

Dr Y V Reddy: Developments in monetary policy and financial markets in India

Address by Dr Y V Reddy, Deputy Governor of the Reserve Bank of India, to the Madras Chamber of Commerce and Industry, Chennai, 24 April 2001.

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I am thankful to the organisers for their perseverance in getting me to Chennai. I am using this opportunity to share with you some explanations on the Monetary and Credit Policy for 2001-02 announced last week. This is the fifth Annual Policy of Reserve Bank of India (RBI) that I have been associated with, and soon after every one of the fine statements, I had publicly articulated some explanations. The purpose has generally been to highlight elements of continuity, change and contextual relevance in each policy. However, on this occasion, a slightly different approach is adopted. To start with, there will be an assessment of the projections made in the policy statements since 1997-98 with reference to outcomes, giving some sort of monetary marksmanship, akin though not similar to fiscal marksmanship. This will be followed by a brief review of the progress in reforms in monetary policy and financial markets during the last five years. The features of the latest Monetary and Credit Policy would then be mentioned to lead to the tasks ahead. The tasks ahead, following from the recent policy statement are presented in four sections, viz., for Reserve Bank of India; for Government of India, for market participants and for technical work on some relevant areas of significance.

Projections and outcomes : an assessment

The monetary projections and underlying assumptions in regard to the macro-economy are contained in the annual statements, and revised, if considered necessary, in mid-year review in October. An analysis of projections and actual out turn since 1997-98 would help appreciate the realism in the analysis as well as the overall macro management.

Broadly speaking, the following inferences can be drawn from such an analysis.

First, the outturn in regard to growth in Gross Domestic Product has been close to the projections indicated in the Policy Statement and/or mid-year review except in 1997-98, when it touched the lowest level at 5.0 per cent.

Second, anticipated inflation has been out of alignment (i.e. beyond one hundred basis points from the projection) only in respect of 1999-2000, when it peaked at 6.8 per cent.

Third, the growth in money supply has been consistently above the projected rate except in 1999-2000, when it was at 14.6 per cent, below the projected level of 15.5-16.0 per cent.

Fourth, the deposit growth has been higher than projected in all the years except in 1999-2000 when the growth was a mere 13.9 per cent compared to the projected level of 16.5 per cent.

Fifth, the growth of non-food credit {including investments in PSU bonds, corporate debentures, Commercial Paper (CP) etc.} has generally been less than projected in all the years.

Sixth, in regard to interest rates, the general preference has been to bring down or soften interest rates while focussing on stability, though no specific rates were indicated. There has been a reduction every year, the range measured by Prime Lending Rates of public sector banks, having come down from 14.0 to 14.5 per cent in 1997-98 to 10.0 to 13.0 per cent in 2000-01.

Seventh, the market borrowing programme of the union government exceeded the projections (as per budget estimates) in all the years except in 2000-01, and there has been a significant borrowing in the fortnight following the end of the fiscal year. In fact, the slippage in 1998-99 and 1999-2000 had been very large, being about Rs. 15,000 crore, accounting for about 0.75 per cent of GDP. The borrowing programme of State Governments has been consistently higher than originally indicated to RBI except during 1997-98.

Eighth, as regards external sector, the current account deficit has been consistently less than 2.0 per cent of GDP, strictly in consonance with the broad policy indications. In fact, it has been significantly lower and at 1.5 per cent or less in all the years.

Ninth, the policy objective of augmenting reserves has also been achieved in every one of the years and the total addition to foreign currency reserves during the period at U.S.\$ 17 billion far exceeded the total addition to external debt (including amounts raised under Resurgent India Bonds and India Millennium Deposits) of U.S.\$ 4.5 billion.

Finally, the conditions in forex markets appear to have been reasonably stable, though there have been several occasions when there were pressures warranting prompt actions by RBI.

There is no doubt that the actual outcomes depend upon several uncertainties and unanticipated events that characterise any policy making during any given medium- term frame. The period under consideration had to contend with several domestic and international events that were unexpected, viz., domestic political uncertainties due to Parliamentary elections, Asian crisis, sanctions against India by the USA, border conflict at Kargil and oil shock or large increase in price of petroleum. Surely, there are lessons to be learnt and elements of good luck that might have visited on occasions but the period also exhibited exercise of sound judgements and enhancement of skills in management at all levels within RBI. What is of greater significance is the fact that the monetary policy was conducted while bringing about significant structural improvements in the financial sector and developing financial markets, especially the money market and the government securities market. Monetary management was greatly facilitated by the solid foundations laid and sound policy framework created by the RBI during the early nineties preceding the period analysed.

Review of progress (1996-2001)

The main objectives of the policy measures during 1996-2001 have been to increase operational effectiveness of monetary policy by broadening and deepening various segments of the financial market, to redefine the regulatory role of the Reserve Bank, to strengthen prudential and supervisory norms, to improve the credit delivery system, and to develop the technological and institutional infrastructure for an efficient financial sector. These measures usually announced as part of Policy Statements help the market agents to appreciate the policy changes in offing and to prepare themselves to meet possible challenges. In evolving these measures, market participants are closely associated and consulted.

The recent experience shows that monetary management in terms of objectives, framework and instruments has undergone significant changes, reflecting broadly the transition of Indian economy from a regulated to liberalised and deregulated regime. In that context, it would be worth the while to address some of the major highlights of these changes and the related issues which have received added and focused attention in recent years.

First, during this period the twin objectives of monetary policy of maintaining price stability and ensuring availability of adequate credit to productive sectors of the economy to support growth have remained unchanged; the relative emphasis on either of these objectives also continues to depend on the circumstances. However, the gradual liberalization of financial markets has increased the potential risks and vulnerability of institutions and has, therefore, implications for financial stability. The linkages between financial stability and price stability have become pronounced in recent times. In this context, the recent policy measures laid emphasis inter alia upon maintaining orderly conditions and containing volatility in financial markets. While the market determined exchange rate system has implications for monetary policy, the international transmission of price changes also need to be recognized in understanding the inflationary process. The structure of the economy and the role of services sector have also been changing which have implications for transmission of monetary policy.

Second, though inflation is not targeted, policy statements including those in the reference period, have been identifying a tolerable level of inflation taking into account the global trends and domestic compulsions. The measurement issues have also come to the fore and the notions of core-inflation and underlying inflation as against headline have been subjects of discussion. There has also been some sensitivity in the market, to the issues relating to measurement of prices in the growing services sector as also asset prices. A national consensus on the need to emphasize price stability in macro policy seems to be emerging.

Third, in a deregulated environment, besides the provision of adequate credit, availability of adequate resources at appropriate costs, i.e., interest rates becomes more important. Stable and preferably a low interest rate regime is conditional upon enabling stable inflationary expectations, which in turn depends on price stability. During the period, the fiscal and other constraints inhibiting the downward flexibility in interest rates had been debated and the need to impart flexibility to interest rates has

emerged as a focal point for policy action. Consequently, there is widespread appreciation of the efforts to ensure reduction in existing high levels of revenue deficit and fiscal deficit, besides rationalising administered interest rates on contractual savings to impart efficiency and operational flexibility to the financial sector.

During this period, most interest rates have been deregulated. The few prescriptions that exist, viz., export credit, small loans, foreign currency deposits are in the nature of ceilings related to market interest rates such as the relevant Prime Lending Rate (PLR) of the concerned bank or the LIBOR of the concerned currency. Currently, the only administered interest rate is on saving deposits. While directed credit continues, the conditions attached to such credit dispensation have been made considerably flexible.

Fourth, the monetary policy framework in India from mid-1980s till 1997-98, can, by and large, be characterised as a monetary targeting framework on the lines recommended by Chakravarty Committee (1985). Because of reasonable stability of the money demand function, the annual growth in broad money (M3) was used as an intermediate target of monetary policy to achieve monetary objectives. In practice, unlike many other countries, which followed such an approach, the monetary targeting approach was used in a flexible manner with a 'feedback'. This was necessary partly because of high level of government borrowings and the fiscal dominance, administered interest rates and the large size of unorganized sector. Deregulation and liberalization of the financial markets combined with increasing openness of the economy during this period necessitated some changes in this framework. Consequently, a multiple indicator approach was announced in 1998-99, wherein interest rates or rates of return in different markets (money, capital and government securities markets) along with such data as on currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange available on high frequency basis are juxtaposed with output data for drawing policy perspectives. Such a shift was gradual and a logical outcome of measures taken over the reform period since early nineties.

Thus the 'exclusive' use of broad money as an intermediate target was de-emphasised, but the growth in broad money (M_3) continues to be used as an important indicator of monetary policy. In a deregulated financial environment with reasonably open capital account, monetary policy has to respond to unexpected changes on short-term basis. The switchover to a multiple indicator approach provided necessary flexibility to the Reserve Bank to respond to changes in domestic and international economic and financial market conditions more effectively. In a medium to long-term perspective, the impact of money supply on inflation, however, cannot be ignored and for purposes of policy, the Reserve Bank still continues to announce projections of money supply compatible with the outlook on growth of GDP and expected inflation.

Fifth, the institutional context in which monetary policy was conducted was vastly different till very recently. Since 1997, a major change has taken place with the discontinuation of the process of automatic monetisation of government deficit. Although the mutually agreed Ways and Means Advances (WMA) sought to put a limit on direct short-term access of funds from the Reserve Bank to the Government, the continued high fiscal deficit made it difficult for the Government to reduce its requirement of borrowings from the banking sector. In the process, the Reserve Bank had to manage liquidity in the system in such a way that the impact of the high fiscal deficit on monetisation as also on interest rates is minimized. In effect, while the fiscal impact on monetisation has been reduced significantly, the interplay between fiscal and monetary operations continued to be significant in the post-1997 scenario.

The overall monetary management becomes difficult with a large and growing borrowing programme of the government, year after year, which puts pressure on the absorptive capacity of the market. The banking system at end-March 2001 held government securities of around 35.0 per cent of its net demand and time liabilities as against the minimum statutory requirement of 25.0 per cent. In terms of volume, such holdings above the statutory liquidity ratio (SLR) amounted to as much as Rs.1,00,000 crore, which is substantially higher than the net annual borrowings of the government.

Sixth, in addition to the changes in the monetary policy framework, targets and indicators, and the institutional context in which monetary policy is being conducted over the past five years, a major transformation has also taken place in the operating procedure of monetary policy. The reform of monetary and financial sectors has enabled the Reserve Bank to expand the array of instruments at its command.

The reliance on reserve requirements, particularly the cash reserve ratio (CRR), has been reduced as an instrument of monetary control. The CRR has been brought down, notwithstanding intra-year variations, from a peak of 15.0 per cent in 1994-95 to 8.0 percent in 2000-01. The objective of policy is to reduce CRR to its statutory minimum of 3.0 per cent over a period of time. The Statutory Liquidity Ratio has already been brought down to its statutory minimum of 25.0 per cent.

The liquidity management in the system is carried out through open market operations (OMO) in the form of outright purchases/sales of government securities and repo and reverse repo operations. The OMO are supplemented by access to the Reserve Bank's standing facilities and direct interest rate signals through changes in the Bank Rate/repo rates.

For transmitting signals of monetary policy, the Bank Rate was initially operationalised as a signaling and reference rate for influencing the interest rates in the economy. Interest rates on advances from the Reserve Bank were linked to the Bank Rate. Refinance/liquidity support at the Bank Rate and repo rates were intended to serve as a ceiling and a floor, respectively, setting an informal corridor for money market particularly the call money market to operate. In the context of the continued large market borrowing programme of the government, the Reserve Bank on occasions adopted a policy of strategically accepting private placement of government securities and then releasing those to the market at an appropriate time without putting undue pressure on interest rates.

In terms of further progress in the use of market-based instruments, a liquidity adjustment facility (LAF) was introduced in June 2000. The LAF enables the Reserve Bank to modulate short-term liquidity under varied financial market conditions in order to ensure stable conditions in the overnight (call) money market. The LAF operates through repo and reverse repo auctions thereby setting a corridor for the short-term interest rate consistent with policy objectives. The LAF operations combined with strategic open market operations consistent with market liquidity conditions has evolved as the principal operating procedure of monetary policy of the Reserve Bank. The next stage of development in this direction aims to move towards a full-fledged LAF by gradually removing/minimizing standing facilities, thus providing appropriate conditions for the Reserve Bank to exercise greater degree of freedom in providing a direction on interest rates to the market.

Seventh, the emerging linkages among money, government securities and foreign exchange markets require the Reserve Bank at times to use short-term monetary measures alongside intervention to arrest excessive volatilities in foreign exchange market. While there is no settled conclusion about the appropriateness of an exchange rate regime within the broad range of corner solutions of 'free float' and a 'currency board', in the present market determined exchange rate regime, the primary objective of the Reserve Bank continues to be the maintenance of orderly conditions in the foreign exchange market, meeting temporary supply-demand gaps which may arise due to uncertainties or other reasons, and curbing destabilizing and self-fulfilling speculative activities. To this end, the Reserve Bank monitors closely the developments in the financial markets at home and abroad and takes such measures, as it considers necessary from time to time.

The recent experience has highlighted the importance of building up foreign exchange reserves to take care of unforeseen contingencies, volatile capital flows and other developments, which can affect expectations adversely. The emerging economies have to rely largely on their own resources during external exigencies (or contagion) as there is no international "lender of last resort" to provide additional liquidity at short notice on acceptable terms. Thus, the need for adequate reserves is unlikely to be eliminated or reduced even if exchange rates are allowed to float freely. The overall approach to the management of India's foreign exchange reserves in recent years has reflected the changing composition of balance of payments, and has endeavoured to reflect the "liquidity risks" associated with different types of flows and other contingencies.

Finally, the gradual switchover to indirect market-based instruments in the conduct of monetary policy was made possible because of simultaneous efforts at developing various segments of the financial market, particularly money, foreign exchange and government securities market.

The increasing responsibility of the Reserve Bank of India in undertaking reform in the financial markets has to be seen essentially in the context of improving the effectiveness of the transmission channel of monetary policy. Development of financial markets has, therefore, encompassed regulatory and legal changes, building up of institutional infrastructure, constant fine-tuning in market microstructure and massive upgradation of technological infrastructure. An important achievement in this area was the amendment to the Securities Contracts Regulation Act, which clarified the regulatory jurisdiction of RBI over the money, government securities and forex segments of the financial market.

The money market is critical in facilitating the conduct of monetary policy and in improving the transmission mechanism. This requires the RBI to have greater control over the liquidity in the system, create an efficient mechanism to impart interest rate signals and undertake continuous refinements to money market instruments. The market for repo is being scientifically developed over a period through widening of participants and instruments, and by bringing uniformity in trading and accounting practices with the help of Fixed Income Money Market and Derivatives Association of India (FIMMDA). A Clearing Corporation has been proposed, so that repo operations could become efficient with adequate safeguards. Similarly, RBI has been closely nurturing the Treasury Bill market. It has increased the range of T-Bills over the years, modified the notified amounts and incorporated changes in the auction formats to suit the needs of the market. The efficacy of Commercial Paper and Certificates of Deposit has also been improved over the years with measures such as reduction in the minimum period and amount of issue, lock-in period, preferring dematerialised form, etc. The most important reform in the money market relates to the initiation of Liquidity Adjustment Facility (LAF). With the announcement of the second phase of LAF, the RBI has moved gradually from a system of segmented refinance to a more fungible system of liquidity adjustment at market related rates. Reform in the call money market has also been announced to make it purely interbank market, over a phased period.

In the Government Securities market, the borrowing programme of the Government has been systematised and rationalised with the establishment of cash and Debt Management Group consisting of officials from RBI and the Government and could be completed without destabilizing the financial markets. Changes have been incorporated in the formats of auction by combining both price-based and yield-based auctions, thereby improving the fungibility and liquidity and paving the way for the development of a market for STRIPS, elongating the maturity for debt, facilitating the emergence of benchmarks, etc. The institutional infrastructure has been strengthened by increasing the number of Primary Dealers and making them functionally stronger through imposition of capital adequacy norms and other prudential norms. PDs have been made more vibrant through careful modulation of responsibilities and facilities. Changes in valuation norms for banks' investment portfolio have been introduced and RBI has moved away from announcing the yield curve for government securities, which is now the responsibility of FIMMDA. Further development of the government securities market hinges on legal reforms proposed by RBI and completion of the technological upgradation process that has already commenced.

Measures initiated to integrate the Indian forex market with global financial system include permitting banks to fix their own position limits and aggregate gap limits, to borrow from and invest abroad up to 15 per cent of Tier I capital, and to arrange to hedge risks for corporate clients through derivative instruments. Given the lack of depth and liquidity in the forex market, the aim is to remove these imperfections.

A hallmark of the reform process in the financial markets is the consensus building, which is operationalised through inter-departmental working groups, inter-agency committees and Technical Advisory Committees at the formulation stages and Financial Markets Committee at the monitoring stage. The aim is to involve all the stakeholders in the formulation and implementation stages. Greater deregulation underscores the importance of closer monitoring of market developments by the regulator. This is institutionalised in the form of Financial Markets Committee (FMC) in the RBI, which meets daily before the opening of the markets and at times on more than one occasion, when situation warrants. The FMC reviews the liquidity and interest rate situation in financial markets and advises the top management on the course of action that would be required by RBI during the day. This institutionalized framework helps the RBI to take an integrated view on all important decisions having an impact on financial markets.

The presentation has not covered important areas relating to prudential regulation, supervision and credit delivery, though they do constitute very critical aspects of financial sector reform.

Features of the Policy

The Policy has to take into account the macro-economic and monetary developments of the previous year. Since last year, a separate detailed document is prepared on the subject, which is a highly recommended reading for serious analysts. This document was issued on April 19, 2001 along with the Statement of the Policy for 2001-02.

The statement itself explains in detail the developments in 2000-01 as well as the projections and outcomes for 2001-02. What is noteworthy is the nuance in the stance of monetary policy, which gives greater emphasis than in the past to (a) credit growth and revival of investment demand; and (b) the interest rate flexibility. This may be described as the contextual response at macro-policy level. At micro level, there are contextual measures such as those relating to urban cooperative banks, and exposure norms of banks to stock market

The second set of measures would emphasise the continuation of some reform aspects of policy. Changes are sought in the liquidity adjustment facility, call money market, repo market and export re-finance. The set of measures when fully implemented in the next two to three years would mean completion of the transition towards indirect instruments of monetary policy, and imparting greater effectiveness of monetary policy transmission. To illustrate, at present, banks get liquidity from non-banks and also from RBI. In fact, RBI is currently obliged to provide eligible amount of liquidity at predetermined rate which gives greater freedom to banks but correspondingly constrains the operations of RBI. Further, now intra-day liquidity cannot be handled by the RBI. The package of measures announced now would take care of these issues and carry the operating environment of monetary policy to international standards.

Similarly, in the area of institutional and technological infrastructure for financial markets, the full implementation of computerisation of Public Debt Office and operationalisation of Clearing Corporation during the course of the year represents culmination of medium term efforts to instill international standards. Incidentally, the modern forex clearing operations proposed in India are pioneering, outside of America and Europe, with Hong Kong becoming operational last year. There will be enormous savings in time and cost of intra bank forex transactions in India. Corporates, mutual funds etc. can operate in the repo market, i.e., access or provide collateralised liquidity for the very short term, with all safeguards. Money market operations need no longer be confined to Mumbai. This should certainly be cheered by Chennai!

The prescription that banks, Financial Institutions, Primary Dealers etc. should invest in CPs and other instruments only in demat form is a significant new measure which will virtually make all these markets into demat mode, thus ensuring safety for all including individual investors.

The movement towards competitive and deregulated interest rate regime has also been completed with linking of all lending rates to PLR of the concerned bank while PLR itself has been transformed into a benchmark rate. With this, the erstwhile non-transparent practices of circumventing PLR when it was a floor, as applied to creditworthy borrowers may end. Also, this gives greater scope for banks to meet emerging business cycles.

In the area of prudential standards, markets carry on impression that the level of Non Performing Assets is understated on account of 180-Day instead of 90-Day norm. This will be clarified once the position is crystallised as per international norm. However, to ensure smooth transition, sufficient time up to 2004 is given for banks to make appropriate provisions. This is a forward looking measure, and a change to meet global standards. Similarly, changes have been proposed in the measurement of capital for exposure purposes and in the level of exposure limit itself. These changes will also be applicable from a future date.

In the recent past, policy statements emphasised change in the role of RBI from being a micro regulator to concentrate on macro aspects. While that process of changing the role is almost complete, the current statement emphasises changing the functions of RBI. It sets the agenda for divesting itself of the functions as debt manager, as owner, and in some ways as regulator say of NBFCs or urban cooperatives and concentrate on monetary management.

There are several areas where progress is reported and further measures indicated, such as in the areas of technology, regulatory review, credit bureau, international financial standards and codes, legal reforms, debt recovery etc. Perhaps there is no need to elaborate these to this gathering.

Tasks ahead for Government

The current monetary policy has signalled important reforms which require changes in existing legislation or introduction of new laws. These include amendments to the Public Debt Act and introduction of Government Securities Bill (to provide flexibility in undertaking transactions in Government securities and facilitate retailing) amendments to the Reserve Bank of India Act (to bring about among other things greater flexibility in monetary policy operations by reducing the statutory

minimum for CRR/SLR, enable separation of debt management functions etc.); passage of Fiscal Responsibility Bill (to bring reasonable control over fiscal management), amendments to the State Bank of India (SBI) and other Acts governing public sector banks, National Housing Bank (NHB), National Bank for Agriculture and Rural Development (NABARD), and Industrial Development Finance Corporation (IDFC) Acts (to transfer ownership of these institutions from the RBI to the Government); a new Deposit Insurance and Credit Guarantee Corporation (DICGC) Act (to make it consistent with financial sector liberalisation); a separate Act for Non-Banking Financial Companies (NBFCs) (to provide enhanced protection to depositors of NBFCs); amendment to Banking Regulation Act (to encompass areas of security laws and regulatory framework of banking), amendment to Negotiable Instruments Act (to bring it in conformity with the Information Technology Act, 2000 to bring electronic cheque, securitised certificate and other evolving products within its ambit); enactment of Bill on asset securitisation (to create an enabling environment for market for asset securitisation).

Apart from legislative changes, an important aspect relating to the supervisory framework for Urban Cooperative Banks has been proposed. This would need to be pursued in consultation with the Central and State Governments.

Tasks ahead for the Reserve Bank of India

First, RBI has already forwarded the draft amendments to the various acts, which is under consideration of the Government. However, some further work may be needed from RBI also.

Second, the changes proposed in the financial sector will need follow-up actions by RBI. For instance, the move over to the second and third stages of LAF would need RBI to have a greater fix on the liquidity in its system. RBI is already formalising a short-term liquidity model, which should provide important inputs to its decision making. This would be all the more critical in the next stage.

Third, on the operational side, RBI would need to be prepared to advance the timing of the auction process under LAF as also be prepared with its systems to conduct discriminatory price auctions under LAF and uniform price auctions with regard to dated securities.

Fourth, further progress in reform in the financial markets depends on the commencement of operations by the Clearing Corporation and maintaining the time schedule for the Negotiated Dealing System, Real Time Gross Settlement system and computerisation of Public Debt Office. RBI would need to closely monitor to ensure timely implementation.

Fifth, although the Regulations Review Authority has ceased its operations, RBI has decided to make the review exercise an integral part of the system by putting in place an alternate mechanism. RBI should ensure that the new arrangements are in place quickly to continue with the work of the erstwhile RRA both in letter and same spirit.

Sixth, apart from this, the progress by the various Committees in RBI relating to the move towards risk based supervision, macro-prudential indicators etc. will have to be hastened.

Seventh, follow-up actions on the work by the Advisory Groups on international standards and codes may be designed in close consultations with the Chairmen concerned.

Finally, keeping abreast with international developments in financial markets as also coping with the dynamics of liberalisation within our country would require continued upgradation of skills of personnel within the RBI.

Tasks ahead for market participants

The monetary policy has bestowed greater flexibility and ushered in a more competitive environment among market participants.

First, banks and Primary Dealers (PDs) should prepare themselves for Stage II of LAF where one-third of the liquidity support normally available to them at fixed rate of interest would now be available at market rate.

Second, with the reform in the call money market having been announced, banks and non-banks should position themselves for a changed environment. While the total liquidity in the money market would not reduce, the composition between collateralised and non-collateralised liquidity would alter resulting in a new set of dynamics. Hence, new counter-party limits would need to be put in place. In

fact, with the operationalisation of Clearing Corporation, the liquidity would improve since more participants and more instruments would be eligible to participate.

Third, with rationalisation in the Primary Lending Rate (PLR) norms and more flexibility in fixed deposit maturity and other terms such as premature withdrawal and interest on overdue deposits, the competition among banks could intensify, which would require banks to be more proactive, improve their infrastructure and operational efficiency as also enhance human skills. Corporates will also have greater incentive to improve their ratings as better corporates would be able to acquire bank loans at finer rates.

Fourth, the move to 90-Day norm for Non Performing Assets (NPAs) for banks and 180-Day norm for Financial Institutions (FIs) would require changes in the interest rate resets and implicitly alterations in systems and procedures. This would require greater credit discipline on the part of corporates regarding repayment of loans as servicing of loans assumes greater importance.

Fifth, many of the changes in prudential regulations that have been announced, viz., credit exposures, consolidated accounting and supervision, move to the new Basel Capital Accord, move towards risk based supervision etc. would need banks to initiate steps to ensure that they are geared to adopt these changes. This would involve substantial upgradation to the existing MIS, risk management practices and procedures and technical skills of staff.

Tasks ahead for working groups

Progress in policy, especially on structural issues involve significant background technical work done within the RBI well before articulating them in a Policy Statement or before embarking on consultations with market participants or other stakeholders. It may be of interest to many observers that the RBI is contemplating working groups or initiation of work on technical papers on some subjects. These relate to (a) directed lending; (b) current account facility; (c) clearing and settlement system and (d) regulatory and supervisory arrangements, and (e) lenders obligations and liability.

Directed lending

While there are widespread reservations about directed lending, in a developing country like India, there is need for some sort of directed lending, especially to agriculture, small-industry and export sector. No doubt, directed lending is not the same as subsidised lending. The current stipulations regarding lending to the above sectors have evolved incrementally resulting in discrimination between foreign and public sector banks; incentive incompatibility due to possibility of making up for shortfall through NABARD, Small Industries Development Bank of India (SIDBI), etc.; and wide interpretation of directed lending to include investments. It is proposed to prepare a technical paper analysing the current situation, the problems and prospects.

Rationalisation of current account facility

At present, current account facility in RBI is extended to banks for the purpose of meeting their statutory obligations, settlement of transactions with RBI/Government and inter-bank transactions. Besides banks, non-banks like insurance companies, mutual funds, primary dealers, National Securities Clearing Corporation Ltd. etc., are also extended current account facility for such purposes as same day settlement as well as use of funds on the same day for call money transactions and facilitating development of the government securities market. However, in the context of the recommendations of the Technical Group on phasing out of non-banks from call/notice money market, the setting up of Clearing Corporation and the proposed opening up of membership of INFINET to all institutions which are maintaining current account and/or SGL account with RBI, it is felt that the present policy of current account facility needs a review. Accordingly, a Working Group has been set up by the RBI to examine the issues of rationalisation of current account facility provided by the RBI. The Group, inter alia, would examine the objectives and practices in regard to extension of current account facility, study international practices and make suitable recommendations.

Clearing and settlement system

Recognising the importance of clear-cut legal framework to govern payments system, RBI's proposals for amendment to Reserve Bank of India Act, 1934 include empowerment of the Bank with appropriate

regulatory and supervisory powers in respect of payments and settlement system in the country. The amendments, once approved will provide the necessary legal framework consistent with emerging complexities and technological developments in such systems globally. More recently, the Advisory Group on Payment and Settlement System (Chairman: Shri M.G. Bhide) which examined the existing status of major systemically important payment systems in the country has also recognised a number of shortcomings, including lack of a well-founded legal framework and absence of risk management system in our Clearing House operations.

Without prejudice to these developments, it is felt necessary to consider several operational aspects. Thus, existing arrangements relating to eligibility norms for admission of new members/sub-members into the Clearing House, level of cash/market value of securities to be maintained as collateral with the RBI by the members to ensure safety of settlement etc., need a thorough review to safeguard the integrity of payment system. Hence, it has been decided to constitute a Working Group to evolve suitable criteria for membership and recommend appropriate prudential safeguards including risk management systems for Clearing House operations. The Working Group will, inter alia, include select members of the Clearing House under the aegis of the RBI and will submit its report in three months.

Review of regulatory and supervisory arrangements

World over, financial innovations, technological development and blurring of distinction between financial institutions have resulted in increasing integration of financial services and markets. Technical advances have also resulted in accelerated pace of innovations and complexities in financial products besides the multi-fold increase in volumes and turnover. Indian financial system is catching up fast with these developments in the post-reform period. The regulatory regimes and supervisory systems in the changing environment face new challenges in safeguarding the integrity, efficiency, soundness and stability of the financial system. This calls for a study of the regulatory and supervisory arrangements. In India, the regulatory and supervisory arrangements have been rendered complex in view of the existence of various types of financial intermediaries with differing charters owing their origins to pre-reform plan strategies.

Currently, institutions that are broadly under the regulatory ambit of Reserve Bank fall in the following categories. (a) Public sector banks which are governed by statutes with close involvement of Government though regulated by RBI. (b) Foreign banks, which are registered as branches and private banks incorporated under Companies Act and regulated by RBI. (c) Urban Cooperative banks, both scheduled and non-scheduled, which are under dual regulation of RBI and the State Governments/Central Government. (d) Non-banking financial companies incorporated under Companies Act which have been recently brought legally within RBI's regulatory framework. Housing Finance companies, however, are regulated and supervised by National Housing Bank. (e) Regional Rural Banks and State and District Central Co-operative Banks, which are regulated by RBI, supervised by NABARD and additionally by Central Government and State Governments; and (e) Development Financial Institutions, some of which are under statute and some under Companies Act, which had been under Government control till recently. RBI has of late brought them to some extent within its regulatory and supervisory ambit.

Both the Madhava Rao Committee and the Capoor Committee had addressed issues of regulation relating to co-operative banks; but, several legislative actions are still to be initiated. Within the financial sector, concerns about systemic risk tend to focus on banks particularly in view of their role in the payments and settlement system. The regulatory oversight should, therefore, duly take into account the role of the financial institutions in the payments system, which is the backbone for an efficient financial system. In addition, the regulatory regime should also recognise the functional orientation and governance structures of different types of institutions. In this context, it will be possible to categorise the financial intermediaries under RBI's regulatory and supervisory umbrella into three categories. First, scheduled banks including cooperative banks that are part of the payment system. Second, commercially-oriented financial intermediaries, i.e., NBFCs and DFIs which have to be regulated keeping in view primarily the protection of depositors' interests and to some extent systemic implications in regard to larger entities. Third, cooperatives which are large in number with some hierarchic structures and widely dispersed and, essentially meant to cater to local areas which need to be regulated essentially to ensure protection of members'/depositors' interests, unless they happen to be scheduled banks. It is proposed to work on a technical paper covering various aspects keeping in view the complexities indicated above and the existing arrangements.

Lenders obligations and liability

While there has been significant attention to the problem of credit recovery and wilful default and diversion of funds by borrowers, especially by large borrowers, sufficient attention has not been paid to the problems that small and medium borrowers face in their relations with lending entities. It is, therefore, considered necessary to prescribe the obligations and liability of lenders, particularly in terms of transparency, notice, confirmation, service, etc. It is proposed to study international practices and obtain views of commercial banks and other interested parties to help formulate its technical paper and parameters for an appropriate legislation.

Conclusion

In conclusion, I have deliberately chosen a place other than Mumbai for explaining these developments since I believe that this policy has the potential to truly integrate different centres of the country through the technological and institutional measures contemplated.