3

Monetary and Banking Developments

The stance of monetary policy as announced by the Reserve Bank of India (RBI) in its annual policy statement for 2004-05 was (i) to ensure the provision of adequate liquidity to meet credit growth and support investment and export demand in the economy while keeping a very close watch on the movements in the price level and (ii) consistent with the above, while continuing with the *status quo*, to pursue an interest rate environment that is conducive to maintaining the momentum of growth and macroeconomic and price stability. The RBI faced two main challenges in the conduct of monetary policy during the current year. The first was a liquidity overhang of over Rs. 81,000 crore from the previous year. The sharp increase in reserve money in the previous year on account of large capital flows further complicated the problem of liquidity. The second related to an acceleration in the inflation rate beyond about 5.0 per cent anticipated at the time of annual policy formulation on the assumption of no significant supply shocks and appropriate management of liquidity. Headline inflation, as measured by the wholesale price index (WPI), touched a high of 8.7 per cent by end-August 2004.

3.2 Taking the two challenges into account, the RBI, in its mid-term review in October, 2004, announced that its overall monetary policy in the second half of 2004-05 would be (i) to ensure provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability, (ii) consistent with the above, to pursue an interest rate environment that is conducive to macroeconomic and price stability, and maintaining the momentum of growth, and (iii) to consider measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations. During the year, the RBI took monetary measures from time to time in response to the evolving situation. The RBI addressed the problem of liquidity overhang through the use of Market Stabilisation Scheme (MSS) and Liquidity Adjustment Facility (LAF). For enabling the RBI to effectively deal with the problem of liquidity overhang, the limit under MSS was raised from Rs. 60,000 crore to Rs. 80,000 crore on August 26, 2004, after the threshold limit of Rs. 50,000 crore was crossed. Liquidity absorption through MSS amounted to Rs. 54,499 crore as on January 28, 2005.

3.3 The RBI discontinued the auction of 7-day and 14-day reverse repo with an overnight fixed rate repo and reverse repo from November 1, 2004,[1] taking into account the bunching of liquidity due to 7-day minimum tenure of LAF repo. This facilitated management of liquidity in a more flexible manner. In September 2004, on review of liquidity conditions, the Reserve Bank announced raising of the cash reserve ratio (CRR), in two stages, by 50 basis points to 5.0 per cent. This reduced the liquidity in the banking system by over Rs.9,000 crore. The

[1] The RBI has switched over to the international usage of the terms ‘repo’ and ‘reverse repo’ effective from October 29, 2004. As per the international usage, absorption of liquidity by the RBI is termed as ‘reverse repo’ and injection as ‘repo’. (Prior to October 29, 2004 absorption of liquidity was termed as ‘repo’ and injection as ‘reverse repo’).

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decision to increase the CRR was partly for absorbing excess liquidity in the system, but more importantly for moderating the inflationary expectations by reiterating the importance of stability in financial market conditions. In addition, the slow-down in capital inflows during the current year and a higher credit demand helped in bringing down the excess liquidity.

3.4 A noticeable development in the current year relates to a significant increase in the flow of bank credit to the commercial sector. The pick up in non-food credit witnessed since the second half of 2003-04 not only continued but accelerated through the current year. During the current year, market borrowings by the Central Government remained at a lower level. Up to January 21, 2005, the Government's net market borrowings, through issuances of dated securities, were lower at Rs. 65,684 crore, including an amount of Rs. 25,000 crore raised under MSS, as compared to Rs. 91,816 crore raised in the corresponding previous period, reflecting pre-payment of high cost loans by States under the debt-swap scheme.

Monetary trends and developments

Broad money (M_3)

3.5 The annual policy statement for 2004-05 of the RBI (May 18, 2004) placed the growth of broad money (M_3) for 2004-05 at 14.0 per cent, consistent with the expected growth and inflation rate. Although the current year started with a high M_3 growth of 16.6 per cent in the previous year, the growth rate over March 31, 2004 decelerated rapidly, and was 9.7 per cent (net of conversion, 9.5 per cent)[2] in the current year up to January 21, 2005, considerbly below 12.1 per cent in the corresponding previous period. M_3 growth on a year-on-year basis, net of conversion effect, as on January 21, 2005, was 13.9 per cent, almost the same as on the corresponding date last year.

3.6 All the major components of M_3, viz., currency with the public, demand and time deposits with banks registered a lower growth in the current fiscal up to January 21, 2005 as compared to the previous year. Among the sources, growth of M_3 in the current year was largely driven by bank credit to the commercial sector and net foreign exchange assets (NFA) of the banking sector. Bank credit to the commercial sector registered a significant increase of 20.4 per cent (net of conversion, 17.2 per cent) in the current year (up to January 21, 2005) compared to 7.9 per cent in the corresponding period last year. Bank credit contributed 10.4 percentage points to the growth of M_3 in the current year. Though the growth of NFA of the banking sector was lower at 13.6 per cent in the current year compared to 28.0 per cent in the corresponding period last year, it still contributed 3.6 percentage points to the growth of M_3 (Table 3.1).

Reserve money (M_0)

3.7 During the current financial year up to January 28, 2005, reserve money grew at a lower rate of 6.4 per cent as compared to 7.8 per cent in the corresponding previous period. This was mainly on account of the lower growth in currency in circulation of 9.0 per cent, down from 11.8 per cent last year. The year-on-year growth of reserve money as on January 28, 2005 was 16.7 per cent compared to 14.1 per cent on the corresponding date last year. In recent years, there has been a significant shift in the sources of reserve money. Net RBI credit to the Government, which drove reserve money growth till 2000-01, has ceased to be an important factor in determining reserve money growth. With large capital flows into the country, NFA of RBI has emerged as the main determinant of reserve money growth. In the current year so far, the RBI's NFA grew by 15.9 per cent on top of a 32.8 per cent growth in the corresponding previous period. Despite its lower growth, NFA contributed 17.7 percentage points to the growth of reserve money in the current year. In contrast, net RBI credit to the Government after declining by 66.9 per cent in the previous year, declined

[2] Net of conversion of a non-banking entity into a banking entity from October 11, 2004.

Table 3.1 : Sources of change in money stock (M_3)

Items	Outstanding balances as on March 31, 2004	January 21, 2005	Variations during Mar. 31 2003 to Mar. 31 2004	Mar. 31 2003 to Jan. 23 2004	Mar. 31 2004 to Jan. 21 2005	Jan. 24 2003 to Jan. 23 2004	Jan. 23 2004 to Jan. 21 2005	Mar. 31 2003 to Mar. 31 2004	Mar. 31 2003 to Jan. 23 2004	Mar. 31 2004 to Jan. 21 2005	Jan. 24 2003 to Jan. 23 2004	Jan. 23 2004 to Jan. 21 2005
1	2	3	4	5	6	7	8	9	10	11	12	13
					Rs. crore					*Percent*		
I. M_1 (Narrow Money)	576651	614759	103071	54258	38108	74640	86921	21.8	11.5	6.6	16.5	16.5
II. M_3 (Broad Money) (1+2+3+4)	2003102	2196876 (2193307)	285143	208064	193774 (190204)	232272	270853 (267285)	16.6	12.1	9.7 (9.5)	13.7	14.1 (13.9)
1. Currency with the public	315493	346930	43912	34600	31437	40711	40749	16.2	12.7	10.0	15.3	13.3
2. Demand deposits with banks	256039	262382	57282	19436	6343	33137	44189	28.8	9.8	2.5	17.9	20.3
3. Time deposits with banks	1426451	1582117 (1578548)	182072	153806	155666 (152096)	157632	183932 (180363)	14.6	12.4	10.9 (10.7)	12.7	13.2 (12.9)
4. "Other" deposits with RBI	5119	5447	1877	222	328	792	1983	57.9	6.8	6.4	29.6	57.2
III. Sources of change in money stock (M_3)	2003102	2196876	285143	208063	193774	232273	270854	16.6	12.1	9.7	13.7	14.1
1. Net bank credit to Governemnt (A+B)	745499	753387 (741194)	68976	47785	7888 (-4305)	76688	29079 (16885)	10.2	7.1	1.1 (-0.6)	11.8	4.0 (2.3)
A. RBIs' net credit to Governent	44908	14187	-75771	-68270	-30721	-55414	-38222	-62.8	-56.6	-68.4	-51.4	-72.9
(i) Central Govt.	36920	11023	-76064	-64734	-25897	-53863	-37227	-67.3	-57.3	-70.1	-52.7	-77.2
(ii) State Govts.	7988	3164	293	-3536	-4824	-1551	-995	3.8	-46.0	-60.4	-27.2	-23.9
B. Other banks credit to Government	700591	739200	144747	116055	38609	132102	67301	26.0	20.9	5.5	24.5	10.0
2. Bank credit to commercial sector (A+B)	1017902	1225825 (1193142)	118922	71042	207923 (175240)	111346	255803 (223121)	13.2	7.9	20.4 (17.2)	13.0	26.4 (23.0)
A. RBIs' credit to commercial sector	2061	1890	-987	-983	-171	-861	-175	-32.4	-32.3	-8.3	-29.4	-8.5
B. Other banks' credit to commercial sector	1015841	1223935	119909	72025	208094	112207	255978	13.4	8.0	20.5	13.1	26.4
3. Net foreign exchange assets of the banking sector	526586	598123	132871	110072	71537	112358	94336	33.7	28.0	13.6	28.7	18.7
4. Government's currency liabilities to the public	7296	7374	225	209	78	288	94	3.2	3.0	1.1	4.1	1.3
5. Banking sector's net non-liabilities other than time deposits	294181	387833	35851	21045	93652	68407	108458	13.9	8.1	31.8	32.4	38.8
Memorandum Items												
1. Money Multiplier (M_3)	4.59	4.85										
2. Velocity of Money	1.48											
3. Net domestic assets	1476516	1598753	152272	97992	122237	119914	176517	11.5	7.4	8.3	9.2	12.4
4. Net domestic credit	1763401	1979212	187898	118827	215811	188034	284882	11.9	7.5	12.2	12.5	16.8

Note: 1. All figures are provisional. RBI data relate to end March after closure of Government accounts. Variations in respect of scheduled commercial banks (SCBs) are based on data for last reporting Friday of March. SCBs time deposits include Rs17, 945 crore on account of procedes from RIBs (Resurgent India Bonds), since August 28,1998 and Rs 25, 662 crore from India Millennium Deposits (IMDs) since November 17, 2000.

2. Figures within bracket are net of conversion of IDBI into bank.

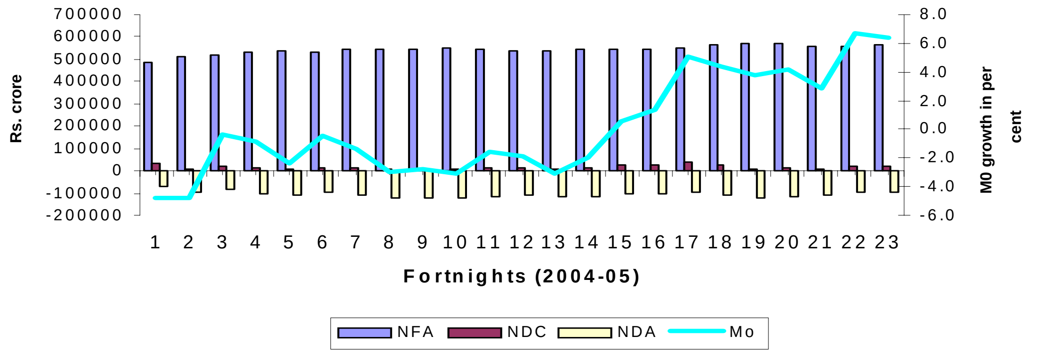
Table 3. 2 : Components and sources of reserve money

Items	Outstanding balances as on		Variations during					Percentage variations				
	March 31,	Jan 28,	2003-04	Financial far		Year-on-year		Full Year	Financial year so far		Year-on-year	
	2004	2005		2003-04	2004-05	2003	2004	2003-04	2003-04	2004-05	2003	2004
1	2	3	4	5	6	7	8	9	10	11	12	13
A. Components of reserve money	436512	464350	67451	28957	27838	49239	66332	18.3	7.8	6.4	14.1	16.7
a. Currency in circulation	327028	356358	44555	33452	29330	42871	40434	15.8	11.8	9.0	15.7	12.8
b. Bankers' deposits with RBI	104365	103590	21019	-5286	-775	5465	25531	25.2	-6.3	-0.7	7.5	32.7
c. "Other" deposits with RBI	5119	4401	1877	791	-718	904	368	57.9	24.4	-14.0	28.9	9.1
B. Source of reserve money												
1. Net RBI credit to Govt.	44907	13530	-75772	-80758	-31377	-68399	-26391	-62.8	-66.9	-69.9	-63.1	-66.1
2. RBI credit to banks	5420	6092	-1741	-3310	673	-2681	2242	-24.3	-46.2	12.4	-41.1	58.2
3. RBI credit to comm. sector	2061	1390	-987	-982	-672	-873	-677	-32.4	-32.2	-32.6	-29.7	-32.8
4. Net foreign exchange assets of RBI	484413	561595	126169	117599	77182	124166	85752	35.2	32.8	15.9	35.3	18.0
5. Government's currency liabilities to the public	7296	7374	225	200	79	288	94	3.2	3.0	1.1	4.1	1.3
6. Net non-monetary liabilities of RBI	107585	125632	-19557	3802	18047	3261	-5312	-15.4	3.0	16.8	2.6	-4.1
Memo items:												
(i) Net domestic assets of RBI	-47901	-97245	-58719	-88642	-49344	-74927	-19420	-542.8	-819.4	103.0	2585.5	25.0
(ii) Net domestic credit by RBI	52388	21012	-78500	-85049	-31376	-71953	-24826	-60.0	-65.0	-59.9	-61.1	-54.2

further by 69.9 per cent in the current year (Table 3.2).

3.8 The progressive shift in the relative importance of the sources of reserve money in favour of NFA became more distinct in 2003-04 with NFA actually exceeding reserve money. The share of NFA in reserve money, which had increased from 9.1 per cent at end-March 1991, to 78.1 per cent at end-March, 2002, increased further to 111.0 per cent at end-March 2004. There was a corresponding decline in the share of net RBI credit to the Government, from over 101 per cent at end-March, 1991 to 45.0 per cent at end-March, 2002 and further to 10.3 per cent at end-March, 2004. Currently, it is 2.9 per cent. The substantial reduction in the share of net RBI credit to Government in recent years can be mainly attributed to sustained open market operations (OMOs) including repo operations under the LAF, sterilisation of foreign currency flows and large build up of cash balances by the Central Government in 2003-04 on account of disinvestment proceeds, large repayment of loans by States under the Debt Swap Scheme and higher mobilisation under savings bonds (Figure 3.1).

Fig. 3.1 **Trends in reserve money, NFA and NDA**



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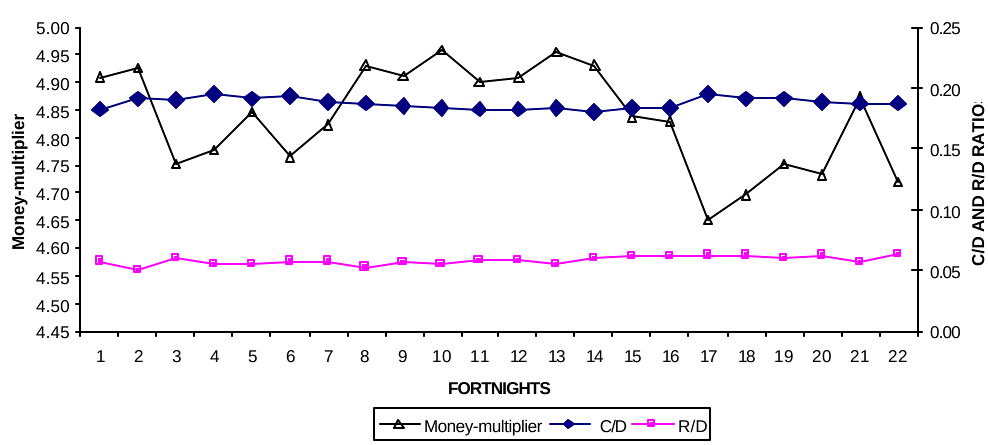
3.9 Changes in the relative importance of sources of reserve money have important implications as pointed out in the Annual Report of the RBI for 2003-04. Firstly, a higher share of foreign exchange assets relative to that of domestic assets in the balance sheet of a central bank strengthens its credibility in conducting monetary policy and exchange market operations. Secondly, monetisation of capital flows, by adding directly to bank liquidity, amplifies the process of credit creation. The rise in NFA, while imparting credibility to monetary management, has raised a few concerns relating to market risk in the event of a sharp appreciation in the rupee, quasi fiscal costs associated with sterilisation of foreign capital flows, and sustaining these operations over time.

3.10 The money multiplier, the ratio of broad money to reserve money, in recent years, has shown fluctuating trends. The money supply multiplier varies inversely with the policy-determined reserve-deposit ratio and the currency-deposit ratio endogenously determined by the public. The money multiplier increased from 4.43 at end-March 2002 to 4.65 at end-March 2003 and then declined to 4.59 at end-March 2004. During the current financial year (up to January 21, 2005), money multiplier varied between 4.96 (August 6, 2004) and 4.65 (November 12, 2004). As on January 21, 2005, this ratio stood at 4.72 compared to 4.77 on the corresponding date a year ago. The decline in the money-multiplier, despite a decline in currency-deposit ratio to 0.1881 (January 21, 2005) from 0.1894 (January 23, 2004), with the people increasingly going for more deposits than currency, was due to an increase in the reserve-deposit ratio from 0.0521 last year to 0.0554 in the current year. The increase in the reserve-deposit ratio was partly on account of an increase in CRR by RBI and as a deliberate policy decision by banks to hold excess reserves with the RBI (Figure 3.2).

Liquidity management

3.11 Liquidity management operations in 2004-05 had to cope with the sharp increase in reserve money in the previous year emanating largely from build-up of excess cash balances by commercial banks towards the end of the year, particularly in the last week of March, 2004. Another problem in liquidity management in the current year was the carry forward of excess liquidity amounting to Rs.81,000 crore from the previous year. The Government and the RBI have been taking appropriate steps to address the concerns emanating from large capital flows. The RBI has been moderating the impact of capital flows through open market sale of Government securities held by it and through repo operations under the LAF. The depletion of the

Fig. 3.2 **Trends in money multiplier, currency-deposit ratio and reserve-deposit ratio**



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stock of Government securities held by the RBI from Rs.1,16,444 crore at end-March, 2003 to Rs.44, 217 crore at end-March, 2004 constrained the OMOs of the RBI. As reported in the Economic Survey 2003-04, MSS was introduced effective April 1, 2004 to augment the stock of Government securities held by the RBI. The ceiling of Rs.60,000 crore fixed for raising treasury bills and dated securities under MSS for the year 2004-05 was raised to Rs.80,000 crore on August 26, 2004, when the amount raised under MSS crossed the threshold limit of Rs.50,000 crore. Liquidity absorption through MSS was Rs. 54,499 crore as on January 28, 2005.

3.12 The RBI had put in place a revised LAF scheme effective March 29, 2004 consisting of i) 7-day fixed rate reverse repo conducted daily, and ii) overnight fixed rate reverse repo conducted daily on weekdays, and iii) repo auction on overnight basis at a fixed rate and gradual phasing out of the extant 14-day repo. In its mid-term review of the annual policy statement for 2004-05 (October 26, 2004), the RBI introduced further changes in the LAF scheme to enhance its effectiveness and to facilitate liquidity management in a flexible manner. These changes relate to operating LAF scheme with overnight fixed rate repo and reverse repo and discontinuation of 7-day and 14-day reverse repo from November 1, 2004. The RBI increased the fixed reverse repo rate by 25 basis points to 4.75 per cent from October 27, 2004.

3.13 The spread between reverse repo and repo rates was reduced from 150 basis points to 125 basis points from October 27, 2004 to maintain the fixed repo rate unchanged at 6.0 per cent. The interest rate on eligible CRR balances was de-linked from the Bank Rate and was reduced to 3.5 per cent. With the operationalisation of MSS, the daily volumes under LAF have come down drastically. Though RBI has been absorbing liquidity under MSS and LAF to address the problem of overhang of liquidity, there have been occasions in recent months when RBI injected liquidity through the LAF window, indicating situations of occasional strains in liquidity in the banking system on account of a significant increase in domestic credit. The outstanding occasional injection of liquidity touched a peak of Rs.17,235 crore on November 18, 2004. Excess liquidity sterilised as on January 28, 2005 was about Rs. 69,259 crore, with Rs. 54,499 crore sterilised under MSS and Rs. 14,760 crore absorbed under LAF. In addition, surplus balances in the Central Government account with the RBI also helped in sterilising excess liquidity from time to time.

Monetary and credit policy

3.14 In India, while the basic objectives of monetary policy, namely, price stability and adequate credit flow to the productive sectors of the economy, have remained the same, the operating environment has changed significantly. As pointed out in the RBI's Report on Currency and Finance 2003-04, there is an increasing focus on the maintenance of financial stability in the context of better linkages between various segments of the financial markets including money, Government securities and forex markets. Managing the capital flows has emerged as an important concern of monetary policy. The phasing out of adhoc treasury bills and their automatic monetisation in 1997 imparted a lot of flexibility to the RBI in monetary management. Simultaneously, however, reserve flows through the balance of payments and increase in the prices of crude petroleum in the international markets have posed new challenges for monetary policy. As indicated earlier, in the current year, the two major constraints facing monetary management were carry forward of excess liquidity of over Rs.81, 000 crore from the previous year and rise in inflation following the rising international prices of petroleum crude.

3.15 The annual policy statement for 2004-05 had placed the growth of GDP in 2004-05 in the range of 6.5 to 7.0 per cent, on the assumption of sustained growth in industrial sector, normal monsoon and good performance of exports. On the assumption of no significant supply shocks and appropriate management of liquidity, inflation rate in 2004-05, on a point-to-point basis, was placed at around 5.0 per cent.

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3.16 M_3 in 2004-05 is projected to expand by 14.0 per cent. Non-food credit adjusted for investment in commercial paper, shares/ debentures/bonds of public sector undertakings (PSUs) and private corporate sector was projected to increase by 16.0 to 16.5 per cent in the annual policy statement of May 2004. This magnitude of credit expansion was expected to adequately meet the credit needs of all the productive sectors of the economy.

3.17 Contrary to the assumptions underlying the annual policy statement for 2004-05, the south west monsoon turned out to be deficient by 13 per cent in the current year. There was a surge in inflation following the rise in international oil and metal prices. The carry forward of liquidity compounded matters. With a view to addressing these issues, the RBI increased the CRR by 50 basis points, in two stages, to 5.0 per cent, thus bringing down the liquidity in the banking system by about Rs. 9,000 crore. The interest rate on eligible CRR balances was de-linked from the Bank Rate and was reduced to 3.5 per cent per annum. The Government of India raised the ceiling of MSS from Rs. 60,000 crore to Rs. 80,000 crore on August 26, 2004 to enable the RBI to effectively deal with the problem of overhang of liquidity. As the inflation was supply induced, the Government also reduced the duty rates on petroleum products twice in the year 2004-05.

3.18 Taking the above developments into account, the RBI in its mid-term review of the annual policy statement for 2004-05 (October 26, 2004), revised its GDP growth projection in 2004-05 from a range of 6.5 to 7.0 per cent to 6.0 to 6.5 per cent. Inflation projection on a point to point basis was raised upwards to 6.5 per cent from around 5.0 per cent projected earlier. RBI has not effected any change in its earlier projection of M_3 and aggregate deposit target of commercial banks. Considering credit growth in the first half, the projection of adjusted non-food bank credit has been revised to 19.0 per cent from 16.0 to 16.5 per cent projected earlier. The mid-term review increased the fixed reverse repo rate by 25 basis points under the LAF to 4.75 per cent from October 27, 2004. The mid-term review also proposed a switch over to the international usage of the terms repo and reverse repo effective October 29, 2004. In the mid-term review, RBI proposed reduction in the spread between the reverse repo rate and repo rate by 25 basis points from 150 basis points to 125 basis points. Accordingly, the fixed repo rate under LAF will continue to remain at 6.0 per cent. The RBI has continued with its policy of active demand management of liquidity through OMOs, including the LAF, MSS and CRR, and using the policy instruments at its disposal flexibly, as and when the situation warrants consistent with the objective of price stability. At the same time, RBI has also been ensuring adequate liquidity in the system so that all legitimate requirements of credit to maintain the growth momentum are met. The other important policy initiatives announced in the mid-term review relate to raising the ceiling on NRE interest rates, reduction of tenure of domestic term deposits, dispensing with the restrictive provisions of service area approach for delivery of agricultural credit, and measures for improving credit delivery to agriculture and small-scale industry (SSI) sectors (Box 3.1).

Interest rates

3.19 The RBI has been following a policy stance of imparting flexibility to the interest rate structure. Concerned over the downward rigidity of lending rates, even while deposit rates were coming down, RBI advised banks to announce their benchmark prime lending rates (BPLRs) based on their actual cost of funds, operating expenses and a minimum margin to cover regulatory requirement. In response to this policy directive, all banks put in place a system of BPLRs in 2003-04. The BPLRs of five major banks are lower by 25 to 50 basis points in December, 2004 compared to the rates prevailing a year ago. During the current year, there has been a marginal firming up of deposit rates by 25 basis points. Interest rates on housing loans have firmed up marginally in the current year for banks. Call money rates firmed up from the second half of the year, reflecting lower liquidity on account of large increase in bank credit. The Bank Rate remained unchanged at 6.0 per cent in the

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Box 3.1: Annual policy statement 2004-05

A: Annual policy statement (May 18, 2004)

- Bank rate kept unchanged at 6.0 per cent.
- Repo rate kept unchanged at 4.5 per cent.
- Revised LAF scheme operationalised.
- The entire amount of export credit refinance to banks and liquidity support to primary dealers made available at the reverse repo rate.
- Almost all commercial banks have adopted the new system of BPLR and the rates are lower in the range of 20-200 basis points from their earlier PLRs
- Banks advised to put in place comprehensive and rigorous risk assessment to relate pricing of credit to risk more appropriately.
- Recommendations of the interim Report of Vyas Committee accepted for implementation in respect of: (a)loans for storage facilities under priority sector lending, (b) securitised agricultural loans as priority sector lending, (c) waiving margin/security requirement for certain agricultural loans up to a limit, (d) NPA for crop loans aligned to crop seasons.
- Micro-finance institutions not to be permitted to accept public deposits unless they comply with the extant regulatory framework of the Reserve Bank.
- Development of mechanism for debt restructuring for medium enterprises on the lines of corporate debt restructuring.
- Definition of infrastructure lending broadened to include: (i) construction relating to projects involving agro-processing and supply of inputs to agriculture, (ii) construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality; and (iii) construction of educational institutions and hospitals.
- Working group constituted for Credit Enhancement by State Governments for financing infrastructure.· Gold Card Scheme for exporters drawn-up.
- To rationalise structure of regional rural banks various options under consideration of the Government and other stakeholders. Vyas committee is also looking into these aspects.
- Limit on the lending of non-bank participants in the call/notice money market reduced to 45 per cent effective June 26, 2004.
- Automated value free transfer of securities between market participants and the CCIL facilitated. The ECB limit enhanced to US$ 500 million under automatic route with minimum average maturity of 5 years. End-use for ECBs enlarged to include overseas direct investment in Joint Ventures/Wholly Owned Subsidiaries to enable them to become global players.
- Resident individuals already permitted to remit freely up to US$ 25,000 per calendar year for any current or capital account transaction.
- Indian corporates and partnership firms allowed to invest overseas up to 100 per cent of their net worth.
- Banks allowed to float long-term bonds to finance infrastructure.
- The extant limit on unsecured exposures for banks withdrawn.
- With effect from April 1, 2005 exposures on all Public Financial Institutions (PFIs) to attract a risk weight of 100 per cent.
- Banks required to maintain capital charge for market risk in respect of securities held for trading by March 31, 2005.
- Banks would be required to maintain capital charge for market risk in respect of the securities included under available for sale category by March 31, 2006.
- Banks to draw a road map for moving towards Basel II by December 31, 2004.
- Banks to make higher provisioning for NPAs in “doubtful more than three years” category.
- Risk based supervision extended to more banks.
- RBI expects most commercial banks to join the RTGS system by June 2004.
- Single window services for all transactions in RBI cash department.
- Operationalisation of On-line Tax Accounting System by June 2004.

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B: Mid-term review (October 26, 2004)

- Bank rate kept unchanged at 6 per cent.
- Switching over to the international usage of the term repo and reverse repo from October 29, 2004.
- Fixed reverse repo rate under LAF increased by 25 basis points to 4.75 per cent from October 27, 2004. The spread between the repo and reverse repo rate reduced by 25 basis points to 125 basis points. Accordingly, the repo rate to remain at 6.0 per cent.
- LAF to be operated with overnight fixed rate repo and reverse repo. Accordingly, auctions of 7-day and 14-day reverse repo discontinued.
- With a view to aligning interest rates with international rates, interest rates on Non-Resident (External) Rupee (NRE) deposits raised to US Dollar LIBOR/SWAP rates of corresponding maturities plus 50 basis points.
- Fixation of ceiling on interest rates on FCNR (B) deposits to be shifted from weekly basis to a monthly basis.
- Banks given freedom to reduce the minimum tenor of retail domestic term deposits (under Rs.15 lakh) from 15 days to 7 days.
- To improve credit delivery, restrictive provisions of service area approach for banks dispensed with, except for Government sponsored programmes.
- The limit on advances under priority sector for dealers in agricultural machinery raised from Rs.20 lakh to Rs.30 lakh and for distribution of inputs for allied activities from Rs.25 lakh to Rs.40 lakh.
- Banks advised to make efforts to increase their disbursements to small and marginal farmers to 40 per cent of their direct advances under special agricultural credit plans (SACP) by March 2007.
- The mechanism of SACP extended to private sector banks. Private sector banks urged to formulate SACPs from the year 2005-06, targeting an annual growth of at least 20-25 per cent of credit disbursement to agriculture.
- Composite loan limit for SSI entrepreneurs enhanced from Rs. 50 lakh to Rs. 1 crore.
- Bank loans to housing sector up to Rs.15 lakh irrespective of location to be treated as part of their priority sector lending.
- The minimum maturity period of commercial paper reduced from 15 to 7 days.
- To promote investment activity, authorised dealers of foreign exchange permitted to issue guarantees/ letters of comfort up to US$ 20 million per transaction for a period up to one year for import of all non-capital goods permissible under the foreign trade policy and up to three years for import of capital goods, subject to prudential guidelines.
- 100 per cent Export oriented units and units set up under Electronics Hardware Technology Parks (EHTPs), Software Technology Parks (STPs) and Bio Technology Parks (BTPs) schemes permitted to repatriate the full value of export proceeds within a period of twelve months.
- The limit of outstanding forward contracts booked by importers/exporters increased from 50 per cent to 100 per cent of their eligible limit.
- As a temporary counter-cyclical measure, the risk weight on housing loans to individuals and investments in Mortgage Backed Securities of Housing Finance Corporations (HFCs), supervised by National Housing Bank (NHB) increased from 50 per cent to 75 per cent and on consumer credit from 100 per cent to 125 per cent.
- Change in the norms for classification of doubtful assets of financial institutions (FIs) . With effect from March 31, 2005, an asset to be classified as doubtful, if it has remained in the sub-standard category for 12 months. FIs permitted to phase out the consequent additional provisioning over a four year period.
- Asset reconstruction companies (ARCs) required to have owned funds of not less than 15 per cent of the assets acquired or Rs. 100 crore, whichever is less for commencement of business.
- Banks advised to advance loans to distressed urban poor to prepay their debt to non-institutional lenders, against appropriate collateral or group securities.
- Investments by banks in securitised assets representing direct lending to the SSI sector to be treated as their direct lending to SSI sector under priority sector, provided the pooled assets represent loans to SSI sector and originated by banks/financial institutions.

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Table 3.3 : Trends in interest rates

(Per cent per annum)

Interest rate	March 26, 2004		January 23, 2004		January 21, 2005	
Bank rate	6.00		6.0		6.00	
CRR	4.50		4.50		5.00	
IDBI[1]	10.25		12.50		10.25	
PLR[2]	10.25-11.00		10.25-11.00		10.25-10.75	*
Deposit Rate[3](> one year)	5.00-5.50		5.00-5.50		5.25-6.25	*
Call money(Borrowings)(low/high)	3.00/4.50		3.49/4.70		4.00/5.25	**
CDs by SCBs	3.87-5.16	$	3.57-6.11		3.96-6.75	&
CPs by companies(at face value)	4.70-6.50	#	4.70-5.75	@	5.40-6.35	@@
91 days T-bills	4.37	#	4.24	$	5.37	#
364 days T-bills	4.44	#	438	$	5.77	##

*** Relates to January 14, 2005** **** Relates to January 28, 2005, & Relates to December 24, 2004**
@ Relates to January 31, 2004, **$ Relates to January 21, 2004**
@@ Relates to January 15, 2005 **# Relates to January 25, 2005**
Relates to January 19, 2005.

Notes : 1. Minimum term lending rate (MTLR).
2. Prime lending rate relates to five major banks.
3. Deposit rate relates to five major banks for term deposits of more than one year maturity.
4. Data cover 90-95 per cent of total transactions reported by participants.

current year. The repo rate (reverse repo rate since October 29, 2004) under LAF was raised by 25 basis points to 4.75 per cent from October 27, 2004. The spread between reverse repo and repo was narrowed by 25 basis points to 125 basis points (Table 3.3).

Banking policy and trends

3.20 With liberalisation and growing integration of the Indian financial sector with the international market, the supervisory and regulatory role of RBI has become critical for the maintenance of financial stability. RBI has been continuously fine-tuning its regulatory and supervisory mechanism in recent years to match international standards. Migration to new capital adequacy framework (Basel II) based on a three-pillar approach, namely, minimum capital requirements, supervisory review, and market discipline, involves implementation challenges for both RBI and banks. RBI has taken a number of initiatives to make migration to Basel II smoother. Banks have been advised to undertake a self-assessment of the existing risk management systems and to simultaneously initiate suitable measures to upgrade them to match international standards. Banks have also been asked to prepare a road map and to review the progress on a quarterly basis.

3.21 In its annual policy statement for 2004-05, the RBI has carried forward initiatives aimed at improving prudential regulation and credit delivery, particularly to agriculture and the SSI sectors. The RBI has introduced higher provisioning requirement for NPAs included under ‘doubtful for more than three years’ category effective March 31, 2005. In order to contain risks arising from non-SLR portfolio of banks, the RBI has prohibited banks from investing in unrated non-SLR securities. Further, the RBI has indicated that with effect from January 1, 2005, only those banks, whose investment in unlisted non-SLR securities are within the prudential limit of 10 per cent of their total investment in non-SLR securities, will be allowed to make fresh investment in such securities up to the prudential limits.

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Financial Performance

3.22 During the year 2003-04, the banking sector witnessed strong growth in deposits and advances. Aggregate deposits of scheduled commercial banks (SCBs) grew by 17.5 per cent compared to 13.4 per cent in 2002-03. Credit and investments by SCBs increased by 15.3 per cent and 25.1 per cent, respectively in 2003-04 compared to 16.1 per cent and 23.3 per cent respectively in 2002-03. These developments coupled with a decline in gross NPAs enabled SCBs to improve their financial performance, despite a lower income growth consequent upon low interest rates. Ratio of net profits to total assets of SCBs improved marginally from 1.0 per cent to 1.1 per cent. Ratio of operating profits to total assets improved from 2.4 per cent in 2002-03 to 2.7 per cent in 2003-04.

3.23 Total income of SCBs increased by 6.6 per cent to Rs. 1,83,767 crore in 2003-04 as compared to an increase of 14.0 per cent in 2002-03. The lower income growth was on account of lower growth of 2.4 per cent in interest income in 2003-04. Income growth in 2003-04 came mainly from other income, which increased by 25.5 per cent. Total expenditure of SCBs grew at a lower rate of 4.0 per cent in 2003-04 compared to 11.3 per cent in 2002-03.

3.24 The lower growth of total expenditure was entirely on account of a decline in interest expenditure from Rs. 93,596 crore in 2002-03 to Rs. 87,567 crore in 2003-04. As a proportion of total assets, interest expenditure declined from 5.5 per cent to 4.4 per cent. Expenditure on provisions and contingencies witnessed an increase of 28.8 per cent in 2003-04 on top of an increaes of 29.3 per cent in the previous year. The financial performance varied across bank groups. Increase in the income of the SCBs varied from 2.4 per cent for old private sector banks to 8.1 per cent for foreign banks. The income of the public sector banks (PSBs) grew by 7.1 per cent in 2003-04. Among income, the growth of interest income was the highest for new private sector banks followed by old private banks, PSBs and foreign banks. The growth of other income was in sharp contrast with the growth in interest income. Growth of other income was the highest in case of foreign banks and the lowest for the old private sector banks. Growth of expenditure was the highest in the case of foreign banks and lowest in the case of old private sector banks. Expenditure on interest declined for all bank groups, following the reduction in deposit rates. The decline in expenditure on interest was the highest for foreign banks (15.5 per cent) and lowest for old private sector banks (5.5 per cent) and PSBs (5.9 per cent).

3.25 The ratio of net profits to total assets was the highest for foreign banks (1.7 per cent) followed by old private sector banks (1.2 per cent), PSBs (1.1 per cent), and new private sector banks (0.8 per cent). The ratio of operating profits to total assets followed more or less a similar pattern with foreign banks performing the best (3.7 per cent), followed by PSBs (2.7 per cent), old private sector banks (2.6 per cent) and new private sector banks (2.0 per cent). There has been an overall improvement in the efficiency of SCBs as evident in the declining ratios for operating expenses to net total income (total income – interest expenditure). For SCBs as a whole the ratio declined from 53.0 per cent in 2001-02 to 48.3 per cent in 2002-03 and further to 45.2 per cent in 2003-04 (Table 3.4).

3.26 The profitability of SCBs, though still high, showed a declining trend in the first half of 2004-05 on account of a fall in treasury income. The ratio of net profit to total assets (annualised) was lower at 1.1 per cent in the second quarter of 2004-05 compared to 1.3 per cent in the corresponding previous quarter.

Interest spread

3.27 Increase in the net interest income or the interest spread, defined as the difference between interest income and interest expenses, of SCBs witnessed in recent years continued in 2003-04. Mainly on account of low interest expenditure, the spread increased by 19.8 per cent in 2003-04 compared to an increase of 19.5 per cent in 2002-03. The increase in the spread of private sector and foreign banks was sharper than that of PSBs. The ratio of spread to total assets had increased for all bank groups in 2003-04. The

Table 3.4 : Working results of scheduled commercial banks

Items	Public sector banks		Foreign banks		Old pvt. sector banks		New pvt. Sector banks		SCBs	
	2002-03	2003-04	2002-03	2003-04	2002-03	2003-04	2002-03	2003-04	2002-03	2003-04
Rs. Crore										
A. Income	128464	137602	12034.6	13012	11279	11551	20567	21602	172345	183767
I) Interest Income	107232	109496	8958	8990	8920	9120	15633	16421	140742	144028
II) Other income	21232	28106	3076.95	4022	2359	2431	4934	5180.6	31603	39739
B. Expenditure	116169	121055	10210	10769	10047	10105	18843	19567.01	155270	161496
I) Interest expended	69853	65765	5055.01	4272	6327	5982	12361	11548	93596	87567
II) Intermediation cost	28895	32363	3251	3752	2147	2374	3774	5041	38067	43530
III) Provisions and contingenies	17422	22928	1904	2744	1573	1749	2708	2978	23607	30400
C. Operating profit (A-Bi-Bii)	29716	39475	3728	4987	2805	3196	4433	5013	40682	52671
D. Net profit (A-B)	12295	16546	1824	2243	1232	1446	1725	2035	17075	22271
E. Net interest income (Spread)	37379	43732	3903	4718	2593	3139	3272	4873	47146	56462
F. Total assets	1285411	1471428	116661	136316	104956	120700	192170	246576	1699198	1975020
As per cent of total assets										
A. Income	10.0	9.4	10.3	9.5	10.7	9.6	10.7	8.8	10.1	9.3
I) Interest Income	8.3	7.4	7.7	6.6	8.5	7.6	8.1	6.7	8.3	7.3
II) Other income	1.7	1.9	2.6	3.0	2.2	2.0	2.6	2.1	1.9	2.0
B. Expenditure	9.0	8.2	8.8	7.9	9.6	8.4	9.8	7.9	9.1	8.2
I) Interest expended	5.4	4.5	4.3	3.1	6.0	5.0	6.4	4.7	5.5	4.4
II) Intermediation cost	2.2	2.2	2.8	2.8	2.0	2.0	2.0	2.0	2.2	2.2
III) Provisions and contingenies	1.4	1.6	1.6	2.0	1.5	1.4	1.4	1.2	1.4	1.5
C. Operating profit	2.3	2.7	3.2	3.7	2.7	2.6	2.3	2.0	2.4	2.7
D. Net profit (A-B)	1.0	1.1	1.6	1.6	1.2	1.2	0.9	0.8	1.0	1.1
E. Net interest income (Spread)	2.91	2.97	3.35	3.46	2.47	2.60	1.70	1.98	2.77	2.86
F. Total assets	1.0	1.1	1.6	1.6	1.2	1.2	0.9	0.8	1.0	1.1
Memo item										
1. Operating expenses as per cent of net income	49.3	45.0	46.6	42.9	43.4	42.6	46.0	50.1	48.3	45.2

ratio was the highest for foreign banks (3.46 per cent) followed by PSBs (2.97 per cent), old private sector banks (2.60 per cent) and new private sector banks (1.98 per cent).

3.28 Interest spread is an important indicator of efficiency of banking operations. The growth of spread in recent years clearly establishes that banks have not fully passed on the benefit of falling interest rates to their customers. Despite the initiatives taken by the RBI, lending rates of banks have exhibited considerable downward rigidity. Net interest income (annualised) of SCBs as a proportion of total assets improved to 3.1 per cent in the second quarter of 2004-05 compared to 2.9 per cent in the corresponding quarter of last year (Table 3.4).

Non-performing assets of the banking sector

3.29 There was a significant decline in the non-performing assets (NPAs) of SCBs in 2003-04, despite adoption of 90 day delinquency norm from March 31, 2004. The gross NPAs of SCBs declined from 4.0 per cent of total assets in 2002-03 to 3.3 per cent in 2003-04. The corresponding decline in net NPAs was from 1.9 per cent to 1.2 per cent. Both gross NPAs and net NPAs declined in absolute terms. While the gross NPAs declined from Rs. 68,717 crore in 2002-03 to Rs. 64,787 crore in 2003-04, net NPAs declined from Rs. 32,670 crore to Rs. 24,617 crore in the same period. There was also a significant decline in the proportion of net NPAs to net advances from 4.4 per cent in 2002-03 to 2.9 per cent in 2003-04. The significant decline in the net NPAs by 24.7 per cent in 2003-04 as compared to 8.1 per cent in 2002-03 was mainly on account of higher provisions (up to 40.0 per cent) for NPAs made by SCBs.

3.30 The decline in NPAs in 2003-04 was witnessed across all bank groups. The decline in net NPAs as a proportion of total assets was quite significant in the case of new private sector banks, followed by PSBs. The ratio of net NPAs to net advances of SCBs declined from 4.4 per cent in 2002-03 to 2.9 per cent in 2003-04. Among the bank groups, old private sector banks had the highest ratio of net NPAs to net advances at 3.8 per cent followed by PSBs (3.0 per cent) new private sector banks

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(2.4 per cent) and foreign banks (1.5 per cent) (Table 3.5).

3.31 An analysis of NPAs by sectors reveals that in 2003-04, advances to non-priority sectors accounted for bulk of the outstanding NPAs in the case of PSBs (51.24 per cent of total) and for private sector banks (75.30 per cent of total). While the share of NPAs in agriculture sector and SSIs of PSBs declined in 2003-04, the share of other priority sectors increased. The share of loans to other priority sectors in priority sector lending also increased. Measures taken to reduce NPAs include reschedulement, restructuring at the bank level, corporate debt restructuring, and recovery through Lok Adalats, Civil Courts, and debt recovery tribunals and compromise settlements. The recovery management received a major fillip with the enactment of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 enabling banks to realise their dues without intervention of courts and tribunals. The Supreme Court in its judgment dated April 8, 2004, while upholding the constitutional validity of the Act, struck down section 17 (2) of the Act as unconstitutional and contrary to Article 14 of the Constitution of India. The Government amended the relevant provisions of the Act to address the concerns expressed by the Supreme Court regarding a fair deal to borrowers through an ordinance dated November 11, 2004. It is expected that the momentum in the recovery of NPAs will be resumed with the amendments to the Act.

3.32 The revised guidelines for compromise settlement of chronic NPAs of PSBs were issued in January 2003 and were extended from time to time till July 31, 2004. The cases filed by SCBs in Lok Adalats for recovery of NPAs stood at 5.20 lakh involving an amount of Rs. 2,674 crore (prov.). The recoveries effected in 1.69 lakh cases amounted to Rs. 352 crore (prov.) as on September 30, 2004. The number of cases filed in debt recovery tribunals stood at 64, 941 as on June 30, 2004, involving an amount of Rs. 91,901 crore. Out of these, 29, 525 cases involving an amount of Rs. 27,869 crore have been adjudicated. The amount recovered was to Rs. 8,593 crore. Under the scheme of corporate debt restructuring introduced in 2001, the number of cases and value of assets restructured stood at 121 and Rs. 69,575 crore, respectively, as on December 31, 2004. Iron and steel, refinery, fertilisers and telecommunication sectors were the major beneficiaries of the scheme. These sectors accounted for more than two-third of the values of assets restructured.

3.33 As credit information is crucial for the development of the financial system and for addressing the problems of NPAs, dissemination of credit information on suit-filed defaulters is being undertaken by the Credit Information Bureau of India Ltd. (CIBIL) from March 2003. In its annual policy statement for 2004-05, the RBI advised banks and financial institutions to review the measures taken for furnishing credit information in respect of all borrowers to CIBIL. In its mid-term review, the RBI again urged the banks to make persistent

Table 3.5 : Non-performing assets of scheduled commercial banks

Items	Gross NPAs (Rs. Crore)			Percentage to gross advances			Percentage to total assets		
	2001-02	2002-03	2003-04	2001-02	2002-03	2003-04	2001-02	2002-03	2003-04
Bank group									
1. Public sector	56473	54090	51538	11.1	9.4	7.8	4.9	4.2	3.5
2. Private sector	11662	11782	10355	9.6	8.1	5.8	4.4	4.0	2.8
3. Foreign	2726	2845	2894	5.4	5.3	4.6	2.4	2.4	2.1
4. SCBs(1+2+3)	70861	68717	64787	10.4	8.8	7.2	4.6	4.0	3.3
Items	**Net NPAs (Rs. Crore)**			**Percentage to net advances**			**Percentage to total assets**		
1. Public sector	27958	24867	18860	5.8	4.5	3.0	2.4	1.9	1.3
2. Private sector	6676	6882	4857	5.7	5.0	2.8	2.5	2.3	1.3
3. Foreign	920	921	900	1.9	1.8	1.5	0.8	0.8	0.7
4. SCBs(1+2+3)	35554	32670	24617	5.5	4.4	2.9	2.3	1.9	1.2

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efforts in obtaining consent from all the borrowers, in order to establish an efficient credit information system, which would help in enhancing the quality of credit decisions, improve the asset quality, and facilitate faster credit delivery.

Capital adequacy ratio

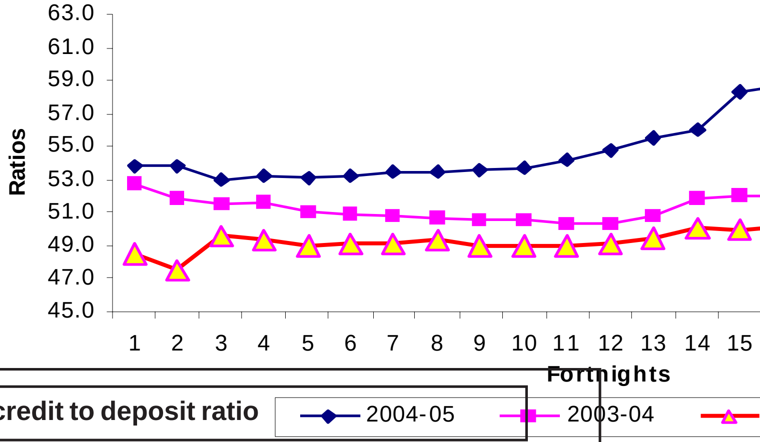
3.34 The concept of minimum capital to risk weighted assets ratio (CRAR) has been developed to ensure that banks can absorb a reasonable level of losses. Application of minimum CRAR protects the interest of depositors and promotes stability and efficiency of the financial system. At the end of March 31, 2004, CRAR of PSBs stood at 13.2 per cent, an improvement of 0.6 per centage point from the previous year. There was also an improvement in the CRAR of old private sector banks from 12.8 per cent in 2002-03 to 13.7 per cent in 2003-04. The CRAR of new private sector banks and foreign banks registered a decline in 2003-04. For the SCBs as a whole the CRAR improved from 12.7 per cent in 2002-03 to 12.9 per cent in 2003-04. All the bank groups had CRAR above the minimum 9 per cent stipulated by the RBI.

3.35 During the current year, there was further improvement in the CRAR of SCBs. The ratio in the first half of 2004-05 improved to 13.4 per cent as compared to 12.9 per cent at the end of 2003-04. Among the bank groups, a substantial improvement was witnessed in the case of new private sector banks from 10.2 per cent as at the end of 2003-04 to 13.5 per cent in the first half of 2004-05. While PSBs and old private banks maintained the CRAR at almost the same level as in the previous year, the CRAR of foreign banks declined to 14.0 per cent in the first half of 2004-05 as compared to 15.0 per cent as at the end of 2003-04.

Bank credit

3.36 The spurt in bank credit witnessed from the second quarter of the previous year continued through the current year. Gross bank credit by SCBs increased by 23.8 per cent (net of conversion, 19.9 per cent) in the current year (up to January 21, 2005) compared to 9.3 per cent in the corresponding period last year. In contrast to the decline of 25.9 per cent witnessed last year, food credit grew by 15.2 per cent in the current year (up to January 21, 2005). Growth of non-food credit up to January 21, 2005 was 24.2 per cent (net of conversion, 20.1 per cent) as compared to an increase of 11.9 per cent in the corresponding previous period. In absolute terms, incremental non-food credit amounted

Fig. 3.3 **Non-food credit to deposit ratio**



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3.37 Reflecting the higher credit off-take, excess liquidity in the banking sector has been witnessing a decline since August, 2004. With growth of manufacturing recording an increase of 9.0 per cent in April to December 2004, the highest after 1995-96, higher growth of non-food credit is likely to continue.

Investment

3.38 Investments by SCBs in Government and other approved securities remained much above the stipulated SLR of 25 per cent of net demand and time liabilities (NDTL) in recent years. At end-March 2004, these investments were 41.3 per cent of NDTL, marginally lower than 41.5 per cent at end-March 2003. During the current year (up to January 21, 2005), SLR investments by the SCBs grew at a lower rate of 5.1 per cent (net of conversion, 3.3 per cent) as compared to 19.0 per cent last year. The year-on-year growth as on January 21, 2005 was also substantially lower at 9.3 per cent (net of conversion, 7.4 per cent) as compared to 23.2 per cent on the corresponding date of last year. The lower growth of SLR investments in the current year is mainly on account of the higher growth of bank credit to the commercial sector and lower level of market borrowings by the Central Government. Even with the lower growth in the current year, outstanding SLR investments were at 42.86 per cent of NDTL as on January 21, 2005. The ratio of SLR investment to aggregate bank deposits in the current financial year has registered a declining trend (Figure 3.4).

3.39 Non-SLR investments by SCBs, comprising investments in commercial paper, shares/ bonds, units of Unit Trust of India and other mutual funds, and debentures issued by private corporate sector and public sector companies, were marginally higher at Rs. 1, 37, 644 crore at end-March 2004 compared to Rs.1,33, 699 crore at end-March 2003. In the current year (up to January 7, 2005), non-SLR Investments by SCBs grew by 0.9 per cent compared to a decline of 5.0 per cent in the corresponding previous period. Total investments (SLR and non-SLR) by SCBs in the current year (up to January 7, 2005) were lower at 4.6 per cent compared to 17.1 per cent in the corresponding period of last year

Sectoral deployment of bank credit

3.40 Available information on sectoral

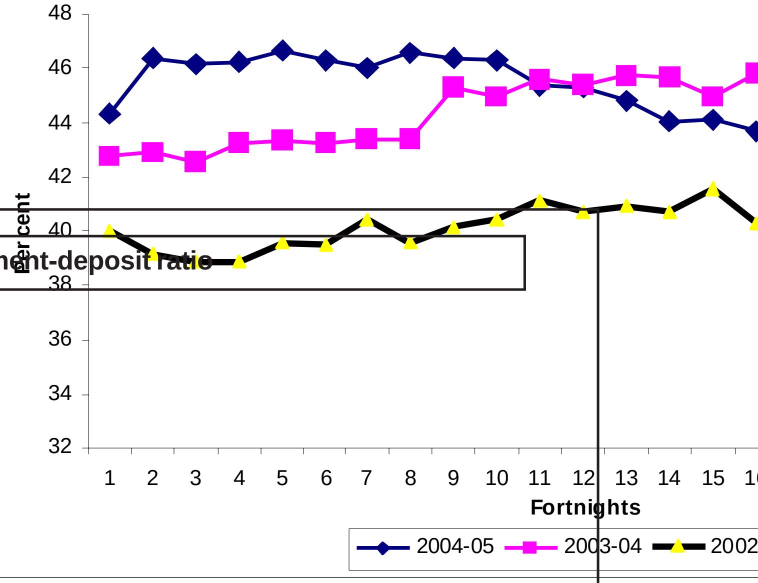

Fig. 3.4 **Investment-deposit ratio**

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cent in 2003-04 compared to 14.9 per cent in 2002-03. While non-food credit increased by 17.5 per cent, food credit declined by 27.3 per cent in 2003-04. Within non-food credit, advances to the non-priority sector housing recorded the highest growth of 42.1 per cent followed by tourism (34.6 per cent) and priority sectors (24.7 per cent). Among the priority sectors, advances to agriculture grew by 23.2 per cent in 2003-04 compared to 17.9 per cent in 2002-03. Advances to other priority sectors witnessed a robust growth of 38.3 per cent compared to 25.1 per cent in the same period last year. Growth of credit to medium and large industries was lower at 5.1 per cent in 2003-04 compared to 16.3 per cent in 2002-03. Credit to SSIs improved from 5.7 per cent in 2002-03 to 9.0 per cent in 2003-04.

3.41 In the current year (up to October 2004), gross bank credit increased by 12.5 per cent compared to 3.5 per cent in the same period of last year. Credit to real estate and housing sectors were the driving force in the expansion of non-food credit during 2004-05 up to October 2004. Credit to real estate increased by 47.7 per cent in the current year (up to October 2004) and that to housing increased by 30.9 per cent compared to 4.3 per cent and 19.8 per cent, respectively, in the same period last year. Credit to priority sector grew by 9.9 per cent in the current year compared to 10.1 per cent in the corresponding period last year. Credit to medium and large industries also grew by 10.3 per cent in the current year compared to a decline of 1.8 per cent in the corresponding previous period (Table 3.6).

Priority sector lending

3.42 Advances by PSBs to priority sector increased by 21.0 per cent in 2003-04 compared to an increase of 18.6 per cent in 2002-03. The share of priority sector advances in total net bank credit (NBC) of PSBs increased from 42.5 per cent in 2002-03 to 44.0 per cent in 2003-04. This level of advances is higher than the target of 40 per cent stipulated for domestic banks. For foreign banks the target fixed for priority sector lending is 32 per cent of NBC. Total outstanding advances by foreign banks to priority sector

Table 3.6: Sectoral deployment of gross bank credit

	Outstanding balances of the end of				Variations during[1]							
	2002-03#	2003-04#	October 2003	October 2004	2002-03	2003-04#	October 2003	October 2004	2002-03	2003-04#	October 2003	October 2004
	(Rs. crore)								Per cent			
I. Gross bank credit	669534	764383	693067	860187	80179	94849	23533	95804	14.9	14.2	3.5	12.5
1. Public food credit	49479	35961	36020	39711	-4499	-13518	-13459	3750	-8.3	-27.3	-27.2	10.4
2. Gross non-food credit	620055	728422	657047	820476	84678	108367	36992	92054	17.5	17.5	6.0	12.6
(a) Priority sectors (i+ii+iii)[2]	211609	263834	232953	290015	28540	52225	21344	26181	16.3	24.7	10.1	9.9
i. Agriculture[3]	73518	90541	79112	101808	10848	17023	5594	11267	17.9	23.2	7.6	12.4
ii. Small scale industry	60394	65855	60430	67177	3287	5461	36	1322	5.7	9.0	0.1	2.0
iii. Other priority sector	77697	107438	93411	121030	14405	29741	15714	13592	25.1	38.3	20.2	12.7
(b) Medium and large industries	235168	247210	230984	272626	28011	12042	-4184	25416	16.3	5.1	-1.8	10.3
(c) Wholesale trade (excluding food procurement)	22578	24867	22317	32447	1939	2289	-261	7580	9.5	10.1	-1.2	30.5
(d) Othersectors	150700	192511	170793	225388	26188	41811	20093	32877	22.8	27.7	13.3	17.1
(1) Housing	36587	51981	43822	68069	12308	15394	7235	16088	55.1	42.1	19.8	30.9
(2) Consumer durables	7219	8274	7877	7316	-111	1055	658	-958	-1.6	14.6	9.1	-11.6
(3) Real estate loans	5894	5577	6150	8240	502	-317	256	2663	19.3	-5.4	4.3	47.7
(4) Tourism and tourism related hotels	2428	3269	2939	3436	266	841	511	167	17.3	34.6	21.0	5.1
(5) Loans to individuals[4]	2001	2020	2504	1956	242	19	503	-64	15.9	0.9	25.1	-3.2
II. Export credit[5]	49202	57687	51147	59222	6424	8485	1945	1535	14.9	17.2	4.0	2.7

1. As on the last reporting Friday of the year.
2. Excluding investments in eligible securities.
3. Indrect finance not included.
4. Against shares and debentures/bonds
5. Inculded under gross non-food credit.
\# Includes the impact of meger of ICICI with ICICI Bank.

Note: Figures for 2003-04 are provisional. Data relate to 48 SCBs which account for 90 per cent of the bank credit of all SCBs. Gross credit data include bills rediscounted with RBI, IDBI, Exim Bank and other approved financial institutions.

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increased from 33.9 per cent in 2002-03 to 34.8 per cent of their NBC. The share of priority sector lending by private banks improved from 44.4 per cent in 2002-03 to 47.4 per cent in 2003-04. Thus all bank groups fulfilled the minimum target set for priority sector lending in 2003-04.

3.43 While the overall target fixed for priority sector lending had been met by all bank groups, shortfalls were noticed in meeting the sub-targets prescribed under priority sector lending. Within the overall target of 40 per cent of NBC for domestic banks, the sub-target fixed for agriculture is 18.0 per cent and that for weaker sections is 10 per cent. Advances by PSBs to agriculture at 15.4 per cent of NBC in 2003-04 fell short in the sub-target by 2.6 percentage points in 2003-04. PSBs also fell short of the sub-target of 10 per cent set for weaker sections by 2.6 percentage points. Advances to agriculture by PSBs remained within a narrow range of 15.4 per cent and 15.7 per cent of NBC between 2000-01 and 2003-04. Advances by private sector banks to agriculture and weaker sections at 15.8 per cent and 1.3 per cent of NBC, respectively, also fell short of the sub-targets in 2003-04.

3.44 The sub-targets fixed for foreign banks are 10 per cent of NBC for SSI and 12 per cent of NBC for export credit. Advances by foreign banks to SSI sector constituted 10.4 per cent of NBC in 2003-04, an improvement of 1.7 percentage points over 2002-03. Foreign banks have consistently exceeded the sub-target under export credit. Credit to the export sector by foreign banks was 18.7 per cent of their NBC in 2003-04.

3.45 The decline in the share of SSI sector in total NBC has been a matter of grave concern. For PSBs, the share of SSI advances in total NBC has declined continuously from 14.2 per cent in 2000-01 to 10.4 per cent in 2003-04. For private sector banks and foreign banks, the corresponding declines have been from 13.8 per cent to 7.1 per cent, and from 10.6 per cent to 10.4 per cent, respectively.

3.46 The RBI has been taking initiatives from time to time to address the problem of declining credit flow to SSI sector. In 2003-04, RBI raised the loan limit for SSI sector from Rs. 15 lakh to Rs. 25 lakh without the requirement of collateral. The RBI constituted a Working Group on flow of credit to SSI sector with Dr. A.S. Ganguly as Chairman. The Group submitted its report in April, 2004. The RBI has already accepted the following recommendations made by the Working Group:

- A full service approach to cater to the needs of the small and medium enterprises (SME) through extension of banking services to recognised SME clusters by adopting a 4-C approach, viz., Customer focus, Cost control, Cross sell and Contain risk.
- Promotion of corporate-linked SME cluster models by banks and financial institutions.
- Adoption of successful micro credit management models by SIDBI and Lead banks.
- Introduction of new instruments for promoting rural industry and improving flow of credit to rural artisans, industries and rural entrepreneurs.
- Higher working capital limits to be taken into account while extending credit to units located in hilly terrain and areas prone to frequent floods.

3.47 The RBI, in its annual policy statement for 2004-05, proposed that CIBIL would develop a system of proper credit records to enable banks to determine appropriate pricing of loans to SME. Furthermore, the RBI proposed a mechanism for debt restructuring for the SME sector. In its mid-term review of the annual policy for 2004-05, RBI announced further measures to improve the credit flow to SSI sector. RBI proposed that investments made by banks in securitised assets representing direct lending to the SSI sector would be treated as their direct lending to SSI sector under priority sector, provided the pooled assets represent loans to SSI sector which are reckoned under priority sector and the securitised loans are originated by banks/ financial institutions. RBI also raised the composite loan limit for SSI entrepreneurs from Rs. 50 lakh to Rs. 1 crore.

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Table 3.7 : Lending to sensitive sectors

Banks	2002-03	2003-04	Per cent	Per cent share in total	
	Rs. Crore		variation	2002-03	2003-04
A. SCBs	**23683**	**27456**	**15.9**	**100.0**	**100.0**
1. Capital market	2484	3334	34.2	10.5	12.2
2. Real estate	12464	14170	13.7	52.6	51.6
3. Commodities	8735	9952	13.9	36.9	36.2
B. PSBs	**15131**	**16414**	**8.5**	**63.9**	**59.8**
1. Capital market	1032	1199	16.1	4.4	4.4
2. Real estate	7988	8558	7.1	33.7	31.2
3. Commodities	6111	6657	8.9	25.8	24.2
C. New pvt. banks	**4424**	**5686**	**28.5**	**18.7**	**20.7**
1. Capital market	660	823	24.7	2.8	3.0
2. Real estate	2702	3270	21.0	11.4	11.9
3. Commodities	1062	1593	50.0	4.5	5.8
D. Old pvt. banks	**2600**	**3001**	**15.4**	**11.0**	**10.9**
1. Capital market	207	280	35.4	0.9	1.0
2. Real estate	1067	1231	15.3	4.5	4.5
3. Commodities	1327	1490	12.3	5.6	5.4
E. Foreign banks	**1528**	**2355**	**54.2**	**6.5**	**8.6**
1. Capital market	585	1032	76.6	2.5	3.8
2. Real estate	708	1111	57.0	3.0	4.0
3. Commodities	235	212	-9.9	1.0	0.8

Lending to sensitive sectors

3.48. Advances by SCBs to sensitive sectors comprising capital market, real estate and commodities amounted to Rs. 27,455 crore at end-March, 2004. Advances by SCBs to the capital market recorded the highest growth of 34.2 per cent in 2003-04 followed by advances to commodities (13.9 per cent) and advances to real estate (13.7 per cent). Real estate continues to remain the dominant sector receiving 51.6 per cent of advances under sensitive sectors followed by commodities (36.2 per cent) and capital market (12.2 per cent). The exposures of SCBs to sensitive sectors remain insignificant; advances to these sectors accounted for only 3 per cent of aggregate bank loans and advances (Table 3.7).

Agricultural credit

3.49 Agricultural growth is crucial for alleviating rural poverty. Access to institutional credit to more farmers and appropriate quantity and quality of agricultural credit are crucial for realising the full potential of agriculture as a profitable activity. Recognising the crucial role of credit, the Tenth Five-Year Plan (2002-07) envisages a substantial jump in credit flows to agriculture to Rs.7,36,750 crore in the plan period as compared to the credit flow of Rs.2,29,956 crore achieved in the Ninth Five-Year Plan period. Credit flow to agriculture sector from all formal sources amounted to Rs. 70,810 crore in 2002-03 and Rs.86,981 crore in 2003-04, much below the levels envisaged in the Tenth Plan. Concerned over the slower growth of agriculture credit, the Government announced a comprehensive policy on June 18, 2004. The policy envisages a 30 per cent increase in credit to agriculture sector in 2004-05 over an estimated credit flow of Rs. 80,000 crore in 2003-04. The implementation of the policy has been entrusted to PSBs, private sector banks, regional rural banks (RRBs) and co-operative banks. The policy has indicated that each rural and semi-urban branch of commercial banks,

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on an average, will take up at least two to three new investment projects in the area of plantation and horticulture, fisheries, organic farming, agro-processing, livestock, micro-irrigation, sprinkler irrigation, watershed management, village pond development and other agricultural activities. NABARD has been asked to advise District Level Technical Committees to review the scales of finance to meet the realistic credit needs of farmers, especially for capital intensive agricultural operations. The Budget for 2004-05, presented in the Parliament on July 8, 2004, proposed doubling of credit to agriculture in three years and announced further measures to achieve the target growth in agricultural credit. These measures include holding the sponsor bank of each RRB squarely responsible for the performance of RRB under its control and an incentive scheme under which RRBs adopting new governance standards and abiding by prudential regulations will qualify for receiving funds from the Government for their restructuring. The Budget proposed setting up of a Task Force to examine the reforms required in the co-operative banking system including the appropriate regulatory regime. The Task Force has since submitted its draft report. The draft report has been put on the websites of the RBI and the Ministry of Finance on January 11, 2005 for inviting comments. The report is likely to be finalised shortly after taking into account the feedback received.

3.50 As indicated in its mid-term review of November, 2003, the RBI constituted an Advisory Committee on flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof. V S Vyas). The Advisory Committee submitted its interim report in April, 2004 and the final report in June, 2004 (Box 3.2).

3.51 Based on the recommendations contained in the interim report of the Vyas Committee, the RBI, in its annual policy statement for 2004-05, announced a number of measures to improve credit delivery to agriculture. These included, treating loans to storage units designed to store agricultural products, irrespective of location, as indirect credit to agriculture, treating investment by banks in securitised assets representing direct (indirect) lending to agriculture as direct (indirect) lending to agriculture, and waiver of margin/security requirement for agricultural loans up to Rs.50,000 and in case of agri-business and agri-clinics for loans up to Rs.5 lakh. In addition, RBI also aligned repayment dates with harvesting of crops by treating loans granted for short duration crops as an NPA, if the instalment of the principal or interest thereon remains unpaid for two crop seasons beyond the due date. Loans granted for long duration crops are treated as an NPA, only if

Box 3.2 : The Advisory Committee on flow of Credit to Agriculture and Related Activities from the Banking System

- A review of mandatory lending to agriculture by commercial banks to enlarge direct lending programmes.
- Public and private sector banks to increase their direct agricultural lending to 12 per cent of net bank credit in the next two years and to 13.5 per cent two years thereafter, within the overall limit of 18.0 per cent of total agricultural lending.
- Banks to increase their disbursements to small and marginal farmers under Special Agricultural Credit Plan (SACP) to 40 per cent by March 2007.
- SACP to be restricted to direct lending and extended to private sector banks.
- Reduction in cost of agricultural credit by enhancing the cost effectiveness of agricultural loans.
- NPA norms for agricultural credit to be aligned with crop seasons. Loans for allied activities to be classified as NPA after 180 days of default.
- Credit flow to small borrowers to be improved through reduction in cost of borrowing, revolving credit packages, procedural simplification, involvement of Panchayati Raj institutions and micro-finance.
- The SAA to be modified to remove rigidities. SAA to be mandatory only for Government-sponsored programmes and the format of village surveys to be changed in view of current realities.

Table 3.8 : Flow of institutional credit to Agriculture

Rs. crore

Agency\Years	1997-98	1999-2000	2002-03	2003-04	2004-05 (Estimated)
Co-operative banks	14,085	18,363	24,296	26,959	31,000
RRBs	2,040	3,172	5,467	7,581	10,500
Commercial banks	15,831	24,733	41,047	52,441	67,000
Total	31,956	46,268	70,810	86,981	1,08,500

Source: National Bank for Agriculture and Rural Development.

the instalment of the principal or interest thereon remains unpaid for one crop season beyond the due date. As recommended by the Vyas Committee, RBI announced that micro-finance institutions would not be permitted to accept public deposits, unless they comply with the extant regulatory framework. The recommendation relating to service area approach (SAA) was accepted and an announcement to this effect was made in the RBI's mid-term review of annual policy statement for 2004-05.

3.52 During the current year, most of the PSBs, co-operative banks and RRBs have reduced the rate of interest on farm loans up to Rs.50,000 to 9.0 per cent and, in some cases, to 8.5 per cent. This has enabled the farmers to derive the benefit of falling interest rates and to improve their margins on farming and allied operations. Also, as a measure to minimise the incidence of under-financing, the scale of finance for crop loans and unit costs of farm investments have been further revised and made more realistic in the current year. Furthermore, to mitigate the risk of agriculture arising out of drought conditions, banks either postponed the recovery of loans or converted short-term credit into medium-term credit with appropriate reschedulement in repayment in the concerned areas. The norms of financing in the Rabi season have been liberalised taking into account the likely shortfall in Kharif output on account of deficient rainfall.

3.53 Aggregate credit flows, both short-term and long-term are estimated to reach Rs.1,08,500 crore in 2004-05 from a level of Rs.86, 981 crore in the previous year (Table 3.8).

Rural infrastructure development fund (RIDF)

3.54 The RIDF was set up by the Government in 1995-96 for financing ongoing rural Infrastructure projects. The Fund is maintained by the National Bank for Agriculture and Rural Development (NABARD). Domestic commercial banks contribute to the Fund to the extent of their shortfall in stipulated priority sector lending to agriculture. The main objective of the Fund is to provide loans to State Governments and State-owned corporations to enable them to complete ongoing rural infrastructure projects. Till the end of 2003-04, nine tranches (I to IX) of RIDF have been completed. In the Interim Budget for the year 2004-05, an announcement was made regarding setting up of Agriculture Infrastructure and Credit Fund and discontinuation of RIDF mechanism. This decision was reconsidered; and the regular Budget presented on July 8, 2004 proposed revival of RIDF with a corpus of Rs. 8,000 crore during 2004-05. Accordingly, RIDF(X) is currently under implementation.

3.55 The total corpus of RIDF (RIDF I to RIDF X) amount to Rs. 42,000 crore. Cumulative sanctions and disbursements under various tranches of RIDF stood at Rs. 37,718 crore and Rs. 22,946 crore, respectively, on December 31, 2004. Out of 1,36,486 projects sanctioned under RIDF I to VIII, 84,584 projects have been completed.

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During the current year till December 31, 2004, sanctions and disbursements under RIDF X amounted to Rs. 3,048 crore and Rs. 52 crore, respectively.

3.56 The shortfall in disbursements of RIDF funds as compared to sanctions continues to remain a matter of concern in the implementation of RIDF. The Government has taken a number of steps to address this problem. The scope of RIDF has been widened to include activities such as rural drinking water schemes, soil conservation, rural market yards, rural health centres and primary schools, mini hydel plants, shishu shiksha kendras, anganwadis, and system improvement in the power sector. From RIDF V onwards, the ambit was extended to projects undertaken by Panchayat Raj institutions and projects in the social sector covering primary education, health and drinking water. The activities to be financed under RIDF X include minor irrigation projects/micro irrigation, flood protection, watershed development/ reclamation of waterlogged areas, drainage, forest development, market yard/godown, apna mandi, rural haats and other marketing infrastructure, cold storage, seed/agriculture/ horticulture farms, plantation and horticulture, grading and certifying mechanisms such as testing and certifying laboratories, etc., community irrigation wells for irrigation purposes for the village as a whole, fishing harbour/jetties, riverine fisheries, animal husbandry and modern abattoir.

3.57 As a measure of disincentive for non-achievement of the agricultural lending target, the rate of interest for the deposits made by the contributing banks in RIDF has been lowered and is charged in inverse proportion to the extent of shortfall in the agricultural lending vis-à-vis the stipulated target of 18 per cent.

3.58 Keeping in view the declining interest rates scenario and the need to further rationalise the interest rate structure under RIDF, the lending and deposits rates in respect of the undisbursed amounts of RIDF IV to IX have been restructured, with effect from November 1, 2003. Accordingly, the State Governments will be required to pay 7 per cent in respect of the undisbursed amounts of RIDF IV to VII and Bank Rate plus 0.5 per centage point in respect of RIDF VIII and IX. The banks will be paid 6 per cent in respect of the undisbursed amounts of RIDF IV to VII, uniformly and varying rates of interest between the Bank rate and Bank Rate minus 3 per centage points (i.e. currently varying between 6 per cent and 3 per cent) in respect of RIDF VIII and RIDF IX.

Table 3.9 : Rate of interest on RIDF deposits

Sl. No.	Shortfall in lending to agriculture in terms of percentage to net bank credit	Rate of interest on the entire deposits to be made in RIDF VIII and RIDF-IX (Per cent per annum)
1.	Less than 2 percentage points	Bank Rate (6% at present)
2.	2 and above, but less than 5 percentage points	Bank Rate minus 1
3.	5 and above, but less than 9 percentage points	Bank Rate minus 2
4.	9 percentage points and above.	Bank Rate minus 3

3.59 In the case of RIDF VIII and IX, therefore, the rates of interest on deposits will continue to be linked to the shortfall in lending to agriculture (Table 3.9). The lending and deposits rates of interest in respect of RIDF X are as applicable to RIDF IX.

Kisan credit cards

3.60 The Kisan credit cards (KCC) scheme, introduced in 1998-99 aims at providing crop loans to farmers in a flexible and cost-effective manner. The scheme is being implemented in all the States and Union Territories by all commercial banks, RRBs, state co-operative banks, central co-operative banks, and primary agricultural co-operative societies. Beneficiaries covered under the KCC are issued with a credit card and a pass book or a credit card-cum-pass book incorporating the name, address and particulars of land, borrowing limit, and the validity period. Production credit limits are fixed taking into account the entire production credit needs for

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a full year plus ancillary activities relating to crop production. Sub-limits are also fixed at the discretion of lending banks. Crop loan/ short-term credit is in the form of a revolving cash credit facility involving any number of drawals and repayments within the limit fixed on the basis of operational land holding, cropping pattern and scale of finance. Till recently, investment credit requirements of farmers remained outside the purview of KCC, causing additional cost and procedural inconvenience to farmers. To address these deficiencies in the KCC scheme, NABARD revised the scheme in August 2004 to cover term loans for agriculture and allied activities. Under the KCC, while the short-term as well as working capital credit is repayable in 12 months, the term loan is to be repaid within a maximum period of five years. Conversion/re-schedulement of loans is permitted in case of damage to crops due to natural calamities. The number of KCCs issued was 414 lakh at end-March, 2004. As on September 30, 2004, cumulative issue of KCCs amounted to 435.61 lakh. Highest number of KCC were issued by co-operative banks (258.56 lakh), followed by commercial banks (132.43 lakh) and RRBs (44.63 lakh).

3.61 At the instance of the RBI, the National Council of Applied Economic Research (NCAER) conducted a survey for assessing the impact of the KCC scheme. The survey has brought out several advantages of the KCC scheme in terms of increase in the flow of credit to the agriculture sector, reduction in borrowings from the informal sector, significant savings in time spent on obtaining credit and an overall reduction in cost of credit delivery. The survey had identified areas requiring policy initiatives to make the scheme more effective. These relate to restrictions imposed on the issuance of KCCs by banks, restrictions on use of KCCs only at card issuing branches, non-availability of incentives for timely repayments, low credit limits and low awareness regarding the provision of personal accident insurance scheme. The RBI has advised the Indian Banks Association to examine these suggestions and come up with remedial measures.

Micro-finance

3.62. The programme of linking self-help group (SHGs) of the rural poor with the banking system was launched as a pilot project in 1992. Over the years the SHG–bank linkage programme has emerged as the major micro-finance programme in the country. 560 banks including 48 commercial banks, 196 RRBs and 316 co-operative banks are now actively involved in the operation of this programme. The programme has been providing the rural poor access to the formal banking system and has achieved several milestones in terms of gender sensitisation, empowerment and poverty alleviation. The programme provides thrift linked credit support to the members of SHGs. While the programme directly benefits the members, it also helps banks in reducing their transaction costs as well as risk in delivering small loans. The Budget for 2004-05 has emphasised the need for promoting the programme more vigorously and for the graduation of SHGs from consumption or production credit to credit for starting micro-enterprises. The Budget has set an indicative target of credit linking 5.85 lakh SHGs by end-March, 2007.

3.63 The number of SHGs linked to banks reached 10.79 lakh by March 31, 2004, covering an estimated 167 lakh poor families. A redeeming feature of the programme is that 90 per cent of the groups linked with banks are exclusively women groups. Cumulative disbursements of bank loans to these SHGs amounted to Rs. 3,904 crore at end-March, 2004 with an average loan of Rs. 36,179 per SHG and Rs. 2,412 per family. Refinance support extended by NABARD amounted to Rs.2, 550 crore. During the current year (up to December 31, 2004), 1.97 lakh new SHGs were provided with bank loans amounting to Rs. 1,134 crore (Table 3.10).

3.64 The RBI has been taking a pro-active role in promoting micro-finance. It set up four Groups in 2002 to look into various aspects of micro-financing. Based on the re-commendations made by these Groups, the RBI announced that banks should provide adequate incentives to their branches in making the procedures for financing the SHGs

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Table 3.10 : Progress of SHGs and bank linkage

Year	Total SHGs financed			Bank loan		
	During the year		Cumulative	During the year		Cumulative
	Amount (Number)	% Growth	(Number)	Amount (Rs. crore)	% Growth	(Rs. crore)
1998-99	32,995		32,995	57		57
1999-00	81,780	148	1,14,775	136	138	193
2000-01	1,49,050	82	2,63,825	288	112	481
2001-02	1,97,653	33	4,61,478	545	89	1026
2002-03	2,55,882	29	7,17,360	1,022	87	2,049
2003-04	3,61,731	41	1,07,9091	1,856	81	3,904
2004-05$	1,96,944	-	12,76,035	1,134	-	5,038

$ up to December 31, 2004.

simple and easy. Based on the recommendations of the Vyas Committee, the RBI, in its annual policy statement for 2004-05, indicated that micro-finance institutions would not be permitted to accept public deposits, unless they comply with the extant regulatory framework.

Non-banking financial companies (NBFCs)

3.65 The RBI regulates NBFCs engaged in equipment leasing, hire purchase finance, loan and investment, residuary non-banking companies (RNBCs) and the deposit taking activity of miscellaneous non-banking companies (chit funds). With the amendment of the RBI Act in 1997, it is obligatory for NBFCs to apply for a certificate of registration (COR). As at the end of June, 2004, the RBI received 38,050 applications for registration. Out of these, the RBI approved 13,671 applications, including 584 applications of companies authorised to accept public deposits. The supervisory role of the RBI encompasses on-site inspection, off-site monitoring, market intelligence and exception reports of statutory auditors.

3.66 In recent years, a declining trend has been observed in the number of operating NBFCs owing to strict application of registration norms. The total number of NBFCs declined from 14,077 at end-June 2002 to 13,849 at end-June 2003, and further to 13,671 at end-June 2004. The corresponding decline in the number of deposit accepting NBFCs was from 784 to 710 and further to 584, respectively. The decline in the number of deposit accepting companies was on account of cancellation of COR and conversion of deposit taking companies into non-deposit taking companies and other reasons.

3.67 Public deposits by 875 reporting deposit accepting NBFCs amounted to Rs. 20,100 crore at end-March 2003, up 6.8 per cent from Rs. 18,822 crore (910 reporting NBFCs) at end-March 2002. Three-fourths of these deposits (Rs. 15,065 crore) were accounted for by RNBCs. The dependence of NBFCs (other than RNBCs) on public deposits has gradually declined from Rs.6,460 crore at end-March 2001 (17.2 per cent of total liabilities) to Rs.5,035 crore at end-March 2003 (13.4 per cent of total liabilities). The borrowings of NBFCs (excluding RNBCs) increased from Rs.24,000 crore at end-March, 2002 to Rs.24,480 crore at end-March, 2003. The assets of the NBFCs (excluding RNBCs) witnessed a decline from Rs. 39,833 crore to Rs. 37,709 crore between end-March 2002 and end-March 2003, a decline of 5.3 per cent. Equipment leasing and hire purchase accounted for 39.9 per cent of the total assets of NBFCs at end-March, 2003, while loan and inter-corporate deposits accounted for 35.3 per cent of their total assets. Income and expenditure of NBFCs registered a decline during 2002-03. Income witnessed a decline of 5.1 per cent to Rs. 5,084 crore. Expenditure of NBFCs declined by 15.6 per cent to Rs. 4,491 crore at end-March 2003. The NBFCs posted a net profit of 0.9 per cent of total assets

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in 2002-03 compared to a loss of 0.5 per cent of the total assets in the previous year.

3.68 Capital adequacy ratio of NBFCs improved marginally, with 93.7 per cent of NBFCs (out of 605 reporting) achieving more than the prescribed 12 per cent capital adequacy ratio in 2002-03 as compared to 93.5 per cent of NBFCs (out of 663 reporting) fulfilling the minimum capital adequacy norm in 2001-02. The gross and net NPAs of the reporting NBFCs have been witnessing a steady decline in recent years. The gross and net NPAs as per cent of credit exposure declined from 10.2 per cent and 7.0 per cent to 8.8 per cent and 2.7 per cent, respectively, between end-March 1999 and end-March 2003.

3.69 The maximum rate of interest that the NBFCs including nidhi and chit fund companies can pay remained unchanged at 11.0 per cent per annum (effective March 4, 2003). The minimum rate of interest payable by RNBCs also remained unchanged at 5 per cent per annum (to be compounded annually) on the amount of deposits received in lump sum or at monthly or longer intervals and at 3.5 per cent per annum (to be compounded annually) on the amount deposited under daily deposit scheme. With a view to rationalising the pattern of directed investments and addressing the systemic risk, the level of investments of RNBCs in Government securities was increased and rating and listing requirements in respect of other approved investments were made mandatory in June, 2004. RNBCs were advised to reduce their discretionary investment to 10 per cent of their deposits by April, 2005 and to completely dispense with it from April, 2006. To avoid systemic risks and for safeguarding the interest of depositors, in its mid-term review of the annual policy statement for 2004-05, the RBI proposed certain measures to improve the functioning of RNBCs. These measures include (i) transparency of operations, especially in the connected lending relationships, (ii) corporate governance standards including professionalisation of the Boards and ensuring 'fit and proper' criteria in consonance with the standards in banks, (iii) avoiding untenable rates of commission to agents, (iv) adherence to 'know your customer' rules, and (v) customer service in terms of clear indication of the identifiable contact with the field agents so that matters such as unclaimed deposits are appropriately addressed.

3.70 Internationally, acceptance of public deposits is restricted to banks alone and non-banks, including NBFCs, can raise resources from institutional sources or by accessing the capital market only. The RBI is planning to hold discussions with the NBFCs in regard to their plan of action for voluntarily phasing out acceptance of deposits, in line with the international practice.

All-India financial institutions (AIFIs)

3.71 With the progressive blurring of functions between banks and financial institutions, the AIFIs are fast losing ground and adopting the business model of a bank to remain viable in the long run (Table 3.11). The merger of ICICI with ICICI bank on March 30, 2002 was the beginning of conversion of AIFIs into universal banks. Taking into account the changing operating environment following the initiation of economic reforms in the early 1990s, the Government decided to transform IDBI into a commercial bank without eschewing its traditional development finance obligations. The migration to the new business model of commercial banking, with its access to low cost, current/saving bank deposits is expected to enable it to overcome most of the limitations of the current model of development finance and also to diversify its client/asset base. In fulfilment of these objectives, the IDBI (Transfer of Undertaking and Repeal) Act, 2003 was enacted in December, 2003, which came into effect from July 2, 2004. The Act provides for repeal of the IDBI Act, corporatisation of IDBI, and its transformation into a commercial bank. IDBI was transformed into IDBI Limited on October 1, 2004, a company under the Companies Act, 1956 and a schedule bank (on October 11, 2004) under the RBI Act, 1934. In a parallel move, the Government approved IDBI's proposal to set up a Stressed Assets Stabilisation Fund

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(SASF), which provides for stressed assets of IDBI amounting to Rs. 9,000 crore to be transferred to SASF against an equivalent amount of 20 years' bond issued by the Government of India in favour of SASF on cash/budget neutral basis. On July 29, 2004, the proposal to merge IDBI Ltd and IDBI Bank was accorded in principle approval by the respective Boards. With the reverse merger of ICICI with ICICI Bank in 2002 and conversion of IDBI into a bank, the importance of AIFIs in the provision of project finance has come down considerably.

3.72 Taking into account the difficulties faced by AIFIs in the changed operating environment, the RBI constituted a Working Group on Development Financing Institutions with Shri N. Sadasivan as its Chairman. The Working Group submitted its report in May, 2004 suggesting a roadmap for development financing and the role of DFIs. The main recommendations made by the Working Group relate to conversion of DFIs, which are inherently unsustainable, into either a bank or an NBFC, strengthening of regulatory framework, raising of risk weightage of certain categories of investment from 20 per cent to 100 per cent and extension of certain relaxations for DFIs for converting into banks for a period of 3 to 5 years after their conversion.

Table 3.11 : Assistance by AIFIs

	2001-02	2002-03	2003-04
A. Sanctions			
1. DFIs	33605	33648	36055
2. Investment institutions	8247	5667	29479
Total	**41851**	**39315**	**65534**
B. Disbursements			
1. DFIs	26423	25357	24463
2. Investment institutions	10380	7488	17402
Total	**36803**	**32845**	**41865**

Notes:

1. **Excluding ICICI and UTI**
2. **Data are provisional and not adjusted for their institutional flows.**
3. **DFIs include All-India Development Banks and specialised financial institutions**

Outlook

3.73 The opening up of the economy, while providing immense opportunities for growth, has changed the focus of monetary management a great deal. The RBI has been effectively managing the capital flows, and the introduction of MSS has considerably improved its manoeuvrability. The enactment of the Fiscal Responsibility and Budget Management (FRBM) Act in 2003 and its operationalisation in 2004-05 is expected to impart more flexibility to RBI in its management of monetary policy.

3.74 The RBI has been making consistent efforts to make lending rates of banks more transparent and to align them with deposit rates. The introduction of BPLRs has, to an extent, addressed the problem of downward rigidity of lending rates. The widening interest spread suggests that further efforts are needed to tackle the problem of downward rigidity of lending rates. The continuing reduction in the NPA levels and interest expenditure should enable banks to set the lending rates on a more realistic basis. This would go a long way in sustaining the growth in non-food credit.

3.75 The initiatives of the Government and the RBI have started yielding results in terms of improvements in credit delivery. Further efforts are required to sustain improvements in the credit flow to agriculture. In this context, there is a need for banks to focus their efforts on commercial crops besides cereals. The constraints in lending to the small scale sector need to be addressed in view of its employment potential. The interest spread charged on loans to the SME sector, relative to large industries sector, needs to be reasonable, reflecting the differential costs, and should be brought down through realignment of lending rates and better credit assessment.

3.76 The declining role of DFIs poses a challenge to banks in meeting the long term requirement for funds. Adherence to the FRBM Act stipulations is likely to reduce the exposure of commercial banks to Government paper and enable banks to undertake more long-term financing to the commercial sector. For this, banks need to hone up their skills in project financing.

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