markets, regulatory role, technological development etc. The details of the objectives of monetary policies during the past ten years help us in understanding how the stance of the monetary policy underwent changes. The Monetary Policy for the year 1991-92 was formulated against the backdrop of high inflation rate and a difficult balance of payments situation and hence it was governed primarily by the need to control...
inflation and the concern about the foreign exchange reserves position. Hence, promotion of exports was high on the list of priorities, besides economic stabilization and structural reforms. Attention was also given, during the year 1992-93, to certain basic ingredients of the financial sector reform such as the reduced reliance on reserve requirements and the development of the Government securities market.

The prime objective of monetary policy shifted to contain the RBI credit to Central Government, in tune with the Central Governments' objective of reduction in the gross fiscal deficit during the year 1993-94, so that monetary policy had enough headroom to support the growth of output. Hence it was indicated to gradually move from direct to indirect instruments of monetary control. Progressive activation of debt management policy, giving greater autonomy to banks in the deployment of their funds, stringent set of prudential norms and maintenance of stable exchange rate, promotion of output growth, price stability and containing RBI credit to central government were the objectives.

The paramount objective of monetary policy during 1994-95 was to ensure a sharp reduction in the inflation rate, by about 4 percentage points, over the prevailing level. The announcement in the budget to phase out automatic monetization of the budget deficit by taking recourse to ad hoc Treasury Bills has been strengthened by the signing of an historic agreement between the GOI and the RBI on September 9, 1994, which formalized this arrangement. Thus the stance of monetary policy for the second half of 1994-95 was limiting monetary expansion. In order to achieve this fundamental objective, the monetary policy targeted control of monetary growth, moderate monetary expansion and moderate growth of primary liquidity and moving from direct to indirect instruments of control.

The link between monetary policy and the budget deficit has been weakened due to the historic accord between the Government and the Reserve Bank, limiting the Government's unilateral access to borrowing through ad hoc Treasury Bills, during the year 1995-96. Against the background of the monetary and credit developments in the earlier two years, the RBI felt that there was a compelling need to moderate monetary and credit growth. In order to achieve this, the stance of monetary policy was to ensure a cautious approach in extending non-food credit and to adequately meet the productive requirements of the economy. Limiting the Government's unilateral access to borrowing through ad hoc treasury bills and moderate growth of money supply with a view to contain inflationary...
pressures and at the same time ensuring the provision of adequate credit to support the growth of the real sector were the other objectives.

Monetary policy for 1996-97 consolidated the hard-won gains against inflation in 1995-96 and credibility of monetary policy. While ensuring that the genuine and legitimate credit requirements of the commercial sector are met, ensuring maintenance of low rate of inflation continued to be the main objective and it was felt that this could be achieved only if monetary policy was supported by a coherent and consistent macro-economic framework. The monetary policy measures were framed to enable banks to have adequate resources to keep up the momentum of credit flows to support output, during 1996-97 and 1997-98. Credit support to sustain growth and a reasonable degree of price and exchange rate stability were the objectives continued to guide the course of monetary policy.

The monetary policy during 1998-99 reflected developments that have taken place during the previous year and the broad economic objectives of the year. Among the important short-term economic objectives for the first half of the year were acceleration of industrial investment and output, maintaining inflation rate at low level, continuing pursuit of financial sector reforms, reducing the level of interest rates and improving credit delivery system, particularly in the context of agriculture and SSI sector.

The financial crisis in South East Asia and Japan has brought to the fore the problems that a weak and fragile domestic financial sector could pose for the real economy. It was established beyond reasonable doubt that while a persistent and unexpected downturn in the real economy created difficult problems for the financial sector, a fragile financial sector could deepen the real economic crisis and impose heavy social costs. It was therefore of utmost importance to strengthen capital adequacy, income recognition and provisioning norms for banks as well as other financial institutions and to move towards full disclosure and transparency in banking operations in line with international best practices. Therefore the policy for the second half of the year aimed at strengthening the financial system.

A major challenge for monetary policy during 1999-2000 was the need to reconcile the conflicting objectives of restraining the overall growth of liquidity in order to ensure price-stability and at the same time facilitate the flow of adequate bank credit for productive sectors of the economy in order to improve growth. Providing liquidity to the market was the main objective of the policy.
Continuing the changed focus on structural measures to strengthen the financial system and to improve the functioning of various segments of financial markets, the monetary policies of the year 2000-01 aimed at increasing operational effectiveness of monetary policy by broadening and deepening the money market, the bond market, and the government securities market. Redefining the regulatory role of the RBI and strengthening the role of RBI in the areas like developing the financial markets and managing liquidity in the economy, providing freedom to banks and at the same time strengthening prudential and statutory norms, improving credit delivery system, particularly for agriculture, exports, services, SSI Sector, Self-Help Groups and Micro-credit institutions and developing technology and infrastructure support to the financial sector with the view to make the same more efficient were the other objectives of the policy.

The Monetary and Credit Policy for 2001-02 announced in April 2001 continues to emphasize the need for adequate availability of bank credit to meet all genuine requirements while ensuring that inflationary pressures are contained. An important objective of monetary policy is to improve its operational effectiveness. The mid-term monetary policy announced on 22nd October 2001 aimed at provision of adequate liquidity to meet credit growth and support revival of investment demand while continuing a vigil on movements in the price level. To quote Bimal Jalan:

"The policy envisages to work 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."

The above discussion gives us a clear understanding of the objectives of the monetary policy during the past ten years. Now we will look into the changes and impact of the monetary policy instruments.

5.3 Reserve Requirements

Almost all the committees constituted to study the monetary and financial sector reforms felt that the reserve ratios are high and recommended reduction...

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Jalan Bimal, Mid-term review of monetary policy on 22.10.2001, RBI, Mumbai, p 15
On careful persuasion of the recommendations, the RBI decided to reduce the reserve ratios and the reserve requirements have been brought down to the minimum levels at the end of the 10 year reform period.

5.3.1 Cash Reserve Ratio (CRR)

One of the important instruments available with the Reserve Bank for mopping up excess liquidity in relation to developments in the real sector, is the Cash Reserve Ratio. More often than not, it was changed unidirectional. A major reform that took place in monetary policy during the 10-year period of economic reforms is the reduction of reserve requirements. The Committee on Financial Sector Reforms recommended that the maximum level of CRR should be 10 per cent. The monetary policy announced on 22nd October 2001, reduced the Cash Reserve Ratio to 5.5 per cent from the level of 15 per cent, at the beginning of the economic reforms. With this the cash reserve ratio was brought down to the level of the ratio prevailing in 1973. Important changes that took place in the CRR since 1991 are detailed below.

Ten per cent of incremental cash reserve ratio was introduced in May 1991 in order to ease the flow of credit to the productive sectors, the scheduled commercial banks were exempted from maintenance of the 10 per cent incremental CRR over the level of net demand and time liabilities (NDTL) as on April 17, 1992. One third of additional cash balances maintained that under the 10 per cent incremental CRR on NDTL was released to banks in three equal installments. Effective from the fortnight beginning October 17, 1992, no interest was paid on the increase in eligible cash balances based on NDTL maintained after March 23, 1990. The stipulation of maintaining the minimum level of 85 per cent of the CRR requirement, on each of the first 13 days of the reporting fortnight was changed. It was to be maintained on the first working day of the reporting fortnight. This stipulation facilitates banks to plan for proper deployment of funds in advance and plan for gainful investments. With a view to rationalizing CRR prescription and moving towards the long-term goal of keeping CRR normally at the statutory level, all the exemptions on the liabilities were withdrawn except inter-bank liabilities, for the computation of NDTL (for requirement of maintenance of CRR) with effect from fortnight beginning November 3, 2001. It is expected that these changes will facilitate the development of a short-term yield curve, develop money market, reduce the regulatory arbitrage between banks and non-banks, enhance the availability of lendable resources with the banks and improve the efficiency of indirect instruments in the conduct of monetary policy. The RBI also made it clear that it
would adopt a flexible approach to effect changes in the requirement of Cash Reserve Ratio, in the event of an emergence of any adverse and unexpected developments in the domestic as well as external sectors

5.3.2 Statutory Liquidity Ratio (SLR)

In tune with the process of economic reforms initiated in the country the SLR was reduced from the high of 38.5 per cent at the beginning of the economic reforms to 25 per cent, which is the minimum level prescribed by the RBI Act 1934. This was recommended by the Narasimham Committee on Financial Sector Reforms. The major changes that took place during the past 10 years are enunciated hereunder.

As the need for a high SLR was diminished with progressive move to market related rates of interest on Government borrowing, the base level SLR on the level of domestic NDTL was progressively brought down to 25 per cent from 34.75 per cent. In order to rationalize overall SLR prescription, SLR on outstanding liabilities under the NRE scheme was rationalised into a single uniform 25 per cent on their entire NDTL.

5.3.3 Inclusion/Exemption of certain liabilities from Reserve/Liquidity requirements

In addition to the prescription of changes in the rates of reserve requirements, the RBI also took up many changes in the structure/calculation of the basis for Reserve Requirements. Liabilities under certain external deposit schemes and Certificate of Deposits (CDs) issued by banks over the pre-May 2, 1992 limit, equivalent to 5 per cent of the fortnightly average outstanding aggregate deposits in 1989-90, were exempted from both CRR and SLR requirements. Certificate of Deposits issued over pre-May 2, 1992 limit were brought under the purview of CRR. Whenever there was paucity of funds, the reserve requirements on external deposits were reduced to attract more inflow of funds and in times of excess reserves the reserve ratios were imposed or increased to restrict the flow of funds into the country. Varied rates were imposed on different external deposit schemes and the base years were different and reference periods were different.

In due course, with a view to bring all liabilities under one umbrella of reserve requirements, uniform rate was prescribed for all categories of deposits.

Gold imported by authorized Banks and lent to jewelry exporters in India for exports are exempted from CRR/SLR requirements. Liabilities under gold deposits mobilized in India were exempted from CRR requirements. Cash in Hand with Banks was included for calculation of CRR for a brief period of one year.
Borrowings of gold mobilized under the gold deposit scheme by authorized banks from authorized banks treated as inter-bank liabilities and exempted from CRR.

In the recent past, several measures have been undertaken with a view to enabling banks to choose an optimum strategy for holding intra-reporting period bank reserves. A lagged reserve maintenance system was introduced under which banks were allowed to maintain reserve requirements on the basis of the last Friday of the second (instead of the first) preceding fortnight. From May 6, 2000, banks were required to maintain a minimum of 65 per cent (instead of the earlier 85 per cent) of the CRR balances on a daily basis from the first working day to the thirteenth day of the fortnight and adjust the balances accordingly on the reporting Friday (i.e., the fourteenth day) and reduced to 50 per cent for the first seven days of the reporting fortnight and 65 per cent for the rest of the days inclusive of the reporting Friday (which earlier did not have a minimum prescription). In order to facilitate the emergence of an inter-bank term money market, inter-bank term liabilities with maturity of 15 days and above were exempted from the maintenance of minimum CRR. In its mid-term review of monetary policy announcement on 22nd October 2001, the RBI has withdrawn all exemptions on the liabilities except inter-bank liabilities, for the computation of NDTL, for requirement of maintenance of CRR. All scheduled commercial banks, excluding Regional Rural Banks, are being paid interest on eligible cash balances maintained with RBI under CRR requirement at the rate of 6 per cent per annum as against 4 per cent earlier and linked to Bank Rate with effect from November 3, 2001.

The empirical results obtained from the use of statistical methods as explained in Chapter 6, proved beyond doubt that the amount released to the public by way of reduction in CRR and SLR affects each and every sector of the economy. Of all the four Monetary Policy instruments selected for study CRR and SLR influence the most on the gross credit, GDP, Wholesale Price Index, Deposits and Credit. They impose a cost on the banking system in as much as interest is not fully paid on reserves. The high cash reserves are one of the reasons for the high level of interest rates. The RBI has recognized the flaw in its Reserve Requirements policy by simplifying the manner in which the reserve requirements are calculated. The plethora of exemptions had turned CRR into a complex instrument and hence the RBI has rationalized it. The CRR was brought down to mere 5.5 per cent, just a little above the minimum 3 per cent level stipulated by the law.

Reserve requirements are needed for the precautionary purpose of meeting unforeseen demand for funds. The banks deal in money and they need a
minimum 'inventory' to meet payment and settlement needs. But the experience of many advanced economies confirms that as the financial sector improves in its sophistication, there is less and less need for such reserves. Indeed, in the US, the Federal Funds System does exactly this: Federal funds are the reserves needed to be kept with the Federal system. Banks with surplus 'fed funds' are able to meet the needs of those without such funds. What is intriguing - and not a little inconsistent - is that in a market-oriented economy such as the US, whenever there arises a need for Federal funds, the Federal Reserve stands ready to supply the resources, at a rate which it prescribes. It is worth the while to copy the system of CRR prescribed by the US only if at the same time we provide the equilibrating mechanism of the Fed Reserve. Reduction in CRR increases the funds available for banks. But of this the compulsory finance under directed lending pulls down the funds available for banks for commercial lending. A high pre-emption of liquid resources from banks in the form of cash reserve is counter productive, especially since it comes in top of capital adequacy and other restrictive norms. Further, it leads to a volatile market for funds, when banks end up frequently short of required reserves, which cannot be fully anticipated.

Any release of reserves by way of reduction in reserve requirements would result in the bank income going up. High cash reserves are one of the reasons for high level of interest rates. Although the reserve requirements are an overall Monetary Policy issue it is the one single measure which impinges heavily on banks' profitability. Besides, balances in the CRR fetch higher rate of interest. Lowering of CRR will help the government to borrow 10 to 15 per cent more than the target. It will also help the country's biggest borrower shave off its loans. Lowering the CRR also swamps the system with adequate liquidity so that there aren't any supply side issues as when credit growth takes off. Cut in the CRR will facilitate the RBI to go for more open market operations.

On the other side, reduction in CRR can only increase the amount of funds available with banks to lend and if all that is to be let out, the prices will have to fall. Fall in CRR increases the availability of funds but reduction in interest rates will affect the profitability of the banks adversely. So, the monetary policy should address the cost of funds.

There is excess of funds with banks now, but not much improvement in non-food credit. The Government should withdraw all subsidies and encourage food for work program, generate employment avenues and spend more money. Eradicate poverty, make people to work and pay them more money. On one hand, we have excess of funds and on the other people are starving for food.
There is a lot of scope for improvement in all sectors of the economy, which will generate more employment opportunities. But because of the political pressures and political favors, much importance is being given for subsidies and write-offs, rather than generating more employment opportunities, which are making people more lethargic. Our infrastructure facilities require more attention. Create better infrastructure facilities. The excess of funds released to the system by way of reduction in Reserve Ratios should concentrate on these aspects.

5.4 Bank Rate

Bank rate has emerged as a signaling indicator/rate after the advent of financial sector liberalization. In the post-nationalization phase, with increased emphasis being bestowed on priority sector lending and concessional lending, the Bank Rate lost much of its significance till the announcement of resurrecting made in April 1997. The Bank Rate was changed only ten times during 1951-74 and only once during the period 1975-91 despite the substantial growth of the financial sector and the pressures on liquidity exerted at different points of time over the 50 years between 1951 and 1991. The Bank Rate has become more active during the 10 years of Economic Reforms. The Bank Rate was changed thirteen times between 1991 and 2001, and brought down to 6.5 per cent at present from the level of 11 per cent at the beginning of reforms. At this rate, it is the lowest since May 1973. In the context of the inflationary pressures, and the need to evolve a benchmark Reserve Bank rate, it was considered apposite to activate the Bank Rate Instrument. In order to make the Bank Rate an effective signal rate as well as a reference rate, all interest rates on advances from the Reserve Bank as also the penal rates on shortfalls in reserve requirements were linked to the Bank Rate. Interest rates on other categories of accommodation from the Reserve Bank as well as term deposit rates up to one year which were not linked to the Bank Rate earlier, were linked to it by the end of the decade of reforms. With a view to aligning the Bank Rate to the changing conditions, the bank rate was revised up and down and stood at 6.5 per cent now.

5.5 Interest Rates

Way back in 1985, the Chakravarty Committee felt that the existing system of administered interest rates has become unduly complex and needs to be modified. Till the 1990s, the restrictive...
policies followed in respect of interest rates were in tune with the restrictive policies followed in the economy. The New Economic Policy brought down the interest rates to the minimum level. The Economic Reforms started with removing the restrictions and the decade of reforms ended with full liberalization of the interest rates in respect of both deposits and advances. It was proved through various studies that interest rates have least impact on the movement of deposits and advances. Empirical results in the present study also proved that the changes that took place during the past 10 years in the interest rates do not have any significant relationship on the movements of Aggregate Deposits and credit. The empirical study reveals that the growth in Aggregate Deposits and advances are interest rate inelastic and it has very limited/no influence in bringing about changes in the deposit/advance levels.

5.5.1 Domestic Deposit rates

The RBI fixes the interest rates. If the RBI ordered them up, they went up and if the RBI ordered them down, they promptly fell, before the dawn on economic reforms. Interest rates have been almost completely deregulated in tune with the Economic Reforms initiated in the economy. Banks are now free to set their own deposit rates. This in tune with the recommendations of the Chakravarthy Committee.

Deposit rates were subject to only one ceiling rate as against the prescribed rates earlier. Keeping the deceleration in the inflation rate and the reduction in lending rate and to enable banks to maintain their economic viability, the maximum rate on domestic term deposits was reduced. Maximum term deposit rate was increased to evolve a more stable asset-liability balance and to ensure attractiveness of term deposits, as per the requirements of the prevailing economic conditions. With a view to providing greater flexibility in determining term deposit rates, banks were given freedom to fix their own interest rates on domestic term deposits. Further, to provide some outlet for management of short-term surplus funds, owing to the developments in the money market and the progressive move from the cash credit system to a loan system the minimum period of term deposits was reduced from 45 days to 15 days in phases.

Restriction on banks that they must offer the same rate on deposits of the same maturity irrespective of the size of such deposits was removed for domestic term deposits of 15 lakh and above. The minimum maturity period of 15 days was reduced to seven days in respect of wholesale deposits (Rs 15 lakh and above). Bank boards were accorded the freedom to formulate their own rules regarding
penal interest rates on premature withdrawal. Considerable freedom was also allowed in respect of interest rates for renewal of overdue term deposits. Banks have also worked out schemes to offer higher and fixed rates of interest on term deposits of senior citizens.

In its mid-term review of Monetary Policy announcement on 22nd October 2001, the Reserve Bank of India has given freedom to Banks to offer “variable” interest rates on longer-term deposits. However, for various reasons, the preference of depositors as well as the traditional practice with banks tended to favour fixed interest rates on term deposits. This practice has effectively reduced the flexibility that banks have in lowering their lending rates in the short run, since the rates on the existing stock of deposits cannot be lowered.

5.5.2. External Deposit rates

The term deposit rates for NRE Accounts for maturity of 46 days to 3 years and above were made subject to a single prescription. Banks were given freedom to fix their own interest rates for deposits of six months and over. A new FCNR (B) scheme was introduced effective May 15, 1993 entailing the commercial banks to provide the exchange rate guarantee to depositors. With a view to providing flexibility to banks, freedom was given to banks to determine their own rates on deposits under FCNR (B) scheme subject to ceilings prescribed by the RBI from time to time. Effective October 22, 1997, the ceiling rates were prescribed at the relevant London Inter-bank Offered Rate (LIBOR) prevailing on the last working day of the previous week for relevant maturity and currency, in respects of deposits of six months and above but less than one year and floating rate deposits. In respect of deposits of maturity of one year and above the interest would be within the ceiling of swap rates for the respective currencies and maturities. Banks were also permitted to determine their own penal interest rates for premature withdrawal of NRE/FCNR (B) deposits and to fix their own overdue interest rates in respect of NRE deposits remaining overdue for period exceeding 14 days, subject to these deposits being renewed. The minimum maturity for FCNR (B) deposits was raised from six months to one year. Banks were given option to choose the current swap rates while offering FCNR (B) deposits. Banks were permitted to offer differential rates of interest on NRE deposits and FCNRB deposits subject to overall ceiling rate on size-group basis on the lines of domestic term deposits. However, for FCNR(B) deposits, the freedom to offer such rates was subject to the overall ceiling prescribed. Banks were also permitted to offer differential rates. Banks were allowed to use current swap rates for fixing interest rate ceilings for the following week. Since April 2001, the
earlier mark-up of 50 basis points over the LIBOR/swap rates in determining the ceiling rate was done away with.

The empirical results furnished in Chapter 6, proved that the changes that took place during the past 10 years, in the interest rates do not have any significant relationship on the Aggregate Deposits movements. The growth in Aggregate deposits is interest rate inelastic and it has very limited or no influence in bringing about changes in the deposit levels. The changes in the Aggregate Deposits also have no impact on the movement of Deposit Rates.

Various studies conducted proved that the deposits with banks have been the most preferred savings mode, followed by the contractual savings from the angle of safety. SEBI’s Survey of Investors (2000) has revealed that 65 per cent of all households in India and 76 per cent of house holds investing in equity and debentures rated bank deposits very safe. Households investment in shares and debentures has declined sharply and has been conspicuously low in recent years. In 1991-92, households invested in shares and debentures 2.3 per cent of their total financial assets, which shrank to 2.4 per cent by 1997-98 and moved up to 2.5 per cent in 1998-99. This ratio includes investment in the units of mutual funds too. Shift of households preference to invest in those assets, which provide safety to their capital and returns, a kind of risk-averse attitude. M Y Khan, in his article Discomforbng Savings rate, commented that

The high propensity to consume and the low per capita income of majority of households also divert funds from risky investments. Increase in consumption first affects the investment in risky assets. A lower rate of interest rates increases consumption. It may induce savings also, as they may fear that interest rates fall further.

Low Interest rates are necessary and desirable in the larger interest of the economy. Having lived in the era of government determined interest rates, people are accustomed to tracking nominal interest rates. But the interest rates that matter is the one adjusted for inflation - the real Interest Rate. In the past ten years, while interest rate on deposits has declined by one percentage points, consumer price inflation has fallen from 6.6 per cent in 1990-91 to 3.5 per cent in 2000-01. As a result, real interest rate rose from more than 4 per cent to over 6.5 per cent. That’s among the highest interest rates in the world. The logic - lower interest rates bring down cost of capital that spurs investment, income and employment.

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It is being argued by a sector of people that when market forces are allowed to determine the rate of interest the rate, will tend to remain high and such high rates can hinder the process of growth. But these critics fail to understand that if rates of interest are kept at artificially low levels, they can only result in diverting funds from the organized to the unorganized sectors, losing total control over the end use of funds. While aggregate savings may not be significantly influenced by changes in the interest rate, there is enough evidence, nevertheless, to show, even in the Indian context, that savings in the form of financial assets are considerably influenced by the interest rate.

A low-interest rate regime directly helps consumers by reducing the cost of hire purchase. But the Government has failed to prevent recurring failures in the financial markets and unable to develop new avenues for savings. There isn't any social security network. Pension funds have not been allowed to offer the kind of risk-return combinations that could suit individual needs. Devoid of options and given collapse of stock markets and equity funds, people are pouring most of their savings in bank deposits. That's borrowing down options at a time when they should be diversifying investments.

Therefore, if the financial institutions are to perform effectively, their major role of mobilising resources, the rate should be allowed to be determined by the forces of supply and demand. The interest rates are influenced by the actions of the monetary authority. In that sense, nowhere in the world is the interest rate purely determined by market forces. It is the function of the monetary authority to move the rate of interest towards a level considered appropriate. Within this overall policy framework, market forces have a greater role in determining the structure of interest rates rather than its level. The monetary authority, however, cannot keep interest rates for long at levels that are inconsistent with the basic supply and demand balance.

In the present depressed market the average saver is unable to choose the right savings instruments. RBI could consider giving shape to its idea of retailing government securities through bank branches. The newly set up Clearing Corporation of India (CCIL) could be entrusted the task of setting all transactions in government securities upto a specified limit and transactions above that limit could be cleared through SGL. Bankers should be advised to provide prompt lines of credit to CCIL to manage contingencies including defaults.

The factors in favour of lower interest rates is the unprecedented surge in bank deposits. At the same time the industrial slowdown has resulted in loan disbursements falling by 37 per cent. As a result most of the deposits are
chasing government paper. It is this deluge of liquidity that has pushed down bond yields by over a hundred basis points in less than one month. The government has been the big gainer having completed over 70 per cent of its targeted borrowing program within six months. But then on the other side, is the worry of the government overshooting its borrowing targeted fiscal deficit.

The RBI can allow banks to offer differential rates on savings deposits. Since most of the banks now offer flexi-deposits (money in savings deposits automatically gets transferred to term deposits after a certain level and earns higher interest rates), it will be possible for them to offer a token one or two per cent interest rates on savings deposits in cities while the present rate of four per cent can be kept for the semi-urban and rural populace. The interest paid on balance in savings deposits may be linked to the average balance maintained in the account. There may be only one type of fixed deposit, which attracts same interest rates.

In the regime of low interest rates, the government and Reserve Bank should maintain same level of inflation. Introduction of the concept of floating interest rates protects depositors from inflation.

5.5.3 Lending Rates

Since the inception of the planning process, lending rates have been under the full control of the Government and Reserve Bank. The lending rate structure was plagued with many norms, guidelines and restrictions. Different rates were prescribed for different purposes. High rates of interest have been levied for unproductive sectors and concessional rates for priority sectors. Reinforcing anti-inflationary policies, the Chakravarty Committee recommended that there was every need to provide credit at concessional interest rate to the priority sector and profitability of banks were some of the important aspects of interest rate policy to be taken into account in modifying the present administered interest rate structure. The committee has not recommended any ceiling on lending rates of banks and banks are expected to peg their lending rates based on fluctuations in business activity and their own cost of funds subject to the 'administered spread'. According to the committee, banks should be given freedom to choose cost and maturity structure of deposits to suit its lending operations subject to maintaining a uniform interest rate structure at all branches.

Ever since financial sector reforms, the RBI has taken up rationalization of interest rates on advances in stages. The concept of PLR was introduced and
later banks were given total freedom to determine their own PLR. Bank rate was linked to the PLR. To quote Dr. Jayanti Lall Jain,

By doing so, RBI has been able to bring the desired reduction in PLR by the reduction in interest rates on deposits. By this measure, not only RBI has addressed the aspirations of industry and trading community to reduce interest rate on borrowings but also made attempts to divert liquidity in the banking system to other financial sectors including capital market. 

Interest rate cut increases the liquidity and puts upward pressure on inflation rate.

During the reform period, lending rates were modified with a view to ensuring that the rates reflected the underlying inflation in the economy and the need for changing positive real rates of interest. First in the context of the need to reduce aggregate demand in the economy as also taking into account the increase in deposit rates and in the context of high inflationary pressures, lending rates of scheduled commercial banks were raised.

The Chakravarty committee recommended that not more than two concessional interest rates should apply to bank credit made available to specified priority sector borrowers, one of which should be equivalent to the basic (minimum) lending rate and the other somewhat lower than basic (minimum) lending rate.

As part of a process of progressive rationalisation of banks' lending rate structure, the lending rate structure was rationalised from the earlier six categories into three categories. When the inflationary situation was under reasonable control, MLR was reduced. MLR for credit limits of over Rs 2 lakhs was abolished and banks were given freedom to fix their own Prime Lending Rates (PLR) subject to the approval of their Board of Directors and the lending rate for credit limits of over Rs 25,000 and up to Rs 2 lakhs for all advances including term loans. The stipulation of effective interest rate on bill discounting of over Rs 2 lakhs, which was at one percentage point below the lending rate under this category, was withdrawn. In the context of the flexible lending rates, effective October 1, 1995, banks were allowed to fix their own interest rate on advances over Rs 2 lakhs against term deposits.

In the context of the need for ensuring viability of RRBs and providing greater maneuverability and ensuring the flow of adequate and sustainable credit to the rural sector, the lending rates of RRBs were freed. In order to ensure that the

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actual lending rates charged by banks are not sharply higher than their respective PLRs, as also to impart transparency in lending rate structure and make the PLR credible, the Reserve Bank advised the banks to announce the maximum spread over the PLR for all advances other than consumer credit along with their PLRs approved by the Boards. With a view to encouraging borrowers to switch over to Loan Delivery System, banks were permitted to prescribe separate PLRs for 'loan component' and 'cash credit component' and separate spreads over the respective PLRs.

As a part of the process of deregulating interest rates on credit limits up to Rs. 2 lakh and in view of the movements in the interest rates, effective October 22, 1997, the lending rate prescription for credit limits of over Rs. 25,000 and up to Rs. 2 Lakh, was changed from a fixed to a ceiling prescription of 'not exceeding'.

With a view to giving banks more freedom to determine the interest rates, banks were allowed in October 1997 to prescribe separate Prime Term Lending Rates (PTLRs) for term loans of 3 years and above. The multiple prescriptions of lending rates linked to loans against FCNR(B)/NR(NR) deposits were dispensed with and banks were given the freedom in relation to uses and rates as available to them in case of advances in general.

In order to remove the disincentive to the flow of credit to small borrowers, effective April 29, 1998, the interest rates on loans up to Rs. 2 lakh were not to exceed the prime-lending rate (PLR) which is the rate available to the prime borrowers with credit limits of over Rs. 2 lakhs of the concerned banks. Effective from April 29, 1998, interest rates on loans and advances granted against domestic/NRE term deposits stipulated not to exceed PLR. Freedom was given to banks, with effect from October 29, 1999, to charge interest rates without reference to PLR in respect of (a) loans covered by refinanced schemes of Term Lending Institutions, (b) lending to Intermediary Agencies, and (c) Discount of bills with a view to encouraging bills culture. All advances against term deposits would be at interest rates equal to PLR or less, effective from April 29, 1998.

Board of Directors of banks were allowed to delegate powers to the ALM Committee to fix interest rates on deposits and were allowed to operate fixed rate for all term loans subject to conformity to ALM guidelines. Banks were allowed to operate different PLRs for different maturities. Banks were allowed to charge suitable rates of interest on advances against domestic/NRE term deposits without reference to the ceiling of PLR in cases where deposit rates were equal to or more than PLR or less than one percentage point below PLR. Freedom was

given to banks to charge interest rates on loans against Domestic/NRE/FCNRB deposits without reference to their own PLR. Effective from March 23, 2000, banks were permitted to charge interest at suitable rates in case of advances up to Rs 2.00 lakh against third party deposits, as in case of advances to depositors against their own deposits.

In April 2000, as part of the efforts to ease the rigidities in the interest rate structure, restriction on fixed rate loans extended only for project loans was withdrawn. Banks were given the freedom to offer all loans on fixed or floating rates while complying with PLR stipulations. The norms relating to the PLR have been progressively liberalized in the recent period. Banks were allowed to offer loans at sub-PLR rates, thereby removing the practice of treating the PLR as a floor for loans above Rs 2 lakh.

5.5.4 Interest rates on Export Credit

In order to make dollar-denominated export credit scheme more attractive and to facilitate an environment for promotion of exports, the rate of interest on refinance under these schemes was reduced. Following reduction in the MLR for advances of above Rs 2 Lakh, the interest rates in respect of usance bills for periods beyond 90 days and up to six months and beyond six months were also reduced from 22 per cent to not exceeding 12 per cent. With a view to rationalizing the interest rates on PSCFC and encouraging a quicker turnaround of credit, interest rate on Post-shipment Export Credit denominated in US Dollars (PSCFC) in respect of usance bills for periods beyond 90 days and up to six months from the date of shipment was enhanced. The interest rate on export credit not otherwise specified for PSCFC, which was 9.5 per cent per annum, was also freed. With a view to facilitate a faster turnover of credit under the PSCFC Scheme, effective January 16, 1996, a rate of interest of 9.5 per cent per annum was prescribed on PSCFC for a total period up to 90 days as against 7.5 per cent per annum earlier, and for credit over 90 days, banks were given freedom to fix their own interest rates. In order to remove the distortion in the effective interest rates, effective February 8, 1996, the interest rate on Post-Shipment Export Rupee Credit for over 90 days and up to 180 days was deregulated.

The rates of interest on foreign currency export credit which were to be fixed with reference to ruling LIBOR were also permitted with effect from August 16, 1999, to be fixed with reference to Euro LIBOR/Euro BOR. Interest rate surcharge of 30 per cent on import finance, in force since January 1998, was withdrawn from October 29, 1999. Minimum prescribed interest rate of 20 per cent per annum on overdue export bills was withdrawn from October 29, 1999. The interest rate
Applicable to overdue export bills in case of export credit not otherwise specified (ECNOS) at post shipment stage was prescribed at 25 per cent per annum (minimum) with effect from May 26, 2000. An interest rate surcharge of 50 per cent was levied on bank credit for imports as a temporary measure on May 26, 2000.

In the April 2001 policy announcement, a significant rationalization of prescribed interest rates on export credit was undertaken. A ceiling rate on rupee export credit is now indicated, linked to the relevant-tenor PLR, and banks were given freedom to charge interest rates below the prescribed rate, effective May 5, 2001. The ceiling rate on foreign currency loans for exports was set at LIBOR plus 10 percentage points, effective April 19, 2001. The revisions in the interest rates are applicable not only to fresh advances but also to the existing advances for the remaining period.

The statistical results furnished in Chapter 6, has statistically proved that the changes that took place during the past 10 years, in the interest rates do not have any significant relationship with the Gross Credit movements.

The progress of reforms brought down the lending rates to the lowest level. A cut in interest rates helps in two ways: it reduces the cost, and it makes new projects viable. The monetary lesson is that interest rates should be cut so fast that even the most cautious entrepreneur will not wish to miss the opportunity to borrow and invest. And the boom that might follow should not be thwarted by an attack on price rises or the desire to save the exchange rate. Bankers are not enthusiastic about the phenomenon. While the lending rate has fallen by 1.5 percentage points, the real rate of interest on advances has gone up by 1.6 percentage points from 7.4 per cent to 9 per cent.

<table>
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Source: Data culled out from various issues of RBI Bulletin.
Reduction in lending rates affect the profitability of banks as the deposits of earlier periods continue to carry the same rate of interest till maturity and the rates on advances fall in tune with the reduction in the lending rates. Though real rate of interest came down, spread has gone down by 0.5 percentage points because of increase in real deposit rates. (Refer Graph - 5 2 and Table 5 1) As such parity should be maintained for both deposits and advances in following either fixed rate method or floating rate method uniformly.

5.6 Refinance Facilities

RBI provides refinance to the commercial banks for credit extended to various sectors of the economy, which in its view needs greater finance. By making changes in the refinance norms, the RBI may restrict/release the funds available for banks. During the past ten years several changes were made to the refinance facilities for restricting the funds or for more flow to certain sectors.

5.6.1 Export Credits (Rupee) Refinance

In view of the paramount need to promote exports and also to provide greater incentive to banks to render export credit, the export credit refinance formula was liberalized and banks’ access to funds under this facility was increased. Base year for providing refinance facility was changed a number of times. The refinance limit was enhanced to 100 per cent increase in export credit over the monthly average level of outstanding export credit of base year. The interest rate on Export Credit (rupee) Refinance was reduced from 10 per cent to 7 per cent with an increase and decrease as per the requirements of the prevailing economic conditions et al.

Collateralised lending facility (CLF) was replaced with General Refinance Facility and provided at Bank Rate (for two weeks). Additional Collateralised lending facility (ACLF) was also provided at the Bank Rate + 2 percentage points. Penal interest of 2 per cent was imposed on CLF and ACLF availed for second block of two weeks. The stipulation of two-week cooling period at the end of 4 weeks of avallment of CLF/ACLF by Banks was removed. Tier I liquidity support against collateral of Government securities based on bidding commitment and other parameters was made available to primary dealers at the Bank Rate for a period of 90 days with effect from April 21, 1999. Tier II liquidity support against collateral of Government Securities to primary dealers for periods not exceeding two weeks at a time at the Bank Rate + 2 percentage points was also provided with effect from April 21, 1999. Banks were given the benefit of rediscounting export bills with Institutions like EXIM Bank and obtaining refinance from
NABARD/ EXIM Bank effective from May 06, 2000

The limits on export credit refinance were fixed at 15 per cent of the total outstanding export credit eligible for refinance as at the end of the second preceding fortnight, effective May 5, 2001, instead of the earlier system of linking refinance to the incremental export credit over a base date, viz., February 16, 1995. The existing refinance limit as on May 4, 2001, as per the earlier formula, is retained as the minimum entitlement up to March 31, 2002. With the announcement of the second phase of LAF, the Reserve Bank has been in the process of moving gradually from a system of segmented refinance to a more fungible system of liquidity adjustment at market-related rates.

5.6.2 Export Credit Refinance Denominated in US Dollars (PSCFC)

With an objective of providing a facility to exporters to avail of post-shipment export credit denominated in foreign currency and pay interest at rates applicable for the foreign currency concerned, a scheme of Post-shipment Export Credit Denominated in Foreign Currency was introduced effective from January 1, 1992. A new refinance facility called 'Refinance Scheme for Post-shipment Export Credit Denominated in US Dollars' was introduced effective from January 4, 1992. Under this scheme, banks were eligible for export credit refinance limits equivalent to 133-1/3 of such credit provided by them to exporters. This refinance limit was reduced progressively to 70 per cent of such credit provided by banks to exporters. Rate of interest on this refinance facility was raised from 5.5 per cent to 6.5 per cent effective from April 18, 1995. Overdue PSCFC was also made ineligible for PSCFC beyond 90 days and up to 6 months from the date of shipment and sanctioned on or after January 16, 1996 was made ineligible for refinance. With a view to removing the distortion in the effective interest rate on the PSCFC facility which was significantly lower than under foreign Currency Post-Shipment Credit with effect from February 8, 1996, PSCFC scheme was terminated. However, the refinance limits against eligible PSCFC was allowed to continue till the respective due dates.

The RBI's refinance facility of export credit to commercial banks constitutes a cornerstone of the overall strategy for India's quest for sturdy export growth. Export credit refinance from the central bank ensures a steady flow of finance support to exporters eliminating resource constraints. The RBI further liberalized and rationalized the export credit refinance facility for scheduled commercial banks. Banks were earlier provided export credit refinance to the extent of 100 per cent of the incremental export credit over the level of such credit as on February 16, 1996. Effective May 5, this year, they were allowed to avail of
export credit refinance to the extent of 15 per cent of the outstanding export credit eligible for refinance at bank rate. RBI should de-link the refinance rate for banks from the bank rate and align it with the current export credit interest rate structure.

5.7 Government Securities Refinance

With a view to developing an active market for Government Securities the gilt-edged market was reorganized in such a way that the Government reduced its dependence on credit from the RBI and the banks. A new refinance facility viz., Government Securities Refinance was introduced in October 1992. Under this facility, banks were granted refinance to the extent of 0.5 per cent of the fortnightly average outstanding aggregate deposits in 1991-92 were made eligible under Government securities at the rate of 14 per cent per annum.

With a view to augmenting resources available under the Government securities refinance facility and imparting liquidity to the excess holdings of Government and other approved securities, effective September 30, 1995, the base year for determining the refinance limits was brought forward to 1994-95. Further, the proportion of refinance limit was raised to one per cent. The refinance limit was provided under two separate limits (a) 0.5 per cent of the fortnightly average outstanding aggregate deposits in 1994-95 against the collateral of Treasury Bills at the rate of 12.5 per cent per annum and (b) 0.5 per cent of the fortnightly average outstanding aggregate deposits in 1994-95 against the collateral of dated Government and other approved securities at the rate of 14 per cent per annum.

Government securities refinance facility was withdrawn in 1996. In the context of a move from sector-specific refinance facilities to a general refinance facility and also with a view to enabling Bank Rate emerge as a reference rate, banks were provided General Refinance to tide over temporary liquidity shortages equivalent to one per cent of each bank’s fortnightly average outstanding aggregate deposits in two blocks of four weeks each at Bank Rate for the first block of four weeks and at Bank Rate plus one percentage point for the second block of four weeks. Banks availing of this facility beyond eight weeks would face automatic debiting of their accounts with the Reserve Bank. Banks can avail of this facility afresh if there is a gap of two weeks during which there is no borrowing under this facility.

With a view to enabling those scheduled commercial banks which were temporarily deploying the rupee resources available against Resurgent India Bonds in Government securities sold by RBI through Open Market Operations, a Special Liquidity Support Facility by way of refinance was introduced to tide over...
their unanticipated liquidity problem Seven more entities were accredited as Primary Dealers (PDs) were in the Government Securities market. With the addition of these seven PDs, the total number of PDs increased to 13. Satellite Dealers (SDs) were permitted to issue Commercial Paper since June 23, 1998. Foreign Institutional Investors (FIIs) were permitted to invest in Government dated securities and Treasury bills within their overall approved debt ceilings. The Government issued a long-term paper with a maturity of 20 years on November 24, 1998 after a gap of seven years. RBI has permitted all non-bank entities, maintaining SGL and current account with the RBI, Mumbai, to undertake repos and reverse repos in notified government securities.

5.7.1 Liquidity Adjustment Facility

Policy initiatives and contemporaneous market development have led to the evolution of a full-fledged LAF in which liquidity is injected (absorbed) through reverse repo (repo) auctions with a view to imparting stability to short-term money market rates and enable orderly market play. The Interim Liquidity Adjustment Facility (ILAF) introduced in April 1999, as a transitional mechanism for providing banks an access to liquidity at fixed interest rates, was replaced by the LAF, effective June 5, 2000. The fixed rate repo gave way to variable rate repo auctions. The Additional Collateralsed Lending Facility (ACLF) for banks and Level II liquidity support to PDs were replaced by variable rate reverse repo auctions with same day settlement. Export credit refinance facility remained unchanged.

Given the satisfactory implementation of the first stage of the LAF during 2000-01, the second stage of the LAF was instituted in the Policy Statement of April 2001. The standing liquidity facilities in the form of the Collateralsed Lending Facility (CLF), export credit refinance to banks and collateralised liquidity support to PDs were divided into two parts in approximately 2:1 ratio, viz., a normal facility provided at the Bank Rate and a backstop facility at a variable daily rate linked to the cut-off rates in regular LAF auctions at 1 per cent above the reverse repo rate. If reverse repo auctions do not take place on a particular day under the LAF, the back-stop facility would be provided at 2-3 percentage points above the repo rate. In the absence of both repo and reverse repo auctions or in case no bids were received/accepted under either repos or reverse repos, the rate for the back-stop facility would be 1-3 percentage points above the National Stock Exchange's Mumbai Inter-bank Offer Rate (NSE-MIBOR). While the major part of the standing facilities continue to be available at the Bank Rate, a part of such facilities is now priced at market-related rates.
Several measures were also undertaken in the April 2001 monetary and credit policy statement with a view to improving the operating procedures of the LAF. The minimum bid size was reduced from Rs 10 crore to Rs 5 crore to facilitate greater participation by small operators. The timing for receipt of bids was advanced by 30 minutes to 10:30 am so that the announcement of results could be made by 12:00 noon. The backstop facility was made available till the close of banking hours. Further, the following options are now available to the Reserve Bank with a view to providing quick interest rate signals in the face of unforeseen exigencies: (i) a switchover to fixed rate repos on overnight basis at interest rates announced as part of auction announcement on the previous evening or before 10:00 am on the day of auction, (ii) Introduction of longer-term repos up to a 14-day period as and when required, in addition to overnight repos, and (iii) introduction of multiple price auctions from May 2001. Apart from releasing to the public the weighted average cut-off yield in case of multiple price auctions, the Reserve Bank publishes data on the scheduled commercial banks' aggregate cash balances maintained with it on a cumulative basis during the reporting fortnight with a lag of two days with a view to stabilizing market expectations and arresting volatility in call rates.

The Liquidity Adjustment Facility (LAF), has emerged as an effective and flexible instrument for influencing liquidity on a day-to-day basis. On the whole, this package of measures had a positive impact. The LAF has rendered the necessary flexibility to RBI to operate on liquidity and to some extent to signal interest rates in the short-term money market. The LAF operations, combined with strategic OMO, have evolved into the principal operating procedure of monetary policy of the Reserve Bank in the short-run. The effectiveness of LAF would be further strengthened as the system moves towards a pure inter-bank call/notice money market coupled with the growth of a deep and liquid repo/reverse repo market for non-bank participants. Effective May 2001, non-banks are permitted to lend up to 85 per cent of their average daily lending during 2000-01. This has not caused any strain on the market with average daily aggregate lending in call money market improving to Rs 19,600 crore during May-September 2001 compared to Rs 10,900 crore during the corresponding period of the previous year. Volatility in call money rates has also come down significantly. It is encouraging to note that the volume of repo operations by non-bank participants has been increasing in the recent period.
5.8 Selective Credit Controls

In addition to the general or quantitative methods of monetary regulation, the RBI uses qualitative techniques also known as selective credit control (SCCs) and moral suasion. SCCs are used by the Central Bank, for regulating the distribution or direction of bank credit to particular sectors and specific purposes. SCCs have special relevance in India, where supply of credit is scarce and credit is likely to flow to less essential activities. SCCs are regarded as useful supplements to general credit regulation. Under the Banking Regulation Act 1949, Section 21 empowers RBI to issue directives to the banking companies regarding their advance portfolio.

5.9. Lending Norms

In view of securities scam in 1991, restrictions were imposed on banks not to increase in the credit outstanding to loans for purchases of consumer durable. Other non-priority sector personal loans, loans to individuals against shares and debentures/bonds and Real estate loans.

In the context of the easing of the pressures on banks' resources and to facilitate recovery of industrial output, these restrictions were withdrawn the next year. Banks were permitted to provide term loans to entrepreneurs and private sector undertakings for technically feasible, financially viable and bankable projects involving creation of infrastructure facilities. Banks were given freedom to decide on their own the levels of holding of individual items of inventory and of receivables while assessing credit requirements of borrowers. The threshold limit for obligatory consortium lending was raised from Rs 5 crore to Rs 50 crore. However, sanction of bridge loan against Euro issue was subject to prior approval of the Reserve Bank.

Banks were advised to extend cash credit facilities to farmers with irrigation facilities and also to other farmers undertaking off farm and allied activities. The ceiling of Rs 50 crores for each bank for grant of term loans for any project was abolished and the overall limit of Rs 200 crores for the banking system as a whole was raised to Rs 500 crores for a single project. A 'Loan System' for Delivery of Bank Credit for working capital purpose was introduced effective April 17, 1995 to bring about greater discipline in credit utilisation and better control over credit flow. Banks were allowed to sanction bridge loans against the commitment of financial institutions and/or other banks where the lending institutions was faced with temporary liquidity constraint.

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Multiple prescriptions linked to loans against FCNR (B) deposits and loans out of FCNR (B) pools and loans against foreign currency were dispensed with and banks were given freedom in relation to uses and rates as available in the case of advances in general. As a measure of imparting an element of discipline in the utilisation of bank credit, the percentage of 'loan component' in the working capital credit limit had been enhanced in stages. Banks were advised to make necessary in-house arrangement for gathering and collection of credit and other information in one place for transmitting it to the Credit Information Bureau, as and when it is established. To provide further operation autonomy to the banks were given freedom to decide on charging penal interest to borrowers. Banks were advised to formulate transparent policy for charging penal interest rates, with the approval of their Boards.

5 9.1 Priority Sector Lending

An integral element of the conduct of monetary policy has been the direction of bank credit to certain sectors such as agriculture, exports, SSIs, infrastructure, housing, micro-credit institutions and SHGs. Policy stipulations have been reinforced through incentives to ensure the adequate allocation of credit by banks in favour of these sectors. Besides improving the volume and terms of credit, policy efforts have been directed towards enhancing and simplifying access to credit by simplifying documentation procedures and decentralising the sanctioning to the branch level. In terms of the statutory responsibility under Section 54 of the RBI Act, 1934, the Reserve Bank has endeavoured to (i) Institutionalise rural credit, (ii) enlarge its coverage, and (iii) ensure provision of timely and adequate credit to as large a segment of the rural population as possible so as to achieve anticipated growth rates in agricultural production and employment. Banks are required to meet targets and sub-targets set under priority sector lending. The credit extended to the priority sectors was meager till the nationalisation of banks in India in the year 1969. With Banks' nationalization, more emphasis is being given for financing to the priority sectors.

Foreign banks were advised to increase the priority sector advances from 15 per cent of their net credit to 32 per cent. Within the enhanced target of 32 per cent, two sub-targets of 10 per cent each in respect of advances to small-scale industries and export sector were fixed and it was enhanced to 12 per cent for export credit. Banks were required to contribute to the Rural Infrastructure Development Fund (RIDF) newly set up at NABARD, an amount equivalent to shortfall in the priority sector target for agricultural lending, subject to a maximum of 15 per cent of the Bank's net credit. Such contributions also
treated as priority sector lending. Banks, falling short of the priority sector target, were required to provide Rs 1,000 crore on a consortium basis to the Khadi and Village Industries Commission, on top of lending to the Handloom Co-operatives, for the purpose of financing viable Khadi Village Industrial units was reckoned as priority sector lending. Entire amount of refinance granted by sponsor banks to the RRBs was also reckoned as priority sector lending.

The coverage of Priority Sector credit was widened considerably. The scope of priority sector lending was rationalized to include bank credit to NBFCs for the purpose of on lending to Small Road and Water Transport Operators and finance for distribution of inputs for activities allied to agriculture up to Rs 15 lakh (raised from Rs 5 lakh) was treated as priority sector lending. Loans to software industry having credit limit up to Rs 1 crore from the banking system and banks investments in venture capital were also made eligible for inclusion in priority sector lending. The ceiling of bank advances under priority sector to retail traders was increased from Rs 2 Lakhs to Rs 5 Lakhs. Advances to the food and agro-based processing sector were included within the definition of priority sector lending by banks to NBFCs or other financial institutions for on lending to the tiny sector was classified under priority sector.

A special cell was set up in the Reserve Bank to liaise with NABARD and micro credit institutions for augmenting the flow of credit to priority sector. Micro credit extended by banks to individual borrowers either directly or through any intermediary was reckoned as part of their priority sector lending.

Redefined SSIs with investments in plants and machinery worth up to Rs 60 Lakhs (Rs 75 Lakhs in the case of ancillary units and export-oriented units) in order to give a fillip to small units with low investment the limit for investment in plant and machinery for considering a unit as SSI was brought down to Rs 1 crore from the earlier Rs 3 crore. Investment in plant and machinery in respect of industry-related Small-Scale Service/Business Enterprises (SSSBE) was increased to Rs 10 lakh from Rs 5 lakh. Under the Credit-Linked Capital Subsidy Scheme for Technology Upgradation of SSI, introduced in October 2000, a 12 per cent back-ended capital subsidy was made admissible on loans granted to the SSIs by scheduled commercial banks/designated State Financial Corporations (SFCs) for technology upgradation in certain selected sectors.

Public sector banks were asked to operationalise at least one specialised SSI branch in every district and centres having cluster of SSI units. Banks were advised to complete the process of operationalising SSI branches by December 31, 2000. As at end-March 2001, there were 390 specialised SSI bank branches.
operating in the country. A Credit Guarantee Fund Scheme for Small Scale Industries was introduced for the purpose of providing guarantees to a substantial extent in respect of credit facilities up to Rs 25 lakh to borrowers in the SSI sector, without any collateral security and/or third party guarantees. To help overcome the hurdles being faced by women in accessing bank credit and credit plus services, the Central Government has drawn up a 14-point Action Plan for public sector banks to strengthen credit delivery to women, particularly in the tiny and SSI sectors.

Keeping in view the importance of agriculture in the economy, the domestic commercial banks have been advised to lend a minimum of 18 per cent of net bank credit to agriculture, of which maximum of 4.5 per cent of net bank credit (NBC) earmarked for indirect lending to agriculture. A novel scheme of Kisan Credit Cards (KCCs) was formulated, which enabled farmers to readily purchase agricultural inputs and draw cash for their production needs. All Banks introduced the Scheme. All eligible farmers are targeted to be brought under the scheme. Banks have also been advised to provide a personal insurance package to the KCC holders. A new scheme entitled the Swarnajayanti Gram Swarogyar Yojana launched.

<table>
<thead>
<tr>
<th>Year ended March</th>
<th>Public Sector Banks</th>
<th>Private Sector Banks</th>
<th>Foreign Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net Bank Credit</td>
<td>Amount</td>
<td>% to NBC</td>
</tr>
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<td>1991*</td>
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<td>42276</td>
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</tr>
<tr>
<td>1992*</td>
<td>112160</td>
<td>44581</td>
<td>39.75</td>
</tr>
<tr>
<td>1993*</td>
<td>132782</td>
<td>48653</td>
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</tr>
<tr>
<td>1994</td>
<td>140914</td>
<td>53107</td>
<td>37.75</td>
</tr>
<tr>
<td>1995</td>
<td>159036</td>
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<td>1996</td>
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<td>1997</td>
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<tr>
<td>1999</td>
<td>246203</td>
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</tr>
<tr>
<td>2000</td>
<td>292943</td>
<td>127807</td>
<td>43.60</td>
</tr>
<tr>
<td>2001</td>
<td>340888</td>
<td>146546</td>
<td>43.00</td>
</tr>
</tbody>
</table>

*For the year ended June

Sources: Handbook of statistics on India Economy Reserve Bank of India.
Collateral requirements for the tiny sector for loans up to Rs 5 lakh were dispensed with. Similarly, to promote the credit flow to small borrowers, the composite loan limit for providing working capital and term loans through a single window were increased from Rs 10 lakh to Rs 25 lakh. Banks were advised to streamline micro-credit and enhance the outreach of micro-credit providers. Recognising micro-credit interventions as an effective tool for poverty alleviation, a Micro Finance Development Fund was set up in the NABARD to, inter alia, promote research, action research, management information systems and dissemination of best practices in micro-finance.

Several measures have been taken to ensure timely and adequate flow of credit to the export sector. Besides improving access to credit through on-line facilities, longer maturity lines of credit and term loans, fast track clearance of export documents was instituted at specialized bank branches. The Reserve Bank directed the commercial banks to set up State Level Committee for Export Promotion. Sub-suppliers of export orders were provided credit within the overall permissible Pre-shipment export credit wherever the export order holder opened letters of credit in the year 1994-95. An interest rate surcharge of 15 per cent was imposed in 1995 on the outstanding under the import credit sub limit of the cash credit, latter was enhanced to 30 per cent.

Monetary policy during the reforms period emphasized much on improvement in credit delivery mechanism particularly for agricultural and Small Scale Sectors Concessionality in lending rates was practically abolished. The flow of resources to priority sector has been widened to include borrowers in the higher range and corporate entities. Lending by banks to NBFCs for specific purposes were included in the priority sectors. By the end of March 31, 2001 43.77 lakh KCCs,
involving a sum of Rs 10,626 crore, have been issued by public sector banks and
2,63,825 Self Help Groups were credit linked, with the cumulative bank loans
extended to the groups amounting to Rs 480.88 Crore. Some initiatives have
also been taken to improve credit flow to the Small Scale Sector. By the end of
March 2001, 390 specialized SSI Bank branches were operationalised. To
increase the outreach of banks to the tiny sector lending by banks to NBFCs for
lending to the tiny sectors was included in the priority sector lending.

5.10 Money Market/ Institutional Developments

The beginning of Economic Reforms in India preludes securities scam in the year
1992. It has made the policy makers to think of introducing structural changes in
money markets. Several modifications were made for strengthening the money
markets, during the past 10 years. The fund based working capital limit of
company issuing Commercial Papers was reduced to Rs 4 Crores and the ceiling
of aggregate amount of Commercial Papers was raised to 75 per cent of
company's fund based working capital and the minimum maturity period was
reduced to 3 months. To impact a measure of independence to Commercial Paper
as a money market instrument, the facility of the stand-by arrangement was
abolished.

The minimum lock-in period for CDs and for units of MMMFs were reduced from
30 days to 15 days. The limits of Certificate Deposits were raised from 5 per cent
to 10 per cent of the fortnightly average outstanding aggregate deposits. Bank-
wise limits on issue of CDs were withdrawn. To provide flexibility to financial
institutions, in October 1993, select FIs were permitted to borrow from the term
money market for periods in the maturity range of 3 months to 6 months within
the stipulated limits for each institution. The stipulation relating to the minimum
rate of interest of 14 per cent on Inter Bank Participation with risk-sharing was
withdrawn and the issuing banks and the participating banks were free to
determine the rate of interest on IBPs with risk-sharing.

The private sector mutual funds approved by SEBI, were allowed to operate only
as lenders in the call/notice money/bill rediscounting market. Private sector was
allowed to set up Monetary Market Fund (MMMFs). The size of MMMFs and limits
on investments by MMMFs were deregulated. Effective January 1, 1996, banks
are free to decide their own foreign exchange overnight open position limits
subject to the approval by the Reserve Bank as against the earlier uniform limit of
Rs 15 crore for each bank. Effective April 3, 1996, the scheme of MMMFs was
made more flexible by bringing it on par with all other mutual funds by allowing
investment by corporates and others. The Scheme of MMMFs was made more
attractive to investors, by reducing the minimum lock-in period from 46 days to 30 days.

Effective from October 22, 1997 banks were allowed to freely buy and sell government securities on an outright basis at prevailing market prices, without any restriction on the period between sale and purchase subject to the stipulation that they should not undertake ready forward transactions in Government securities with non-bank clients. Restriction of minimum period of 3 days for inter-bank Repo transactions for Repos and Reverse Repos Market were withdrawn.

MMMFs were permitted to offer 'cheque writing' facility to their investors. A special funds facility was introduced on October 03, 2000 for Banks and primary dealers to provide intra-day funds to facilitate settlement of securities transactions in case of GRIDLOCK. MMMFs were allowed to set up a separate entity in the form of 'Trust' only and not in the form of a Money Market Deposit Account (MMDA). With effect from March 7, 2000 MMMFs were brought within the purview of SEBI regulations. The Securities and Exchange Board of India (SEBI) tightened entry norms relating to primary issues in view of stock market debacle. Debenture Trustees Regulations were modified to ensure an arm's length relationship between the issuer and the trustee, besides laying down of responsibilities for different intermediaries. Banks' exposure to the capital market by way of investments in shares, convertible debentures and units of equity oriented mutual funds, within the overall exposure to sensitive sectors, were restricted to 5 per cent of the outstanding domestic credit as on March 31 of the previous year.

The SEBI undertook several measures to improve the functioning of the stock market. Besides granting approval for trading in futures contracts based on Bombay Stock Exchange Sensitive Index (BSE Sensex) and the Standard and Poor (S&P) CNX Nifty, the SEBI permitted introduction of new products in the form of Continuous Net Settlement (CNS), carry forward in the rolling settlement segment, Automated Lending and Borrowing Mechanism (ALBM), and Automated Lending and Borrowing Mechanism under Rolling Settlement (ALBRS). Disclosure norms relating to material information and market surveillance system covering such aspects as maintenance of records, code of ethics for elected directors, empowerment of stock exchanges, stock watch system, etc were tightened. During the first week of March 2001, the equity markets experienced some 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 some commercial banks also. The SEBI undertook several measures to...
stabilize conditions in the stock exchanges including banning of naked short sales, imposition of additional deposit margins on net outstanding sales of all shares and restraining broker-directors from acting as directors on the Governing Board of the BSE. Subsequently, in May 2001, SEBI announced significant changes in the capital market in keeping with the international practices and operations in the securities markets.

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. Investment norms relating to Mutual Funds (MFs) were liberalised. Disclosure and transparency standards relating to Asset Management Companies (AMCs) were also tightened. Despite all these changes, still there is a lot to be improved in the money market operations, as these changes could not arrest the irregularities in the system.

The decade of economic reforms started with securities scam and ended with securities scam and UTI Scam. Indian financial markets became very sensitive to any changes that took place at the national or regional or international level, either political or financial or even weather. The fundamentals of the securities market should be strong enough to withstand any unwarranted changes that took place and which are nothing to do with the securities.

5.11 Monetary Targeting and Moneyisation of Fiscal Deficit

The setting of monetary policy during the early 1980s more often than not, used to be in the backdrop of an 'uncomfortably high' overall growth of liquidity (M3). Following the recommendations of the Chakravarthy Committee, monetary targeting approach was pursued in a formal sense since about the middle of the 1980s.

Reasonable stability in the demand function for money with respect to a select set of variables, administered interest rate structure and the absence of significant innovations in the financial sector and lack of large cross border capital flows facilitated the adoption of broad money (M3) as an intermediate target of monetary policy. The rationale for monetary targeting was espoused by C Rangan, former governor of the Reserve Bank as follows.
Monetary aggregates as intermediate targets are appropriate for two reasons. First, since the money demand function for India has remained reasonably stable, it continues to be helpful in predicting price movements with reasonable accuracy at least over a period of time, say 3 to 5 years. Secondly, the money stock target is relatively well understood by the public at large. With the money supply target, the stance of monetary policy is unambiguously defined and gives a clear signal to market participants.66

However, Rangarajan cautions that India’s is a ‘far cry’ from mindless monetarism and that the monetary authority has to continuously monitor a range of aggregates and that the RBI is not bound by a fixed rate of growth of money supply. Monetary targeting in the Indian context required much more flexibility than that in some of the advanced countries which had a constant money supply growth rate and gave little discretion to the central bank. As the Chakravarthy Committee argued, “In a developing country like India, where significant structural changes are sought to be achieved to facilitate the growth process, the mechanical application of a constant money supply growth rule can have no place.”

The RBI recognized that ensuring price stability through monetary targeting would be effective only if simultaneously, fiscal deficit, particularly, expansion of net RBI credit to the central government, which has accounted for the bulk of the creation of the reserve money over the years, is contained within a reasonable limit. It was, therefore, clear from the outset that inflation in India was perceived not simply as a monetary phenomenon, but more importantly, as a fiscal one. In a monetary targeting framework, the focus of policy has been on the broad money aggregate and variations in the wholesale price index is taken as the headline inflation. The setting of monetary targets and the actual achievements are summarized in Table 7.3. Although monetary targeting was adopted in mid-1980s, it was not before 1991-92 that monetary targeting achieved its pride of place in formulation of monetary policy. In India, monetary targeting exercise produced a mixed result. It is only on 4 occasions that the monetary targets could actually be achieved. The growth rate of broad money increased from 15.1

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per cent in 1990-91 to 16.7 per cent in 2000-2001. There was perceptible improvement in the inflation rate, which fell from 12.1 in 1990-91 to 4.9 per cent in 2000-2001. Initially, monetary targets were framed in terms of setting indicative ceilings on the basis of observe growth in the previous years. In the 1990s, the monetary targets were set either as point targets or in a narrow range implying a higher probability of missing such targets. The pressures on monetary expansion emanated from monetisation of fiscal deficit and latter on from capital inflows. The practice of automatic monetisation of the budgetary deficit was done away with effective April 1997. The monetised deficit as percentage to the gross fiscal deficit reached an alarming rate of 39.76 per cent by 1990-91. It was restricted at the minimum level in the later years, except during the year 1995-96. The monetised deficit for the year ended March 2001 is only 5.99 per cent. In fact, it was -5.34 per cent for the year ended March 1999-2000. The RBI’s finance to the Central Government stood at 30.65 per cent of internal liabilities and 27.58 per cent of the total liabilities. The same was brought down to 13.26 per cent and 12.59 per cent respectively for the year ended March 2001.

### Table 5.3: Monetisation of the Central Government Deficit by RBI

<table>
<thead>
<tr>
<th>Year</th>
<th>GFD</th>
<th>MD</th>
<th>MD as % of GFD</th>
<th>GFD as % of GDP</th>
<th>MD as % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>1985-86</td>
<td>21857</td>
<td>6190</td>
<td>25.32</td>
<td>8.33</td>
<td>2.36</td>
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<td>1986-87</td>
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<td>7091</td>
<td>26.92</td>
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<tr>
<td>1987-88</td>
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<td>6559</td>
<td>24.16</td>
<td>8.12</td>
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<tr>
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<td>30923</td>
<td>6503</td>
<td>21.03</td>
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<td>13813</td>
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<td>17745</td>
<td>39.76</td>
<td>8.33</td>
<td>2.75</td>
</tr>
<tr>
<td>1991-92</td>
<td>36325</td>
<td>5506</td>
<td>15.16</td>
<td>5.86</td>
<td>0.89</td>
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<tr>
<td>1992-93</td>
<td>40173</td>
<td>4257</td>
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<td>5.66</td>
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<td>1993-94</td>
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<td>3.69</td>
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<td>1995-96</td>
<td>60243</td>
<td>19855</td>
<td>32.96</td>
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<td>1.77</td>
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<tr>
<td>1996-97</td>
<td>58733</td>
<td>1934</td>
<td>2.90</td>
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<td>1998-99</td>
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<td>11800</td>
<td>10.41</td>
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<td>1999-2000</td>
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<td>2000-2001</td>
<td>111972</td>
<td>6705</td>
<td>5.99</td>
<td>5.86</td>
<td>0.35</td>
</tr>
</tbody>
</table>

Source: Handbook of Statistics on Indian Economy, Reserve Bank of India

GFD: Gross Fiscal Deficit

MD: Monetised Deficit - Increase in the net RBI Credit to the Central Government which is the sum of net increase in the holdings of 91-day Treasury bills of the RBI and its contribution to the market borrowings of the Central Government.
If success were to be judged by the number of years in which the monetary targets were achieved, there were more failures. In terms of the overall objectives of monetary policy, the inflation rate came down. This achievement however, could not be entirely attributed to monetary targeting exercise. The international experiences suggest that many a countries in the world that moved away from monetary targeting approach prompted by market oriented financial sector reforms and international capital flows. And the experience in India is no different from that of the world. The expansion of money supply emanating from monetisation of government deficit and in more recent period from capital flows rendered the control of monetary aggregates more difficult. The government should have full control at least on one of the two factors that greatly influence the inflation. In the present context of liberalization of financial sector, interest rates were completely deregulated. Hence, the government should have full control over money supply and hence should continue to pursue monetary targeting approach and it should always limit the money supply to the targeted level.

5.12. Internal Debt Management Policies

During the reform period, an active debt management policy was pursued to prudently influence the composition, maturity structure and yield of Government securities which by reducing monetised deficit and effectively controlling money
supply, enhanced the efficacy of monetary policy. Accordingly many reform measures were introduced such as auctions of 364 day Treasury Bills and 91 day Treasury Bills, Government dated securities of varied maturities and Repurchase Agreement (Repo) auction. With the introduction of auction system, the interest rates on Government borrowing instruments were closely market related. The cut-off yields of 91-day Treasury Bills were significantly higher than the earlier fixed discount rate of 4.6 per cent per annum. The cut-off yields of 364-day Treasury Bills ranged between 10.96 per cent and 11.42 per cent. The coupon rate on 15-year State Government securities turned out to be 13 per cent.

In order to develop an efficient secondary market for Government securities, the Reserve Bank decided to set up 'Securities Trading Corporation of India (STCI). The maximum maturity period of State Government securities was reduced from 15 years to 10 years. The coupon rate on 10-year State Government securities was hiked to 13.5 per cent in order to make these securities attractive. A new instrument called 'Zero Coupon Bond' of five year maturity was introduced on auction basis.

<table>
<thead>
<tr>
<th>Table 5.5</th>
<th>Monetary Targeting - Target versus Actual</th>
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<tr>
<td>Objective/Target</td>
<td>Actual (per cent)</td>
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<td>M3</td>
<td>GDP</td>
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<td>1990-91</td>
<td>154</td>
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<tr>
<td>1991-92</td>
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<td>1992-93</td>
<td>11 (Max)</td>
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<td>1993-94</td>
<td>12</td>
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<tr>
<td>1994-95</td>
<td>14-15</td>
</tr>
<tr>
<td>1995-96</td>
<td>15.5 (Max)</td>
</tr>
<tr>
<td>1996-97</td>
<td>15.5-16</td>
</tr>
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<td>1997-98</td>
<td>15-15.5</td>
</tr>
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<td>1998-99</td>
<td>15</td>
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<tr>
<td>1999-2000</td>
<td>14.6</td>
</tr>
<tr>
<td>2000-2001</td>
<td>16.7</td>
</tr>
</tbody>
</table>

Source RBI Annual Reports

A historic agreement was signed on September 9, 1994 between the Reserve Bank and the GOI on the net issue of adhoc Treasury Bills. As per the agreement, the net issue of adhoc treasury bills for the year were decided in advance and the net issue of adhoc Treasury Bills exceeded the limit for more than ten consecutive working days at any time during the financial year, the Reserve Bank was to automatically reduce only the excess beyond the prescribed level of adhoc Treasury Bills by auctioning Treasury Bills or selling fresh GOI dated securities in the market. Open market borrowings were made available.
only to State Governments and not to State-guaranteed institutions. State Governments and non-Government provident funds were allowed to participate in 91-day Treasury Bills auctions on a non-competitive basis with allotment at weighted average price. Repo facility with RBI in Government dated securities was extended to STCI and DFHI to provide liquidity support to their operations. To strengthen Government securities market, guidelines and procedure for enlistment of Primary Dealers in Government securities market were issued on March 29, 1995. A scheme for auction sale of Central Government securities held in the Reserve Bank's portfolio was introduced. The role of investment management on behalf of Provident Funds was de-linked from the Reserve Bank. Guidelines and procedure for enlistment of Primary Dealers in the Government securities market were issued to develop the institutional set up for a secondary market in Government securities.

An auction system for conversion of Treasury Bills into dated GOI securities was introduced. A system of Delivery Versus Payment (DVP) in Government securities was introduced in Mumbai to synchronize the transfer of securities with the payment thereby reducing the settlement risk in securities transaction and also preventing diversion of funds in the case of transactions through Subsidiary General Ledger (SGL). New instrument of Floating Rate Bonds was introduced. The DVP system was extended to auction Treasury Bills. With effect from March 1, 1996, DFHI and STCI started functioning as Primary Dealer (PD) in Government Securities Market out of the six 'in principle' approvals granted in November 1995.

With a view to encouraging schemes of mutual funds dedicated to Government securities and creating a wider investor base for Government securities, a provision for liquidity support to mutual funds dedicated exclusively to investments in Government securities either by way of outright purchases or reverse repos in Central Government securities up to 20 per cent of outstanding investment. In addition to DFHI and STCI, four more PDs viz SBI Gilt Ltd. PNB Gilt Ltd. Gilt Securities Trading Corporation Ltd. and ICICI Securities Co Ltd. became operational from June 1, 1996. As part of measures to develop secondary market in Government securities and making the market deep and broad based, banks were permitted for retailing of Government securities with non-bank clients. With a view to providing incentives to PDs to develop the secondary market in Government securities, commission was paid on their primary purchases of Central Government securities. PDs were allowed to access commercial paper market. The Reserve Bank has announced on December 31,
1996, the guidelines for setting up of Satellite Dealers with the aim of strengthening the infrastructure in Government securities market.

The facility of routing transactions through the Discount and Finance House of India (DFHI) was extended to all primary dealers. The minimum size of a transaction was reduced from RS 20 crore to RS 10 crore and further to RS 5 crore. The practice of reverse repos with Primary Dealers (PDs) in specified securities was dispensed with, and instead, liquidity support against the security of holdings in Subsidiary General Ledger (SGL) accounts was provided. The minimum size of transaction for primary dealers to be routed through the DFHI was reduced to 3 crore.

In order to provide flexibility and depth to the secondary market, the restriction on transferability period for CDs issued by both banks and financial institutions was withdrawn. In order to improve the functional efficiency of the market, the rating for term deposits was accepted by select all India Financial Institutions which were governed by RBI guidelines has been made mandatory. The minimum maturity of CDs reduced from 3 months to 15 days. Restriction on transferability period for CDs was withdrawn on October 10, 2000. Greater flexibility was given to corporate to raise resources through Commercial Papers.

The Liquidity Adjustment Facility (LAF) has emerged as an effective mechanism for absorbing and/or injecting liquidity on a day-to-day basis in a flexible manner as well as transmitting short-term interest rate signals and, in the process, providing an informal corridor for the call money market. Given the satisfactory experience with the LAF, the endeavour of monetary policy has been to make it more efficient, by removing some of the existing institutional, procedural and technological constraints. The Reserve Bank initiated a package of measures covering the LAF, call money market and standing liquidity facilities with a view to enhancing the smooth flow of funds across instruments and participants, resulting in further integration of the money market, thereby rendering it a more effective channel of monetary policy.

Changes in operating procedures were implemented to improve the efficiency of LAF and increase operational flexibility of the scheme to enable small level operators to participate. With a view to stabilising market expectations and arresting volatility in call rates, the Reserve Bank reserved the discretion to switchover to fixed rate repos on overnight basis and to introduce longer-term repos up to a 14-day period as and when required. The multiple price auction introduced on an experimental basis in May 2001 has been extended.
maintained with the Reserve Bank and the weighted average cut-off yield in case of the multiple price auction is being released to the public.

5.13 Capital Adequacy Norms

Another major element of financial sector reform has been the introduction of prudential norms and regulations aimed at ensuring the safety and soundness of the financial system, imparting greater transparency and accountability in operations and restoring the credibility of, and confidence in the Indian financial system. Prudential norms serve two primary purposes, first they bring out the true position of a bank's loan portfolio and secondly they help to arrest its deterioration. In the absence of an effective prudential framework, the reform process can run into difficulties. The introduction of prudential regulations as part of the reform process is, therefore, a must. Prudential regulations also include norms relating to capital adequacy. A capital risk weighted asset system has been introduced more or less in conformity with international standards. Indian banks, which have branches abroad, were required to achieve the norm of 8 per cent as on 13 March 1995. Foreign banks operating in India achieved this norm as on 31 March 1993. Other banks were required to achieve the 8 per cent norm by March 1996.

As per the recommendations of the Narasimham Committee, Report-II set out the agenda for further reforms which include further refinements of prudential norms and enhancement of capital base of banks. The committee recommended enhancement of capital adequacy ratio from 8 per cent to 10 per cent by 2002. Revised Capital Adequacy Norms were put in use. The revised norms provide additional charge on capital for various kinds of risks including credit risk, market risk, operation risk, interest rate risk etc.


The Committee on Financial Sector Reforms recommended introduction of prudential norms in the financial sector. Accordingly a prudential system of
income recognition, classification of assets and provisioning for bad debts was put in place. Prudential reforms introduced in India relate to income recognition, asset classification, provisioning of bad and doubtful debts and capital adequacy. A proper definition of income is essential in order to ensure that banks take into account income, which is actually realized. Banks have been given a clear definition of what constitutes a "non-performing" asset and instructions have been issued that no interest should be charged and taken to income account on any "non-performing" asset. The definition of a "non-performing" asset also is being tightened over time. Banks are now required to make provisions on advances depending on the classification of assets into the four broad groups (1) standard asset (2) substandard asset (3) doubtful asset and (4) loss asset. The provisioning requirement ranges from 10 per cent to 100 percent depending on the category of asset. Banks have now fully met with the new provisioning requirements.

In order to reflect actual financial health of banks, the Reserve Bank instructed the commercial banks to treat an amount in respect of term loans, overdrafts and cash discounted and other accounts as "past due" when not paid on the due date (since revised to 30 days beyond the due date). A non-performing asset is defined as a credit facility in respect of which interest has remained as 'past due' for a period of four quarters ending March 31, 1993, three quarters ending March 31, 1994 and two quarters ending March 31, 1995 and onwards. Banks were instructed not to charge and take to income account interest on all Non-Performing Assets (NPAs) and make stipulated full provision against NPAS identified.

The ratio of 'permanent' and 'current' investment in approved securities was enhanced to be 60:40. Banks were advised that interest accrued and credited to income account during the previous year end in respect of accounts identified as NPAs for the first time during the year ended March should be reversed or provided for as on that date. As a part of tightening the prudential norms, banks were advised to make a general provision on standard assets.

In certain situations where loans have been rescheduled, but borrowers have started servicing their loans on a regular basis after a short gap, the classification of loans as sub-standard for at least two years of satisfactory performance under the renegotiated or rescheduled terms was reduced to one year (or four quarters), if the interest and installment of loans are serviced regularly as per the terms of rescheduling. Bank's investments in all securities including securities outside SLR, were subjected to assign a risk weight of 2.5 per cent for market
risk. This was also made applicable to investments in securities carrying 100 per cent risk weight, since in line with best practices, some capital cushion should also be provided for market risk in addition to credit risk. Relaxation in-group exposure norms with regard to financing of infrastructure projects was made available in respect of four sectors, viz., roads, power, telecommunication and ports only. Further, banks which adopted a more prudent method of valuation of securities than the one suggested were required to continue with the practice followed by them. Banks were advised to assign risk weight of 100 per cent only on those State Government guaranteed securities issued by the defaulting entities and not on all the securities issued or guaranteed by that State Government. No provision need to be made for period of one year in respect of additional credit facilities granted to SSI units which are identified as sick where rehabilitation packages/nursing program have been drawn by the banks themselves or under consortium arrangements. Banks were advised to make general provision of 0.25 per cent on Standard Assets on global portfolio basis and not on domestic advances alone. The provisions towards standard assets are to be shown separately as 'contingent provisions against standard assets' and would not be eligible for inclusion in Tier II Capital. It was clarified to the banks that the extra provision needed on the event of a depreciation in the value of the investments should be debited to the Profit and Loss Account and if required, as equivalent amount may be transferred from the 'Investment Fluctuation Reserve Account' to the Profit and Loss Account as a 'below the line' item after determining the profit for the year. On prudential considerations and in line with international standard, banks were advised that they may voluntarily build-in the risk weighted components of their subsidiaries into their own balance sheet on notional basis, at par with the risk weights applicable to the bank's own assets. Banks were further advised to earmark additional capital in their books over a period of time so as to obviate the possibility of impairment to their net worth when switchover to unified balance sheet for the group as a whole is adopted after some time.

The concept of past due in the identification of non-performing assets was dispensed with and banks were advised to draw action plans for moving over to the international practice of classifying loans as non-performing when the interest and/or principal remains overdue for a period more than 90 days as against the existing 180 days from the year ending March 31, 2004. In July 2000, guidelines were issued for recovery of dues relating to non-performing assets (NPAs) of public sector banks with outstanding up to Rs 5 crore. The guidelines provide a
simple, non-discretionary and non-discriminatory mechanism for recovery of NPAs in all sectors through compromise settlements.

5.15 Recovery of Bank Loans

In fact, the major task before the Indian banks is to reduce the ratio of non-performing assets to total assets. Based upon the new income recognition assets to total assets for the banking industry, as a whole was around 23.2 percent. This meant that the effective rate of return on loans to the banks was only 76 percent of the nominal rate of return. So long as these sterile assets remain on the books, it is difficult for banks to raise their profitability to the desired level.

Banks have accordingly been designing strategies for restructuring bad debts, improving recovery and reducing non-performing assets. Individual banks have to take a range of initiatives taking into account the circumstances specific to them. In order to improve the climate for recovery, separate recovery tribunals were set up. As they became fully operative, banks are able to recover quickly funds, which are due to them.

In July 1995, RBI had issued broad guidelines to scheduled commercial banks for compromise or negotiated settlement of NPAs. In May 1999, in order to facilitate settlement of NPAs in the small sector, the Reserve Bank issued guidelines for the constitution of Settlement Advisory Committees (SACs) in public sector banks. Banks had, however, represented that much progress could not be made in the recovery of NPAs despite setting up of SACs. Accordingly, in July 2000, a simplified, non-discretionary and non-discriminatory guidelines were circulated to provide a one-time impetus to reduction of the stock of chronic NPAs which covered accounts up to Rs 5 crore in all sectors including the small scale sector, but excluded any cases of willful default, fraud or malfeasance. The settlement scheme laid out by these guidelines was operative till June 2001 and all applications received up to that date were processed by September 30, 2001.

Under this scheme, the public sector banks have recovered a total sum of Rs 2,192 crore in respect of 5,23,000 accounts as on July 30, 2001.

Powers of Chairman and Managing Director of public sector banks for waiver/write-off of loans were raised from Rs 10 lakh to Rs. 50 lakh. On October 177
21, 1999, RBI decided that in respect of agricultural advances and advances for other purposes granted by banks to PACS/FFSs under the on lending system, only that particular credit facility granted to a PACS/FFS which is in default for a period of two harvest seasons after it has become past due be classified as NPA and not all the credit facilities sanctioned. Keeping in view the importance of credit discipline for reduction in NPAs, banks were advised on 25th January 2000, to insist on a declaration from the account holder, at the time of opening of current account, to the effect that he is not enjoying any credit facility with any other bank or a declaration giving particulars of credit facilities enjoyed with other banks.

The most critical area in the improvement of profit is reduction in non-performing assets (NPAs). The NPAs of all public sector banks aggregated to Rs 39,258 crore in 1992-93 when new norms were set in. The level of NPAs has declined to 19.8 per cent as of 1994-95. It is interesting to note that in the case of 19 nationalised banks the aggregate reduction in NPAs during 1994-95 was Rs 6,682 crores. Gross NPAs of the public sector banks came down to 16 per cent by 31 March 1996 and further to 13 per cent by March 2001. The Net NPAs as per cent to Net Advances was brought down to 7 per cent by March 2001.

Some critics have even taken objection to the introduction of prudential norms. They regard such an introduction as either irrelevant or premature. It is indeed surprising that objections could be raised against the introduction of prudential norms. These norms are basically intended to improve the soundness of the working of institutions. In order to avoid a serious setback to the functioning of banks and other institutions, prudential norms have also been introduced in India in a phased manner. Progressively, the definition of non-performing assets has been tightened. The circumstances prevailing in the Indian financial sector have been taken into account in determining the phasing in of prudential norms. The prudential norms have served a useful role wherever they have been introduced. They have compelled institutions to pay greater attention to the quality of lending. It is true that as a consequence of the introduction of capital adequacy norms, the government had to allocate a fairly large amount of funds in order to enable the public sector banks to achieve the required capital adequacy standards. There has been no cash outflow because capital has been inducted in the form of bonds. Nevertheless, there is an outflow as far as the government is concerned in the form of interest payments and the phased amortization of bonds. The recapitalisation became necessary in order to strengthen the balance sheets of banks. Some critics have even sought to establish a relationship
between the write off of bad loans and recapitalisation. But it is necessary to recognize that these two are independent processes. The write off of bad loans is part of the program of cleaning the balance sheet of banks, while recapitalisation has been necessitated by the weakened financial position. Had the prudential norms been introduced earlier, much of the problems of non-performing assets confronted by banks today could have been avoided.

One argument against liberalization has been that it could lead banks to lend at higher and higher rates of interest and thereby accept higher levels of risk. Literature describes this phenomenon as a process of "adverse selection." In fact, the answer to adverse selection is the prescription of prudential norms, which will compel banks not to accept risk beyond a point. In any case, banks have never been pure profit maximizers. Profit maximization has always been subject to the constraint of acceptable level of risk. The prudential norms make this constraint explicit.

Various committees constituted for suggesting the financial sector reforms unanimously recommended constitution of Asset Reconstruction Corporation and changes in legal system for speedy recovery of non-performing advances, which the banks in India are suffering from. Unless some changes are brought out in the legal framework, where there is severe punishment for the willful defaulter, the recovery performance will not be improved. Handing over the financial fraud cases to investigating agencies will create panic among general public and more particularly among investors. The financial markets should be given free hand to play and the government and RBI should keep a vigil on the movements and transactions. If the cases are handed over to the investigating agencies, because of a small lapse in the system elsewhere, it would create panic among the public and it will take many years to regain confidence. It will take longer time to recover to complete the investigation and recovery of the dues. The remedial action should be quick disposal of the assets and realization of the loss. Whatever loss to the financing agency should be made good immediately, by seizing the properties of the defaulters. It has proved multiple times that even constitution of special courts for trailing these cases didn’t yield desired results. Innumerable number of cases, involving thousands of crores of rupees is held up in legal complications, making the financial institutions holding non-performing assets. The writing off debts discouraged repayment of loans and advances. Hence, the Government should make it clear that there will not be any more debt relief schemes.
5.16 Restructuring of Banks

Along with relaxing the external constraints and introducing the prudential norms, a major effort has been to strengthen the banking system in general and public sector banks in particular, through these appropriate institution building measures of (i) recapitalisation (ii) improving the quality of the loan portfolio (iii) instilling a greater element of competition and (iv) strengthening the supervisory process.

A major component of the restructuring program undertaken in public sector banks is to recapitalise them by injecting capital funds. An aggregate amount of Rs. 20446.12 Crore were provided by Government towards recapitalisation of banks. Since the bonds in which the additional capital is invested carry a rate of interest of 10 per cent, banks get the benefit of additional income, besides the strengthening of their capital base. Government allowed four PSBs to reduce their capital by writing off accumulated losses equivalent to Rs. 6037.18 crore. Four banks raised subordinated debt for inclusion in their Tier II capital.

The State Bank of India Act 1955 was amended by an Ordinance in October 1993 to enhance the scope of the provision for partial private shareholding. SBI was the first public sector bank to tap the capital market with an equity cum bond issue of Rs. 3212.18 crores in December 1993. New Bank of India was merged with the Punjab National Bank Banking Companies (Acquisition and Transfer of Undertakings) Acts 1970/1980 were amended permitting the banks to raise capital up to 49 per cent from the public. Oriental Bank of Commerce was the first nationalised bank to access the capital market with an equity issue of Rs. 387.24 crores. The GOI promulgated an Ordinance in January 1995 to amend the Banking Companies (Acquisition and Transfer of Undertakings) Acts 1970/1980 for enabling the banks to reduce their paid-up capital. Dena Bank entered the capital market to raise Rs. 180 crores in October 1996 while Bank of Baroda entered the capital market to raise Rs. 850 crores in December 1996. Three PSBs viz., Corporation Bank, State Bank of Bikaner and Jaipur and State Bank of Travancore accessed the capital market to raise their capital. As at the end of March 1998, PSBs raised capital worth Rs. 6015 crore, including proceeds from the GDR issue of SBI aggregating Rs. 1270 Crores raised during 1996-97.

The Kashinath Seth Bank Ltd. was amalgamated with the State Bank of India on January 1, 1996. Punjab Co-operative Bank Ltd. and Bari Doab Bank Ltd., was amalgamated with Oriental Bank of Commerce with effect from April 8, 1997.
5.17 Bank Branch Licensing

Prior to the introduction of the economic reforms, opening of a bank branch was under the control of RBI. With progress of financial sector reforms, autonomy was conferred on many financial institutions and so more autonomy was given to banks to decide the location/opening/closing of its branches, depending on the viability.

The branch licensing policy for 1990-95 provided operational autonomy to banks to rationalise the structure of their branches. Banks were permitted to shift their existing branches within the same locality, open specialised branches, and convert the existing non-viable rural branches into satellite offices and spin-off business of a branch. Also, banks, which attained the stipulated capital adequacy norms and prudential accounting standards, were permitted to set up new branch offices/upgrade the extension countries into full-fledged new branches without the prior approval of the Reserve Bank.

Banks were allowed to close, with the Reserve Bank approval, on mutual consultation, one loss-making branch at rural centers served by two commercial bank branches excluding RRBs. RRBs were allowed in December 1993 to relocate their loss incurring branches at new places within their service area/area of operation. Specialized Agricultural Finance Branches were opened to adequately deal with high-tech agricultural financing. The banks which fulfil the criteria such as a) CRAR at 8 per cent b) Minimum net owned funds at Rs. 100 core c) Net profit for 3 consecutive years d) Gross NPA not exceeding 15 per cent of total advances were given freedom to open branches.

5.18 Private Sector Banks

A more competitive environment was created for banks during the reforms period. Banks are already facing competition from non-bank finance companies primarily on the lending side and from mutual funds and other similar institutions on the deposit side. They, therefore, need to gear themselves up to meet this challenge. But significantly banks are facing competition from within their industry. New banks are now being set up in the private sector although the challenge from these new banks will for some time minimal. Improvement in the efficiency of the public sector banks will have to come from within and from the need to improve their profitability. Banks with strong balance sheets are now going to the capital market and raising funds. This will also make them accountable to a wider base of shareholders resulting in better performance.
Regional rural banks, which were opened to cater to the financial needs of the countryside, where the commercial banks cannot reach, incurred huge losses and became a burden for the sponsoring banks. To make them viable and profitable, many changes were introduced. In line with the Bhandari Committee and Basu Committee recommendations, the branch licensing policy for RRBs was modified. 70 RRBs freed from the Service Area obligations and freedom was given to relocate their loss-making branches preferably within the same block or convert them into satellite/mobile offices. Two loss-making branches of the same RRB within five kms were permitted to merge. RRBs with Service Area obligations were allowed to relocate loss-making branches at ‘Specified Centers’ within their Service Area and to convert their loss-making branches into satellite/mobile offices. Two branches of the same RRB within five kms in a geographically contiguous Service Area were allowed to be merged. These RRBs were allowed to open new branches at ‘specified center’ within their area of operation. RRBs were allowed to deploy a part of their surplus non-SLR funds in credit portfolios of their sponsor banks and in specified investment avenues like UTI listed schemes etc.

An Export Group under the Chairmanship of Dr. N.K. Thingalaya was set up to examine the issues concerning the managerial and financial restructuring of RRBs. The group monitors the progress in this regard. RRBs were advised to adopt income recognition and asset classification norms from 1995-96 and provisioning norms from 1996-97 onwards. A sum of Rs 443.57 crores was infused as recapitalisation to 70 RRBs. With effect from May 28, 2000, RRBs having minimum working capital of Rs. 25 crore and satisfying other criteria were authorised to open and maintain NRE accounts in rupees.

5.20 Regulatory and Supervisory Issues

A strong system of supervision is essential for a sound banking system. Much importance has been given to strengthen the financial system of the country during the past ten years of economic reforms. Various measures were taken by the Government and the Reserve Bank to improve the regulatory and supervisory role of the monitoring agencies. There has to be an alert mechanism for monitoring compliance with prudential regulations and directives of the Reserve Bank and other regulatory agencies. The system of external supervision of banks has been revamped with the setting up of a separate Board for Supervision (BFS) within the Reserve Bank, concentrating exclusively on supervisory issues. The board ensures compliance with regulations and guidelines in the areas of credit management, asset classification, income recognition, capital adequacy.
provisioning and treasury operations. A Board for Financial Supervision (BFS) was set up within the Reserve Bank to ensure implementation of regulations in the areas of credit management, asset classification, income recognition, capital adequacy and treasury operations. BFS under the Chairmanship of Governor of the Reserve Bank. An audit sub-committee comprising the Vice Chairman and two members of the BFS was also set up to examine on an on-going basis, the system of auditing of banks, financial institutions and non-banking financial companies. BFS also supervises the all-India financial institutions and non-banking financial companies. A Working Group on Internal Controls in Bank set up in February 1995 to review the internal control and inspection/audit system in banks (Chairman R. J. Jilani) submitted its report on September 20, 1995. A Working Group to ‘Review the System of On-site Supervision over Banks’ headed by Shri S. Padmanabhan constituted in February 1995, submitted its report on November 8, 1995. New approach to on-site inspection of banks in accordance with the recommendations of the Padmanabhan Working Group (1995) was adopted from the cycle of inspections commencing July 1997. It focuses on the mandated aspects of solvency, liquidity, financial and operational health, based on a modified version of the CAMEL model viz Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems and controls, shedding the audit elements under the prevailing inspection system. The role of external auditors in bank supervision has been strengthened. Besides audit in the annual accounts, auditors were required to verify and certify certain other aspects like adherence to statutory liquidity requirements, prudential norms relating to income recognition, classification of borrowal accounts and provisioning as also financial ratios to be disclosed in the balance sheets of banks. Two supervisory rating models based on CAMELS and CACS (Capital adequacy, Asset quality, Compliance and Systems) factors for rating have been worked out on the lines recommended by the Padmanabhan Working Group. The Reserve Bank developed a rating model for SCBs based on CAMELS factor and a rating model of the foreign banks based on CACS factors. The prime purpose of introducing the system of supervisory rating of banks was to summarise the performance of individual banks and also to assess the aggregate strength and soundness of the banking system. SCBs were advised, to disclose the details of the maturity profile of deposits and borrowings, loans and advances and investment, movements in provisions and lending to sensitive sectors as additional information in the ‘Notes on Accounts’ to the Balance sheet. Detailed guidelines were issued for risk management system in banks were issued. The guidelines broadly cover management of credit, market and...
operational risks The guidelines on risk management issued together with the ALM guidelines were purported to serve as a benchmark to the banks, which were yet to establish an integrated risk management system. The Board of the banks was required to review the progress in implementation of the guidelines at half-yearly intervals. With a view to strengthening the internal inspection/audit of banks, banks were advised to formulate a comprehensive policy document for internal inspection/audit, which requires to be reviewed periodically, keeping in view the changing environment, directives and guidelines of the Reserve Bank. The time lag for making provision against net debit balance in inter-branch accounts was reduced from three years to two.

Risk-based supervision (RBS) approach of banks was introduced. The risk-based supervision approach entails the monitoring of banks by allocating supervisory resources and focusing supervisory attention according to the risk profile of each institution. In order to bring more transparency to the balance sheets of public sector banks and as a further step towards consolidated supervision and to provide additional disclosures, the public sector banks were asked to annex the balance sheet, profit and loss account, Report of the Board of Directors and the Report of the Auditors in respect of each of their subsidiaries to their balance sheet beginning from the year ending March 31, 2001.

The Reserve Bank has been conducting self-assessments of the Indian banking system vis-a-vis the Core Principles of Effective Banking Supervision. These assessments, supported by an external assessment by the IMF in November 1999, indicate that systems in India are largely compliant with the Core Principles. As a member of the Working Group on Capital of the Core Principles Liaison Group (CPLG), the Reserve Bank has provided the perspectives of the non-G-10 countries in the drafting of the New Capital Accord. With regard to the New Capital Accord, it has expressed the view that where banks are of simple structure and have subsidiaries, the Accord could be adopted on stand-alone basis with the full deduction of equity contribution made to subsidiaries from the total capital. Secondly, for assigning preferential risk weights for banking book assets (excluding claims on the sovereign), preference has been expressed for assessments made by the domestic rating agencies as opposed to external rating agencies. The Standing Committee on International Financial Standards and Codes (Chairman: Dr. Y. V. Reddy) was constituted by the Reserve Bank and GOI for identifying the developments in global standards and codes with a view to considering the applicability of these standards and codes to the Indian financial system. The reports of the ten advisory groups, constituted by the Standing
Committee, in the areas of accounting and auditing, banking supervision, bankruptcy law, corporate governance, data dissemination, fiscal transparency, insurance regulation, transparency in monetary and financial policies, payment and settlement systems and securities market regulation assessed the appropriateness of international standards and codes in these areas to the Indian context and recommended, where necessary, measures to improve existing standards.

5.21 Frauds and Malpractice's

Frauds and malpractice became a regular feature in the financial sector, starting from the lowest to the highest level of the organization. The Government and the RBI tried to arrest the trend and many policy changes were initiated in that direction. The recommendations of Ghosh Committee on frauds and malpractice in banks were introduced in the year 1992-93. Banks were advised to devise a system of close watch on new deposit accounts and cash deposits and withdrawals for Rs 10 lakh and above and to introduce the practice of informing the employer Bank whenever an employee of a bank opens an account with a branch other than that of his posting. The RBI has set up Advisory Board on Bank frauds in February 1997 under the chairmanship of Shri S S Tarapore. The Advisory Board on Bank Frauds set up in February 1997 has been redesigned as the Central Advisory Board on Bank Frauds (CABF) on March 1, 1999. The Board takes up bank fraud cases of officers at the level of General Managers and above. The decisions and directions of the Board on the referred cases enable banks to enhance staff accountability and prevent the occurrence of frauds.

During the reform period, the RBI has tried to strengthen its supervisory and regulatory role. But the recurrence of frauds and failures in the financial sector proves that there is some lacuna in the regulatory and supervisory role of the apex bank. To quote SS Tarapore, 'Supervision is where the action really is',

The world over, financial regulation and supervision are treated as two sides of the same coin. But in India, there has been confusion regarding these closely inter-related activities. The origin of this problem goes back to the dirigista regime of the seventies and early eighties. We lived in a world where the RBI delighted in micro management and therefore prescribed almost every activity of the banks, so much so that a good banker was one who could rattle off the maze of regulatory controls. We lived in an innocent world where we believed that regulation was so rigorous that banks dared not violate the regulatory framework and thus, supervision was redundant.76

To quote Shri P V Indiresan

76 Tarapore SS "Supervision is where the action really is" Financial Express, 10 102001, page 8
The Indian financial institutions, pressured by politicians, lend recklessly. Scared of the consequences, wherever they are free of political pressure, they go too slow and miss out on worth while opportunities. Thus they get the worst of both the worlds. They provide too much accommodation to the undeserving and too little for the deserving.1

It is not as if financial irregularities did not take place in those days. There was a Nelson's Eye approach but when things really went out of hand, the authorities sought the scalp of a couple of bank chairmen. It seemed to have underestimated the extent of greed and the dare delivery of violators of the framework who knew full well that a contemporaneous supervisory system just did not exist. But all this changed with the reforms of the early nineties. In the aftermath of the securities irregularities, which surfaced in early 1992, there was a felt need to undertake a structural transformation of the system. Regulation was separated from supervision. The RBI put out Prompt Corrective Action. Regulation should be light and supervision should be stringent. Any violation should invite penalties that should be widely publicized. As it happened very recently in the USA, where Federal Bank imposed penalty on State Bank of India and Citibank for violation of certain norms. It is not necessary to use punitive penalties. The present legal framework provides for a system of mild penalties but use of these penalties with wide publicity would serve the purpose. Rather than writing letters of displeasure to bank chairmen, a decisive small fine, which would ensure those banks, do not violate the regulatory framework. But before the RBI can put such penalties in place it needs to upgrade its supervisory skills.

There is an imperative need to set up a dedicated autonomous Center for Excellence in Regulation and Supervision wherein supervisory skills are continuously upgraded. The retired or senior officials of commercial banks, who know the tricks of the trade, should be empanelled in the Supervisory/Regulatory institutions. Representatives of the customers and members of the capital market also should be nominated for the institutions, who will have a watch on the operations. A system has to be evolved under which if somebody violates the regulatory framework, hurting the depositors there has to be quick redress. The actual world operates on a real time basis and the role of the regulator/supervisor is to ensure that markets function, as they are meant to function, bearing in mind the interests of depositors. It is best to undertake preemptive supervisory action before people have loose money. Supervision is where the action really is and the RBI should put its top performers in the supervisory function.

1Indraneel P V "Vision 2020 Why don't bankers have self confidence?" Economic Times, 30-7-2001
5.22 Investment Norms

The new economic policy paved a path for inviting more investments in various sectors of the economy. Investment norms were liberalized to attract more investors into India. Ceiling of 5 per cent of incremental deposits of the previous year on bank's investment in PSU bonds was withdrawn. Standby facility for CP was abolished, after issuance of CP, the banks were advised to effect a 'pro tanto' reduction in the cash credit limit. The period for transferring the share held by banks in their names against advances to share and stock brokers held by them as stock-in-trade, was raised to 9 months from a period of more than 3 months earlier. Besides the monetary limit for such advances was raised to Rs 5 lakhs from Rs 3 lakhs earlier.

Banks were permitted to acquire shares and debentures in the secondary market within the ceiling of 5 per cent of incremental deposits of the previous year prescribed for investments in corporate shares, debentures and units of mutual funds. Banks were also permitted to purchase PSU bonds in the secondary market (other than inter-bank transactions). The limit for sanction of advances against shares and advances to individuals was raised from Rs 5 lakh to Rs 10 lakh and were given freedom to decide the appropriate levels of authority for sanction of such advances.

Banks were advised to classify a minimum of 75 per cent of their investment in approved securities as current investments. Investments by a Bank in Tier II bonds issued by other banks were permitted. In order to encourage flow of finance for venture capital, the overall ceiling of investment by banks in ordinary shares, convertible debentures of corporate and units of mutual funds etc. of 5 per cent of their incremental deposits of the previous year was enhanced to the extent of bank's investment in venture capital. Banks were advised not to participate in the equity of any financial services venture such as portfolio investments in the equity of financial companies, including Stock Exchanges, depositories etc., without obtaining the prior approval of the Reserve Bank.

Regional Rural Banks were allowed to invest in Tier - II Bonds Issued by sponsor banks or other banks and Financial Institutions only to the extent of 10 percent of RRBs owned funds.

Valuation norms applicable for banks' investment portfolios were modified to reflect market movements. Commercial banks were advised to classify their entire investment portfolio under three categories, viz., "held to maturity", "available for sale" and "held for trading". Investments available for sale or held
for trading were required to be marked to market periodically. Guidelines were also issued regarding classification and provisioning norms for restructured accounts in the standard and substandard categories.

5.23 Technological Issues

After a prolonged opposition from the Unions and Associations for mechanisation, Indian Banks are fully empowered with electronic banking. Many changes undertook during the past ten years of economic reforms to improve the mechanisation and computerisation in the financial sectors. Under the World Bank's Financial Sector Development Project, the participating banks could obtain a modernization and institutional development loan of US $150 million for extending, inter-alia, automation and computerisation of banking operations. The India Financial NETwork (INFINET) based on satellite communication was augmented by additional licensed transponder capacity as well as by other communication modes. Such a development would strengthen the technological infrastructure and hence help to improve financial market integrations. Guidelines were issued to banks for issuing debit cards and smart cards with a view to helping banks to introduce appropriate schemes in issuing of electronic cards to ease pressure on physical cash. Real Time Gross Settlement (RTGS) design specifications covering the entire gamut of policy, operational and implementation were issued. The INdian Financial NETwork (INFINET) which initially comprised only the public sector banks was opened up for participation by other categories of members. The Information Technology Act, 2000 has given legal recognition to creation, transmission and retention of an electronic (or magnetic) data to be treated as valid proof in a court of law, except in those areas, which continue to be governed by the provisions of the Negotiable Instruments Act, 1881. Payment System Legislation in the form of amendments to various Acts as also the need for framing new legislation for the regulation of multiple electronic payments is under consideration. Several measures to ensure the authenticity of the message across the Internet have been suggested by the Working Group on Internet Banking.

Visibly sweeping changes took place during the reforms period is introduction of technology in the financial sector. Internet banking, Tele banking, Anytime banking is introduced in the banking industry. Customer need not go to a bank branch within the stipulated hours to transact his transactions. There are now 450 ATMs installed by various public sector banks in India. The number of fully computerized public sector bank branches went up to 6982 by the end of March.
2001 73 per cent of total commercial banking business by March 2001, as against stipulation of 70 per cent by Central Vigilance Officer.

5.24 Customer services

Measures were taken to effectively meet the grievances of the customers. Offices of ombudsman are being set up to provide satisfactory redressal of consumer grievances relating to banking services. In this context, mention must be made of the emphasis being placed on the introduction of technology in the banking industry in a broad-based manner. Over a phased programme, several hundred branches are slated to become fully automated. Efforts are also on to improve the payments system by introducing appropriate technology. Banks are drawing up corporate and business plans to expand their business restructuring plans aimed at achieving viability over the medium term of two to three years. This is to ensure that the capitalisation exercise is carried out on a sustainable basis. Such concrete plans should enable banks to ensure on a time bound basis, certain improvements, which are urgently called for.

Customer service in the banking sector was perceived as an integral part of the overall financial sector reforms. Accordingly, the Reserve Bank initiated speedy action relating to a) advancing of working hours b) extension of business hours c) acceptance of small denomination notes d) exchange of soiled and mutilated notes e) immediate credit of local cheques up to Rs 5,000 and f) payment of interest at enhanced rate on delayed collection of outstation instruments at minimum lending rates when the proceeds of the instruments were to be credited to cash credit.

As part of implementation of the recommendations of the Golpona Committee on customer service in banks, the Reserve Bank advised all commercial banks to monitor and evaluate 25 core recommendations of the Committee in the prescribed format. Few more services were introduced for better customers service viz., immediate credit of outstation cheques, allowing customers to use the credited funds latest by the third working day from the date of acceptance of the cheque, constitution of a committee under a General Manager to identify the areas and factors for delays in collection of outstation instruments etc. Stand alone ATMs at places other than branches and extension counters were allowed to provide functional facilities such as PIN Changes, Requisition for cheque books, statement of accounts, Balance enquiry and Inter-account transfer. For expeditious and inexpensive resolution of customer complaints against deficiency in banking services, the Banking Ombudsman Scheme, 1995 was introduced in June 1995. So far 8 ombudsman were appointed one each at New Delhi.
Mumbai, Bhopal, Bangalore, Chandigarh, Hyderabad Patna and Jaipur. After 10 years of reforms, there is a remarkable change in the service extended to customer. Now the customer has become the king and bankers are competing to win over them.

5.25 Dividend declaration by Banks

In the context of changes envisaged in the holding of equity of public sector banks consequent upon the issue of shares to the public, effective May 19, 1995, public sector banks were made subject to prior approval for payment of interim dividend, dividend higher than 25 per cent and in cases of non-fulfilment of four stipulated conditions: (i) compliance with the provisions of Section 15 of the Banking Regulation Act 1949; (ii) proposed dividend out of current year’s profit being not more than 25 per cent; (iii) compliance with the extant regulations on transfer of profits to statutory reserves and setting up of required provisions and (iv) observance of prudential accounting and capital adequacy requirements.

5.26 Reforms in Insurance Sector

A Committee on Reforms in the Insurance Sector was set up in 1992-93, under the chairmanship of Shri R N Malhotra, to make recommendations on reforms in insurance sector. As per the recommendations of the Committee, a three-member board for the interim Insurance Regulatory Authority (IRA) was constituted in January 1996.

Banks and registered NBFCs have been permitted to enter the insurance business under the Insurance Regulatory and Development Authority (IRDA) Act, 1999. The Reserve Bank issued guidelines in this regard for banks and NBFCs to enter into insurance business: (i) on risk participation basis, (ii) for strategic investment in an insurance company without any risk participation and (iii) for agency business on behalf of insurance companies on fee basis without any risk participation. Certain eligibility criteria have been prescribed for entry of banks and NBFCs into insurance business through the above routes.

5.27 Progress/Achievement

The reform process has started yielding results and this is reflected in the working results of banks. Operating profits of 27 public sector banks improved from Rs 3069 crores on 1992-93 to Rs 3755 crores in 1993-94 and further to Rs 5520 crores in 1994-95. During the second phase of reforms, the operating profit of the public sector banks rose to 10552 crores for March 1999, 13055 crores for March 2000 and to Rs 13902 crores for the year ended March 2001. The burden...
of provisioning during 1993-94 was exceptionally high as the banks had to provide for the backlog of provisions for 1992-93 in addition to fresh provisioning for the year. Consequently net profits declined from Rs 416 Crores in 1990-91 to Rs 4349 crore in 1993-94. The public sector banks as a group finally turned the corner in 1994-95, recording a net profit of Rs 1116 crores. The process of improvement has thereafter turned to Rs 4316 crore during 2000-2001 as compared with Rs 5116 as on March 2000 and Rs. 3258 crore in the preceding year. The operating and net profits were arrived at after absorbing VRS expenditure aggregating to Rs. 3079 Crores for the year ended March 2001. The comparative performance of banks for the past ten years are furnished in Annexure - II.

Profits before provisioning of public sector banks as a percentage of average working funds showed an improvement rising from 0.91 per cent in 1992-93 to 0.97 per cent in 1993-94, to 1.26 per cent in 1994-95, and 24 per cent for the year ended March 2000, but declined to 6 per cent for the year ended March 2001, because of absorption of VRS expenditure. With the tightening of prudential accounting stands, the ratio of net profits to total assets marginally declined from (-) 1 per cent in 1992-93 to (-) 1.17 per cent during 1993-94. It recovered thereafter to 0.26 per cent in 1994-95 and to 0.26 per cent in March 2000. The banks have thus demonstrated their capacity to cope with the new challenges.

The analysis of the working results of the 27 public sector banks shows that in 1992-93, 15 banks showed positive operating and net profit, while four banks showed positive operating profit but negative net profit. Eight banks showed negative operating and net profit. In 1994-95, 19 banks showed positive operating and net profit and seven banks showed positive operating profit. Only one bank showed loss. Of the 27 banks, 21 have reached the required capital adequacy ratio by 31 March 1996 and all banks have acquired the required CAR except 1 bank, at present.

Graph 5.9: Net profit as % to total assets

Source: RBI Annual Reports
While several of the quantitative indices of performance have shown improvement, there are many areas in which weaknesses still persist. The customer service needs improvement. Technology needs to be upgraded and housekeeping has to improve in terms of reconciliation of entries and balancing of books. Credit appraisal must be quicker and better and transmission of funds speedier. All of these must become the focus of attention in the next phase of the reform process.

It is not surprising that the sweeping nature of the financial sector reforms has evoked some criticism. While the banking community and the customers, in general, have welcomed the changes that have been ushered in, criticism have mainly emanated from those who are anchored to certain ideological moorings. Internationally, a trenchant critic of financial sector reforms has been Joseph Stiglitz who has argued that financial markets are vulnerable to "market failures" more than any other market and therefore, Government intervention in financial markets is imperative. He writes, there exist forms of government intervention that will not only make these (financial) markets function better but will also improve the performance of the economy. The need for intervention in the financial markets is not denied by anyone. All advocates of financial sector reform have pleaded that deregulation should be accompanied, if not preceded by putting in place a rigorous set of prudential standards to be met by financial institutions. As John Crow, former Governor of Bank of Canada, said, "deregulation does not mean de-supervision". Internationally accepted common standards for income recognition, provisioning and capital adequacy have come into force in almost all countries. It is when Stiglitz argues for a more intrusive form of intervention, which includes directed credit and maintaining low interest rates through a system of financial repression that differences begin to emerge. Even here the differences are those of degree rather than of kind. Stiglitz himself talks of the failure to distinguish between small and large repressions. While cross subsidies of interest rate as well as some forms of directed credit can be built into a system of credit dispensation, the issue becomes serious when such subsidies reach levels at which the very viability of the financial institutions is at stake. To some extent, Stiglitz recognizes this when he says that there is a role for Government in financial markets but the success of Government interventions has been mixed. It is important that intervention be well designed. In fact, what he calls for are imaginative forms of Government intervention. The crux of the problem lies in determining whether or not a specific policy intervention is imaginative enough i.e. whether it would be more effective than...
reliance on market force. The art of policy making thus really lies in the electric selection of policy interventions.

On the issue of Government borrowing at market related rates of interests, the only way in which the Government can meet its requirements at below market rates will be either through a mandatory requirement forcing banks and other financial institutions to invest certain proportion of their liabilities in Government paper or by simply borrowing from the central bank, generating an increase in money supply. The first alternative leads to a situation in which the viability of the financial institutions themselves get eroded. While obviously certain liquidity requirements can be imposed, beyond a point, it can only turn the financial institutions into loss making entities. If the Government borrows excessively from the central bank, it can only fuel inflation by expanding money supply beyond reasonable limits. It is sometimes argued that the high rates of interest that the government has to pay on its borrowing worsen the fiscal deficit. But it is overlooked that high interest rates themselves are not the cause but the effect of unduly large fiscal deficit. The answer to reducing the interest payments lies basically in the Government containing the fiscal deficit and not artificially trying to keep the rates of interest low. While a high interest rate may not be a sufficient deterrent in containing borrowing, nevertheless, it serves a useful function in making explicit the rule cost of Government borrowing.

The chief merit of our reform process has been the cautious sequencing of reforms and the consistent and mutually reinforced character of the various measures taken. Introduction of prudential norms, widening of the capital base, and strengthening of the organizational infrastructure have all gone hand in hand.

5 28. The other side of the Reforms

The New Economic Policy initiated brought good progress in many sectors and improved international confidence on India. But the other side of the coin is not so gloomy. To quote D. Naik, ‘Mess in the financial sector’

Financial sector reforms were initiated in India in 1992-93 to promote a diversified, efficient and competitive financial system with the ultimate objective of improving the allocative efficiency of available resources through operational flexibility, improved financial viability and institutional strengthening. However, looking at the sorry state of the financial sector today, it is apparent that something has gone terribly wrong with the reform process in this sector. Over the last decade, the country’s financial sector moved from one crisis to another without learning any lessons from the past mistakes. 72

In the 1992 securities scam, considerable bank funds were transferred with impunity from banks and corporate houses to brokers' accounts and utilised to rig up share prices. Nearly a decade later, another stock market scandal turned out to be of a much bigger dimension. In this case also there was gross misuse of bank funds that led to the liquidation of Machavapura Co-operative Bank. In 1997-98, CRB Capital, the Rs 1000 crore financial conglomerate, which was even granted a provisional banking licence, duped millions of small investors of their investments in its mutual fund and fixed deposits. The plantation companies that mushroomed in the first half of the 1990s, duped investors of almost Rs 8,000 crores and vanished. They promised investors incredible amount in seven years and launched a massive newspaper and TV advertisement campaigns. What is more shocking, all of them got away without any punishment. The events over the past few months are quite disturbing.

In fact, the UTI fiasco for the second time in less than three years, the IFCI, bail-outs of Rs 1,000 crore, bailout packages for three weak public sector banks to the tune of Rs 2,550 crore for re-capitalization do not fully reflect the extent of rot. According to experts, these instances may be only the tip of the iceberg. Recently, the premier Development financial institution, the IDBI also joined the queue seeking succor. It asked the RBI to extend the Rs 1,440 crore loan tenure to 50 years and wants the government to infuse long-term preference capital. The financial health of the public sector banks is also far from satisfactory barring few exceptions.

The government injected a massive Rs 20,446 crore towards recapitalisation of the PSBs till end March 1999 to help them fulfill the new capital adequacy norms. The government did not provide any more funds for this purpose in subsequent budgets and asked the banks to lend for themselves by raising funds from the capital market, if necessary. Even so, recently it had to work out the bailout package of Rs 2,550 crore for three weak. In fact, the Verma panel recommended injection of Rs 5,000 crore in these banks but the Talwar Committee scaled it down to Rs 3,000 crore and the government further brought it down to Rs 2,250 crore. There are indications that three more PSBs may join the weak banks list soon. Notwithstanding the efforts made over the past few years to bring down the non-performing assets (NPAs) of PSBs, their level is still unacceptably high. In the last two years, the government allowed 27 PSBs to write off corporate loans worth Rs 8,245 78 crore to reduce bad debts. Despite this, the NPAs or unpaid loans of these banks increased from Rs 53,294 crore last year to Rs 54,773 crore this year. The health of the financial institutions is...
Their NPAs have mounted to over Rs 18,000 crore. While the NPAs of IFCI have soared to 29.7 per cent, those of IDBI have gone up to 18.44 per cent. Bad management, political appointments to top positions and government interference are to blame for this. The picture is worse in the case of the non-banking financial companies (NBFCs), the co-operative banking sector and the mutual fund industry that mushroomed over the past decade.

There was an uncontrolled and unregulated growth of NBFCs till 1995-96. Soon the sector was struck by disaster as millions of investors lost their money because of their mismanagement of their fund, the most notable being that of CRB Capital. Small investors including pensioners lost their fortunes by investing in mutual funds, particularly in equity based ones. All these episodes and the current mess in the financial sector point to major inadequacies in the implementation of reforms and in particular, the failure to put in place an efficient regulatory framework. Viewed with the benefit of hindsight, it is apparent that the approach taken to financial sector reform in India has been piecemeal and incoherent. The two Narasimham Committees (1991 and 1998) largely set the reform agenda for this sector. Though most recommendations of these Committees were accepted, not all have been implemented. Only the recommendations concerning the RBI and monetary policy have been implemented in few cases with some modifications.

The RBI has covered a lot of ground in rationalising and deregulating progressively the interest rate structure, lowering the SLR and CRR and providing the banking sector greater operational freedom including the flexibility in determining the PLR. But there is no much credit off take. Stringent norms are being introduced only after some financial frauds came to lime light. In the case of NBFCs, the norms were tightened after the CRB Capital episode. Their capital adequacy requirement was raised to 10 per cent by March 31, 1998 and 12 per cent by March 31, 1999. It was also stipulated that the NBFCs could accept public deposits only if they satisfy the preconditions of possessing captioned funds of at least Rs 25 lakh. But the recent failures and frauds of the NBFCs and co-operative banks proves that there is no proper supervisory mechanism. In case of co-operative banks, however, because of dual control that of the RBI and the State Governments the RBI has not been able to impose the required discipline.

There is large-scale interference of politicians and mismanagement of funds by these banks. The RBI has been supervising not only commercial banks but also the term lending and other specialised financial institutions and NBFCs.
emphasis is on putting into effect international best practices and attaining CAMELS (capital adequacy, asset quality management, earnings, liquidity and system) through offsite and onsite monitoring and auditing standards. To quote RBI Annual Report 1997-98.

The South-East Asian crisis has demonstrated the need for having strong supervisory arrangements not only for the sake of financial soundness but also for maintenance of international confidence in economies. However, the recent events indicate that while the RBI is aware of the importance of monitoring and auditing, the actual implementation has been far from satisfactory. What is more disappointing is the growing weakness in the credit delivery system of banks and their failure to meet the needs of the real sectors of the economy despite the several reform measures the RBI introduced, including the reduction of SLR and CRR.

While the banking sector is flush with funds, the credit deposit ratio has been hovering around a little over 50 per cent for the past three four years. Ideally, this ratio should be around 70 per cent. What is particularly disappointing is that the CDR is stagnating around this level at a time when priority sectors such as agriculture and small scale industries are starved of credit. The lowering of SLR and CRR requirements was expected to release more banking sector funds to the real sectors of the economy. But the SLR continues to remain at around 38 per cent as banks continue to prefer investments in risk free government securities instead of lending to the productive sectors of the economy.

The tendency to borrow to finance the fiscal deficit has also contributed to this phenomenon. The abolition of ad hoc Treasury Bills by the RBI and introduction of Ways and Means Advances (WMAs) effective from April 1, 1997 was hailed as a historic reform relating to the fiscal monetary relationship. Under the new system of WMAs, financial limits have been fixed to accommodate temporary mismatches in government receipts and payments and the interest rates on WMAs are market related. However, this reform has not deterred the government from reckless borrowings and thus exerting upward pressure on the interest rate structure. The bank's excess investment in government securities (over and above the SLR requirement) adds up to over Rs 100,000 crore.

The economic slowdown of last three years has put further pressure on the profitability of banks and financial institutions with mounting bad debts. Hence,

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27 Reserve Bank of India, Annual Report 1997-98, RBI, Mumbai, p 3
there is an urgent need to refocus on bank credit to commercial and productive sectors

Nobel laureates for year 2001, Joseph Stiglitz, George Akerlof, Mikhelsen, in their contribution "Information Economics", for which they were awarded the Nobel Prize, argued that it is not the Government control that led to the poor growth of the economies, but it is dis-information that is the root cause of the present problems. They felt that it is only dis-information that led the developing countries into the present mess. It is proved in India, on several occasions by way of frauds in various segments of the financial sectors. The distorted information furnished by the financial organization is taken for granted by the RBI and GOI. No independent inquiry/assessment is being done by the controlling/supervising agencies. So, the dis-information is the cause and action of the recurring failure of financial market. Be it stock market scam or UTI scam or bank scam. The required information is being collected from the organization concerned, who always try projecting only positive aspects of the organization. Though we talk much about transparency in financial policy and framework, in practice no proper transparency. There should be proper mechanism to assess the fit falls in the data furnished.

5.29 The Road Ahead

The first decade of the banking sector reform came to an end and we are moving on to the next stage of the reform. In the years to come, the Indian financial system will grow not only in size but also in complexity as the forces of competition gain further depth. While the policy environment will remain supportive of healthy growth and development with an accent on greater operational flexibility as well as greater operational flexibility, greater prudential regulation and supervision, the thrust of the second phase of reform would have to be on improvement in the organisational effectiveness of banks and other financial entities. It is not the availability of funds or the cost of funds that is more important. All that it is needed is the demand and supply for funds. Even with the lowering of reserve requirements, and interest rates to the minimum level, the credit off take is not improving to the desired level. Hence the next generation of reforms should concentrate on creating safe avenues for credit disbursements. High level of NPAs, poor recovery, generation of fresh NPAs, accountability syndrome and capital adequacy norms created fear psychosis and discouraged fresh lending by banks. As sufficient ground was laid by the first decade of reforms in strengthening of the financial system, the next phase of reforms should concentrate more on encouraging credit off take.
Going by the experiences of commercial banks in other countries, the following trends may tend to dominate the future course of banking development in India:

- Greater specialisation of banks in different niches of the market such as retail, agriculture, export and the small scale and corporate sector.

- Greater reliance on non-fund business such as advisory and consultancy services, guarantee and custody services.

- Greater overlap in product coverage between commercial banks and non-bank financial intermediaries and.

- Greater financial disintermediation with large companies accessing securitised debt domestically and from financial markets abroad.

Banks have to prepare themselves to grapple with these challenges and convert them into opportunities, which calls for critical introspection and intelligent anticipation. In this regard, several imperatives merit attention.

Banks would have to move away from excessive concentration on asset management and adopt a more general approach of asset-liability management aimed at modifying their liability structure in consonance with the desired asset structure. This entails a continuous process of planning, organising and controlling asset liability volumes, maturities, rates and yields. The recent turmoil in the call money market with call rates exhibiting a proclivity to zoom and collapse has not only caused considerable discomfort to banks which were over-extending themselves through excessive reliance on money market borrowings but also has underscored the earnest need for avoiding large maturity mismatches between banks' assets and liabilities. It is essential for banks to understand the growing interdependence of various market segments and to develop interdependence of various market segments, and to develop the necessary expertise for forecasting the relevant variables taking into account this interdependence.

Management of credit risks would have to be accorded a very high priority. Persistence of large non-performing assets is essentially a reflection of a poor credit risk management system. While the ratio of NPAs to total loan assets has come down, yet in absolute terms, the volume of NPAs has remained large. Since a high level of NPAs is symptomatic of poor credit management, banks with high NPAs would particularly need to put in place an effective credit appraisal and management system.
Banks would have to equip themselves to operate in an increasingly deregulated interest rate environment. A framework would have to be created for carefully assessing the pressures of demand for credit on the one side and the availability of funds through various sources on the other. Banks need to exercise this freedom judiciously so that there is a balance between bank profitability and the requirements of credit. Risk assessment is an important part of credit analysis. As banks would also be increasingly subject to the interest rate risk with fluctuation in the interest rate, special attention would have to be given to developing the necessary treasury management expertise while managing their investment portfolios.

A significant improvement in customer service by banks can no longer be ignored. In an increasingly competitive environment, banks, which provide poor customer service, will find themselves losing their clients. In this regard, there is a paramount need for banks to put in place appropriate corporate strategies depending upon the nature of their clientele.

Finally, the housekeeping issues within would have to be addressed in a proactive and innovative manner. Computerisation and overall upgradation of technology rationalisation of branch structure and staffing, reduction of costs, inculcating greater degree of professionalism and improvement in productivity must receive their due attention regularly functioning of banks.

A well regulated modern financial sector is essential in a globalised economy. Financial innovation has been shown to contribute to development. Market based economies have, in general, done better, because of the constant identification and improved satisfaction of customer needs, including needs for financial products. Reforms offered a real opportunity for us to catch up, to leap from being extremely backward to being more state-of-the-art than many countries, which are locked into older, less efficient technology. Good progress has been made in market microstructure, but the small investor has disappeared from the market and finance is contributing less to the real economy. Financial institutions are looking for well-established firms to lend to, banks only want to lend to the government or the consumer, and the IPO market has collapsed. No one is willing to lend to start-ups. Finance blames over-regulation. In most countries financial reforms led to over-expansion of credit, regulators were not able to keep up since regulatory skill were often lacking and major crises followed. In India, we seem to be following a middle path because credit has dried up, but we have escaped with only minor crises. Better regulation and modern infrastructure are essential, but they have a short-run cost. More attention to sequencing and...
consistency of reform, across financial sectors, with monetary policy, and the investing habits of the Indian Public will moderate the cost. In transition innovative partnerships with government can reduce risk. Direct regulations can partially substitute for strict capital adequacy and thus moderate the fall in expected profits in the course of reform. Competition and more freedoms should encourage banks to develop information on loan quality, which is their comparative advantage and reforms in bankruptcy law will make collateralisation of loans easier. Financial institutions are used to unthinkingly riding the yield curve. Better loan information, recovery and efficiency are the way out of this perennial crisis.

Households have to get used to moving from a stable system of assured returns, under government ownership to more opportunities for a controlled participation in the risks and rewards of development. Earlier the government pooled risks, with taxpayer subsidising finance wherever and whenever necessary. This has indirectly led to syphoning of government money going to the big industries. This has limitations and the government has no money. The market has to grow and take over these functions. Indian finance has a history of dubious deals and mistrust. Such policies are being implemented worldwide.

Banks should diversify their finance to various sectors of the economy. There was an excessive finance to Agriculture sector immediately after nationalization and the non-priority sectors were completely neglected. Now more importance is being given for non-priority sector advances. The concept of directed lending should completely be eliminated and banks should be given full freedom to decide whom to finance.

Economy needs deregulation so that it responds to economic forces rather than to bureaucratic and political whims. There are still too many rules and regulations that serve simply to interfere with business activity. In the old days, the justification given for interference was 'Socialism' or 'Planning'. Now it is "Globalisation and modernisation". What is needed now is not mere downsizing of the government, but freedom from controls.

To sum up, as quoted in the RBI's Annual Report, 2000-01,

"The major thrust of financial sector reforms would continue to be on the development of financial markets, strengthening of the financial system and prudential and supervisory norms, improvement in credit delivery and modernization of the technological environment of the financial sector." 74

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74 Reserve Bank of India, Annual Report 2000-01, RBI, Mumbai, p. 146
In the second phase of reforms, success will depend primarily on the organisational effectiveness of banks for which the initiatives will have to come from banks themselves. The areas, which need improvement, are known. Imaginative corporate planning combined with organisational restructuring is a necessary prerequisite to achieve results. Public sector banks need to be given greater autonomy with respect to recruitment and promotion of personnel and in general management of staff and in determining the organisational structure. Greater accountability has to go with greater autonomy.

The RBI has done a commendable job of creating enough opportunities for banks to improve profitability. But only well equipped banks capable of implementing these changes can harness the proposed benefits. The monetary policies of the past ten years seems a well designed combination of measures to propel the financial sector on the path of reforms. The RBI clearly underlines the significance of strengthening the banking system in pursuing the financial sector reforms. If banks do not upgrade their systems, skill, technology and responsiveness to use the operational freedom, the only option will be to exit from the financial market. Any further delay in the recoupment of operational efficiency may prove an irreparable loss and such banks may lose the competitive edge in the market. The RBI’s measures set a clear agenda for banks to respond or perish in the new millennium.

Looking at the current volatility, the RBI picked up the spirit of budgetary provisions but kept implementation of some of the specific measures at bay. But it put in place the long-term strategies without allowing short-term objectives to retard the reform process. The central bank did a lot of homework to provide a continuing policy document as an extension of the chain of policies announced in the post-reform period, reflecting its commitment to financial sector reforms.

Through the various reform measures, we have laid the foundation for an efficient and well functioning financial system. Significant changes have already taken place. True, we have miles to go. But the steps that have been taken are in the right direction. The cumulative experiences provide us the necessary confidence.

5.30 Conclusion

To conclude, the first decade of economic reforms is highly successful in many spheres. There is an all round progress in the economy. Sufficient ground has been prepared for meeting the international challenges. Financial sector is

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76 Rao K Srinivasa, Credit Policy, ‘Banks must respond or perish’, Business Line, 25.5.1999
The strengthened financial institutions has improved a lot. But there is a lot more to be done. The improved strength of the financial institutions has not improved the financial system of the economy. The next generation of reforms should concentrate on improving the credit delivery mechanism. The monetary policy should always have inflation and growth rate as its target and the policy measures to be initiated should be directed to achieve the targeted inflation. Keeping the interest rates, CRR, SLR at the lowest level and restricting its role to the supervisory functioning and money control, the RBI should allow the market free play. The functioning of the financial system should be completely free from any sort of political pressure. The financial sector should be given free hand in its financial dealings and functioning within the broad guidelines of the Government.

The financial system of the country should be permitted to function independently, with no government intervention. The RBI should confine its activity to control money supply and supervisory role. There should be no infusion of capital by government and the banks should be permitted to borrow to meet the capital requirements and improve their efficiency to meet the challenges in the changed circumstances. Banks should develop their own risk management techniques and update the techniques as demanded by the prevailing circumstances. Banks should take fast decisions and act promptly. Any delay in decision-making results in wrong decisions and will not be remunerative. RBI should de-link itself from public debt management and should function as advisor to the government on economy and restrict its activity to a supervisory role.