RESERVE BANK OF INDIA

Monetary Policy Statement
2011-12

(Including Developmental and Regulatory Policies)

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Governor

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CONTENTS

ACRONYMS

AACS	-	As Applicable to Co-operative Societies
AD	-	Authorised Dealer
AMA	-	Advanced Measurement Approach
ASA	-	Alternate Standardised Approach
ATM	-	Automated Teller Machine
BC	-	Business Correspondent
BCBS	-	Basel Committee on Banking Supervision
BPLR	-	Benchmark Prime Lending Rate
CAD	-	Current Account Deficit
CBLO	-	Collateralised Borrowing and Lending Obligation
CBS	-	Core Banking Solution
CCIL	-	Clearing Corporation of India Limited
CDs	-	Certificates of Deposit
CDS	-	Credit Default Swap
CERSAI	-	Central Registry of Securitisation Asset Reconstruction and Security Interest of India
CI	-	Confidence Interval
CMD	-	Chairman and Managing Director
CPI	-	Consumer Price Index
CRR	-	Cash Reserve Ratio
CSPs	-	Customer Service Providers
CSGL	-	Constituent Subsidiary General Ledger
DCCBs	-	District Central Co-operative Banks
DoMFs	-	Debt Oriented Mutual Funds
DvP	-	Delivery versus Payment
ECS	-	Electronic Clearing Service
EMEs	-	Emerging Market Economies
FAO	-	Food and Agriculture Organisation
FDI	-	Foreign Direct Investment
FEMA	-	Foreign Exchange Management Act

FII	-	Foreign Institutional Investor
FIP	-	Financial Inclusion Plan
FSB	-	Financial Stability Board
FSR	-	Financial Stability Report
FSS	-	Farmers Service Societies
GCC	-	General Credit Card
GDP	-	Gross Domestic Product
G-20	-	Group of Twenty
IASB	-	International Accounting Standard Board
IBA	-	Indian Banks' Association
ICT	-	Information and Communication Technology
IDRBT	-	Institute for Development and Research in Banking Technology
IFRSs	-	International Financial Reporting Standards
IIP	-	Index of Industrial Production
IMA	-	Internal Models Approach
IMD	-	India Meteorological Department
IMF	-	International Monetary Fund
IND AS	-	Indian Accounting Standards
INFINET	-	Indian Financial Network
IOS	-	Industrial Outlook Survey
IRB	-	Internal Rating Based
IRFs	-	Interest Rate Futures
ISO	-	International Organisation for Standardisation
IT	-	Information Technology
JLG	-	Joint Liability Group
KCC	-	Kisan Credit Card
LAF	-	Liquidity Adjustment Facility
LAMPS	-	Large Adivasi Multi-purpose Co-operative Societies
M_3	-	Broad Money
MENA	-	Middle East and North Africa
MFIs	-	Micro Finance Institutions

MIS	-	Management Information System
MoU	-	Memorandum of Understanding
MSF	-	Marginal Standing Facility
MSEs	-	Micro and Small Enterprises
MSMEs	-	Micro, Small and Medium Enterprises
NABARD	-	National Bank for Agriculture and Rural Development
NBFCs	-	Non-Banking Financial Companies
NDS	-	Negotiated Dealing System
NDTL	-	Net Demand and Time Liabilities
NEFT	-	National Electronic Funds Transfer
NG-RTGS	-	Next Generation Real Time Gross Settlement
NRIs	-	Non-resident Indians
OBICUS	-	Order Books, Inventories and Capacity Utilisation Survey
OMO	-	Open Market Operation
OTC	-	Over-the-Counter
PACS	-	Primary Agricultural Credit Societies
PCR	-	Provisioning Coverage Ratio
PIN	-	Personal Identification Number
PIOs	-	Persons of Indian Origin
PMI	-	Purchasing Managers' Index
PoS	-	Points of Sale
PSBs	-	Public Sector Banks
Q	-	Quarterly
RBI	-	Reserve Bank of India
REER	-	Real Effective Exchange Rate
RRBs	-	Regional Rural Banks
RTGS	-	Real Time Gross Settlement
SARFAESI	-	Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest
SCBs	-	Scheduled Commercial Banks
SEBI	-	Securities and Exchange Board of India
SGL	-	Subsidiary General Ledger

SHG	-	Self-Help Group
SLAF	-	Second LAF
SLR	-	Statutory Liquidity Ratio
StCBs	-	State Co-operative Banks
TSA	-	The Standardised Approach
UCBs	-	Urban Co-operative Banks
US	-	United States of America
WEO	-	World Economic Outlook
WOS	-	Wholly Owned Subsidiary
WPI	-	Wholesale Price Index
XML	-	Extensible Mark up Language
Y-o-Y	-	Year-on-Year

Reserve Bank of India
Monetary Policy Statement 2011-12

By
Dr. D. Subbarao
Governor

Introduction

The Annual Policy for 2011-12 is set in conditions significantly different than they were a year ago. Last year's policy was made in an environment of incipient domestic recovery amidst uncertainty about the state of the global economy, a perception that was reinforced with the precipitation of the Greek sovereign debt crisis a few weeks later. While signs of inflation were visible, they were driven primarily by food. However, food price pressure spilling over into more generalised inflation was clearly a risk as the recovery consolidated and domestic resource utilisation rose to levels which stretched capacities. Throughout the year, the goal of monetary policy was to nurture the recovery in the face of persistent global uncertainty while trying to contain the spillover of supply-side inflation.

2. The trend of moderating inflation and consolidating growth in the second and third quarters of 2010-11 justified the calibrated policy approach of the Reserve Bank. However, the resurgence of inflation in the last quarter of 2010-11 was a matter of concern. Although the trigger was the sharp uptrend in international commodity prices, the fact that these were quickly passing through into the entire range of domestic manufactured goods indicated that pricing power is significant. In other words, demand has been strong enough to allow significant pass-through of input price increases. Significantly, this is happening even as there are visible signs of moderating growth, particularly in capital goods production and investment spending, suggesting that cumulative monetary actions are beginning to have an impact on demand.

3. Thus, three factors have shaped the outlook and monetary strategy for 2011-12. First, global commodity prices, which have surged in recent months, are likely to, at best, remain firm and may well increase further over the course of the year. Second, headline and core inflation have significantly overshot even the most pessimistic projections over the past few months. In terms of the likely trajectory of inflation over the year, the first suggests that high inflation will persist and may get worse. The second raises concerns about inflationary expectations becoming unhinged.

4. The third factor, countering these forces, is the likely moderation in demand, which should help reduce pricing power and the extent of pass-through of commodity prices. This cannot be ignored in the policy calculation. However, a significant factor influencing aggregate demand during the year will be the fiscal situation. While the budget estimates offered reassurance of a rollback, the critical assumption that petroleum and fertiliser subsidies would be capped is bound to be seriously tested

at prevailing crude oil prices. Even though adjustment of administered retail prices may add to inflation in the short run, the Reserve Bank believes that this needs to be done as soon as possible. Otherwise, the consequent increase in the fiscal deficit will counter the moderating trend in aggregate demand.

5. The monetary policy trajectory that is being initiated in this Annual Statement is based on the following premise. Over the long run, high inflation is inimical to sustained growth as it harms investment by creating uncertainty. Current elevated rates of inflation pose significant risks to future growth. Bringing them down, therefore, even at the cost of some growth in the short-run, should take precedence.

6. Against this backdrop, this Statement sets out the Reserve Bank's assessment of the current macroeconomic situation and projections. It is organised in two parts. Part A covers Monetary Policy and is divided into four Sections. Section I provides an overview of global and domestic macroeconomic developments. Section II sets out the outlook and projections for growth, inflation and monetary aggregates. Section III explains the stance of monetary policy. Section IV specifies the monetary and liquidity measures, including the modified operating procedures in the light of the recommendations of the Working Group on Operating Procedure of Monetary Policy (Chairman: Shri Deepak Mohanty) and the feedback received thereon.

7. Part B covers Developmental and Regulatory Policies and is divided into six sections: Financial Stability (Section I), Interest Rate Policy (Section II), Financial Markets (Section III), Credit Delivery and Financial Inclusion (Section IV), Regulatory and Supervisory Measures for Commercial Banks (Section V) and Institutional Developments (Section VI).

8. Part A of this Statement should be read and understood together with the detailed review in *Macroeconomic and Monetary Developments* released yesterday by the Reserve Bank.

Part A. Monetary Policy

I. The State of the Economy

Global Economy

9. The global economy during the first quater of 2011 continued with the momentum of late 2010. The global manufacturing purchasing managers' index (PMI) for February 2011 was close to a record high, while the global services PMI recorded its fastest pace of expansion in almost five years. Although these indices slipped somewhat in March 2011, they signalled continuing expansion. However, consumer confidence in major countries, which improved during January-February 2011, moderated in March 2011 on the back of higher oil prices.

10. GDP growth in the US, which was strong at 3.1 per cent (q-o-q seasonally adjusted annualised rate) in Q4 of 2010, slipped to 1.8 per cent reflecting a decline in government spending, deceleration in private consumption and increase in imports. Clearly, a number of weaknesses persist. The US housing market remains weak. More generally, unemployment rates continue to remain elevated in major advanced economies, *albeit* with some improvement

in the US. Concerns about sovereign debt in the euro area have now been reinforced by developments in the US. Finally, and most importantly, commodity price increases have accelerated, engendering global inflationary fears and posing downside risks to growth.

11. The Brent crude price surged from an average of US$ 75 a barrel during May-September 2010 to US$ 123 a barrel by April 2011. The International Monetary Fund's (IMF) in its April 2011 World Economic Outlook (WEO) has assumed US$ 107 a barrel for the full year 2011. Initially, oil prices were buoyed by strong global demand and excessive liquidity. Since February 2011, oil prices have come under further pressure on account of apprehensions about supply disruptions due to political developments in the Middle East and North African (MENA) region. The demand for oil is expected to increase with the possibility of Japan substituting some of its shut-in nuclear power capacity with oil-based generation, combined with higher energy usage once reconstruction gets underway.

12. In the recent period, commodity prices have been under pressure due to strong demand from emerging market economies (EMEs) and the financialisation of commodity markets. Global consumption of most base metals is estimated to have reached new highs in 2010. According to the Food and Agriculture Organisation (FAO), international food prices rose by 37 per cent (y-o-y) in March 2011, reflecting both higher demand and weather related supply disruptions. The increase in global food prices was led by the prices of cereals (60 per cent), edible oils (49 per cent) and sugar (41 per cent).

13. Commodity prices are now exerting a direct impact on inflation in advanced economies, despite substantial negative output gaps. They have also accentuated inflationary pressures in EMEs, which were already experiencing strong revival in demand. While major EMEs have been tightening monetary policies for more than a year now, the European Central Bank has recently raised its policy rate - the first central bank to do so among the major advanced economies - after maintaining them at historically low levels for almost two years. Central banks in other advanced economies are also under pressure to withdraw monetary accommodation. The above trend poses appreciable downside risks to global economic activity.

Domestic Economy

14. The Indian economy is estimated to have grown by 8.6 per cent during 2010-11. Agricultural growth was above trend, following a good monsoon. The index of industrial production (IIP), which grew by 10.4 per cent during the first half of 2010-11, moderated subsequently, bringing down the overall growth for April-February 2010-11 to 7.8 per cent. The main contributor to this decline was a deceleration in the capital goods sector. However, other indicators, such as the manufacturing PMI, tax collections, corporate sales and earnings growth, credit off-take by industry (other than infrastructure) and export performance, suggested that economic activity was strong.

15. According to the Reserve Bank’s Order Books, Inventories and Capacity Utilisation Survey (OBICUS), the order books of manufacturing companies grew by 7 per cent in October-December 2010 as against 9 per cent in the previous quarter indicating sustained demand *albeit* with some moderation. The Reserve Bank’s

forward looking Industrial Outlook Survey (IOS) shows a decline in the business expectations index for January-March 2011 after two quarters of increase.

16. Leading indicators of services sector suggest continuing growth momentum. Credit to the services sector grew by 24 per cent in 2010-11 as compared with 12.5 per cent in the previous year. Other indicators such as commercial vehicles production and foreign tourist arrivals also showed an acceleration. However, the services PMI for March 2011 showed some moderation as compared with the previous month.

17. Inflation was the primary macroeconomic concern throughout 2010-11. It was driven by a combination of factors, both structural and transitory. Based on drivers of inflation, the year 2010-11 can be broadly divided into three periods. In the first period from April to July 2010, the increase in wholesale price index (WPI) by 3.5 per cent was driven largely by food items and the fuel and power group, which together contributed more than 60 per cent of the increase in WPI. During the second period from August to November 2010, while WPI showed a lower increase of 1.8 per cent, more than 70 per cent of the increase was contributed by food and non-food primary articles and minerals. In the third period from December 2010 to March 2011, WPI increased sharply by 3.4 per cent, driven mainly by fuel and power group and non-food manufactured products, which together contributed over 80 per cent of the increase in WPI. Thus, the inflationary pressures, which emanated from food, clearly became generalised as the year progressed.

18. As food price inflation moderated, consumer price index (CPI) measures of inflation declined to 8.8-9.1 per cent in March 2011 from 13.3-15.0 per cent in April 2010. Over the same period, WPI inflation remained elevated reflecting increases in non-food primary articles prices and importantly, non-food manufactured product prices. This led to a broad convergence of WPI and CPI inflation by the end of 2010-11.

19. Broad money supply (M_3) growth at 15.9 per cent (year-on-year) during 2010-11 was lower than the Reserve Bank's indicative trajectory of 17 per cent due to slow deposit growth and acceleration in currency growth. The higher currency demand slowed the money multiplier. Consequently, M_3 growth slowed despite a significant increase in reserve money. This suggests that money supply growth was not a contributing factor to inflation.

20. Non-food credit growth, which had been trending upwards from the beginning of the year, reached an intra-year high of 24.2 per cent (year-on-year) in December 2010. It slowed down subsequently to 21.2 per cent by March 2011, which was marginally higher than the Reserve Bank's indicative projection of 20 per cent.

21. The Reserve Bank's estimates show that the total flow of financial resources from banks, domestic non-bank and external sources to the commercial sector during 2010-11, at ₹12,00,000 crore, was 12.3 per cent higher than that in the previous year. There was a decline in non-bank sources of funds in 2010-11 as compared with that in the previous year. The decline was particularly noticeable in foreign direct investment. However, this was more than offset by the higher flow of funds from the banking sector.

22. Data on sectoral deployment of bank credit show significant increases in

credit flow to industry and services. Within industry, credit growth to infrastructure was robust. Credit flows improved in respect of metals, textiles, engineering, food processing, and gems and jewellery, among others. Within services, credit growth accelerated to commercial real estate and non-banking financial companies. Housing and vehicle loans recovered in 2010-11.

23. The Base Rate system replaced the Benchmark Prime Lending Rate (BPLR) system with effect from July 1, 2010. Major scheduled commercial banks (SCBs), constituting about 81 per cent of total banking business, raised their Base Rates by 50-165 basis points between October 2010 and March 2011. Base Rates of 64 major banks with a share of around 98 per cent in the total bank credit were in the range of 8.00-9.50 per cent (March 2011), reflecting greater convergence in Base Rates announced by major banks. The weighted average lending rate in the banking system was 10.5 per cent as at end-March 2010. Data from select banks indicate that the weighted average yield on advances, which is a proxy measure for effective lending rates, is projected to increase from 9.7 per cent in 2010-11 to 10.3 per cent in 2011-12. This suggests that the Base Rate system has improved the transmission from the policy rates to banks' lending rates.

24. After remaining in surplus for 18 months, liquidity conditions transited to a deficit mode towards end-May 2010. This was the consequence of a large build-up in government cash balances as a result of higher than expected proceeds from spectrum auctions. Beginning October 2010, liquidity conditions became even tighter. Both frictional factors such as the above-normal build up in government cash balances and structural factors such as high currency demand growth and credit growth outpacing deposit growth contributed to tight liquidity conditions. Although a systemic liquidity deficit was consistent with the anti-inflationary stance of monetary policy, the extent of tightness since October 2010 was outside the comfort level of (+)/(-) one per cent of net demand and time liabilities (NDTL) of SCBs.

25. The Reserve Bank initiated several measures to ease the liquidity situation. These were: (i) additional liquidity support under the liquidity adjustment facility (LAF) to SCBs up to one per cent of their NDTL by temporary waiver of penal interest for any shortfall in maintenance of statutory liquidity ratio (SLR) - for a brief period the limit was two per cent of NDTL, which was reduced to one per cent following the permanent reduction in the SLR; (ii) reduction in the SLR by one per cent; (iii) conducting open market operations; and (iv) conducting the second LAF (SLAF) on a daily basis.

26. Liquidity conditions have eased significantly in recent weeks, following a sharp reduction in government cash balances and moderation in the credit-deposit ratio of banks. Consequently, net liquidity injected by the Reserve Bank through its repo operations declined from a daily average of around ₹1,20,000 crore in December 2010 to around ₹81,000 crore in March 2011. The average daily net liquidity injected by the Reserve Bank fell sharply to ₹19,000 crore in April 2011 as government balances moved from positive to negative.

27. In order to facilitate better liquidity management, the Reserve Bank extended the two liquidity easing measures, *viz.*, additional liquidity support under the LAF to SCBs up to one per cent of their NDTL and the SLAF on a daily basis up to May 6, 2011.

28. Yields on government securities eased during the first quarter of 2010-11 in expectation of an improved fiscal position due to higher than anticipated revenues in spectrum auctions. Yields hardened thereafter till January 2011 on account of increase in inflation and consequent rate hike expectations as well as tight liquidity conditions. Yields, however, moderated in February and March 2011 on the back of improvement in liquidity conditions, lower than expected budgeted fiscal deficit and the projected market borrowing programme for the first half of 2011-12. Significantly, the stability of long-term yields, despite the current high rates of inflation, suggests that inflationary expectations remain anchored.

29. The Union Budget for 2011-12 has emphasised the Government's commitment to carry on the process of fiscal consolidation by budgeting a lower fiscal deficit (4.6 per cent of GDP in 2011-12 as compared with 5.1 per cent in 2010-11). The revenue deficit to GDP ratio is estimated to remain unchanged at 3.4 per cent in 2011-12.

30. During 2010-11, the rupee dollar exchange rate showed two-way movements in the range of ₹44.03-47.58 per US dollar. On an average basis, the 6-currency real effective exchange rate (REER) appreciated by 12.7 per cent in 2010-11, the 30-currency REER by 4.5 per cent and the 36-currency REER by 7.7 per cent.

31. The current account deficit (CAD) during April-December 2010 was US$ 38.9 billion, up from US$ 25.5 billion during the corresponding period of 2009. During the fourth quarter of 2010-11, exports grew at a robust pace of 46.6 per cent, while growth in imports decelerated to 22.8 per cent. Consequently, the CAD, which was 3.1 per cent during April-December 2010, is now estimated to moderate to around 2.5 per cent of GDP for 2010-11 as against 2.8 per cent during 2009-10.

32. Although net capital inflows increased significantly to US$ 52.7 billion during April-December 2010 (US$ 37.6 billion a year ago), the composition shifted towards volatile flows such as FII investments and trade credits. Net inflows under FDI were lower. As the CAD is expected to be significant in 2011-12, the sustainability of financing it becomes important.

II. Outlook and Projections

Global Outlook

Growth

33. The global recovery is expected to sustain in 2011, although growth will slow down marginally from its pace in 2010. According to the IMF WEO (April 2011), global growth is likely to moderate from 5.0 per cent in 2010 to 4.4 per cent in 2011. Growth is projected to decelerate in advanced economies due to waning of impact of fiscal stimulus, and high oil and other commodity prices. Growth in EMEs is also expected to decelerate on account of monetary tightening and rising commodity prices.

Inflation

34. The IMF WEO (April 2011) projects global CPI inflation to rise from 3.7 per cent in 2010 to 4.5 per cent in 2011. While advanced economies face inflationary pressures from high commodity prices, EMEs face pressures from both strong domestic demand and high commodity prices. CPI inflation in the advanced

economies is projected to increase from 1.6 per cent in 2010 to 2.2 per cent in 2011, and in the EMEs from 6.2 per cent to 6.9 per cent.

Domestic Outlook

Growth

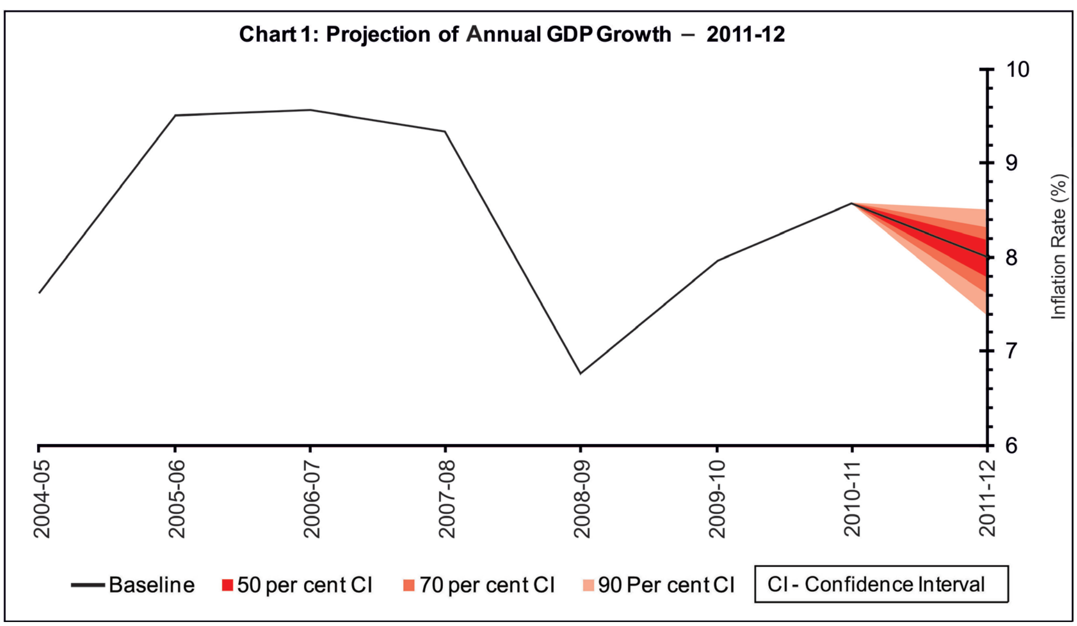
35. Real GDP growth for 2010-11 was estimated at 8.6 per cent. Signs of moderation, however, emerged in the second half of the year. Particularly significant were the slowdown in capital goods production and investment spending. Going forward, high oil and other commodity prices and the impact of the anti-inflationary monetary stance will weigh on growth. Most business confidence surveys conducted by various agencies show a decline in business confidence. The Reserve Bank's IOS conducted during March 2011, as mentioned earlier, indicates some moderation in business expectations for the quarter ended June 2011.

36. Growth is expected to moderate in 2011-12 from its pace in 2010-11. First, notwithstanding the preliminary indication of a normal monsoon by the India Meteorological Department (IMD) during 2011, agriculture growth is likely to revert to its trend growth from the higher base of last year. Second, the pace of industrial activity has been slowing mainly due to the impact of past monetary policy actions and high input prices. External demand too may slow if global recovery slackens.

37. Based on the assumption of a normal monsoon and crude oil prices averaging US$ 110 a barrel over 2011-12, the baseline projection of real GDP growth for 2011-12 for policy purposes is placed at around 8 per cent. The growth is projected to be in the range of 7.4 per cent and 8.5 per cent in 2011-12 with 90 per cent probability (Chart 1).

Inflation

38. The Reserve Bank's forecasts systematically under-predicted year-end inflation during 2010-11. Even after a significant upward revision from 5.5 per cent to 7 per cent in the Third Quarter Policy Review in January 2011 and then to



8 per cent in the Mid-Quarter Review in March 2011, the forecasts remained below the provisional number of 9 per cent for March 2011. The analysis in the previous section reveals that the surge in headline inflation, despite an overall moderation in food inflation, was the combination of two factors: an unanticipated increase in oil and commodity prices, including the large upward revision in administered coal prices in March 2011, and demand pressures reflected in significant increase in inflation in non-food manufactured products.

39. Against this backdrop, several factors will play a role in the inflation outlook, going forward. First, there is a significant suppressed component of inflation as the increase in crude oil prices has not been passed on completely. The last increase in administered mineral oil prices was effected in June 2010 when the Indian basket of crude oil was US$ 74.3 per barrel. Subsequently, it increased to US$ 110.7 per barrel in March 2011. Similarly, administered electricity prices have not gone up even as input prices, particularly those of coal, have increased significantly. Hence, the timing of changes in administered prices as indicated above will have a significant influence on the inflation path.

40. Second, the outlook for crude oil prices in the near future is uncertain, given the geo-political situation in the MENA region. In any case, the likelihood of oil prices moderating significantly is low. The IMF WEO (April 2011) has assumed a baseline average crude oil price of US$ 107 per barrel for 2011 and US$ 108 per barrel for 2012.

41. Third, incomplete pass-through of higher crude prices will have an impact on aggregate demand though higher subsidy expenditure, which is expansionary and can add to inflationary pressure.

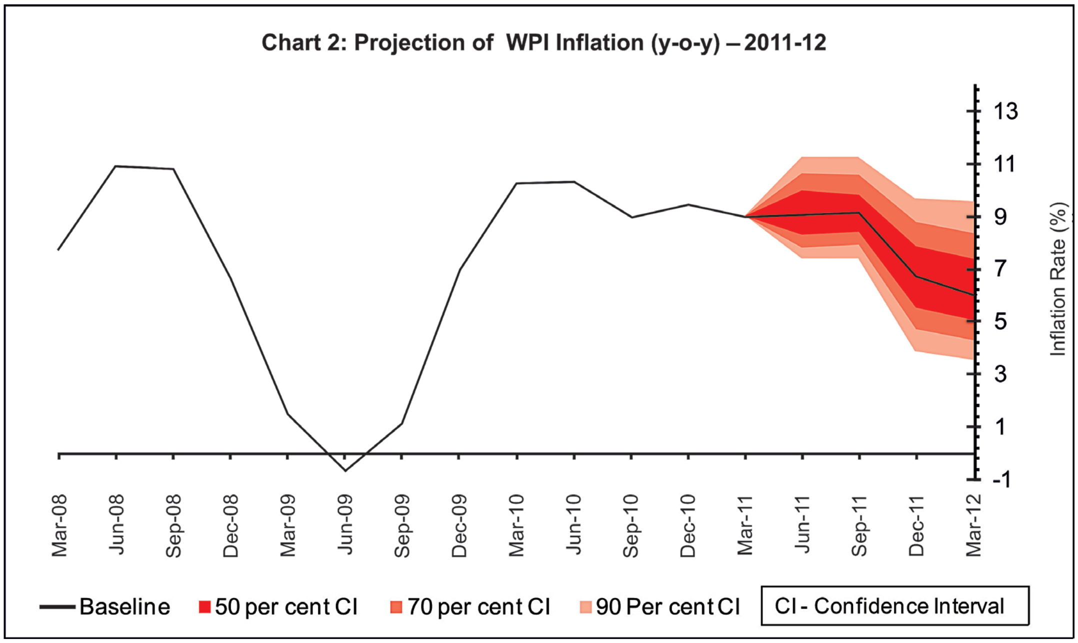
42. Fourth, there have been sharp increases in the prices of several important industrial raw materials, such as minerals, fibres, especially cotton, rubber, besides coal and crude oil. In addition, there is also upward pressure on wages. The extent to which the increase in input prices translates into output prices will have an influence on the inflation path.

43. Fifth, while the south-west monsoon 2011 is expected to be normal, its impact on moderation in food inflation may be less than commensurate, given a strong structural component in food inflation and elevated global food price situation.

44. Sixth, even though demand pressures were evidently strong enough to induce the generalisation of commodity price increases in recent months, signs of moderation in growth suggest that this driver of inflation will ease in the coming months. The cumulative impact of monetary actions over the past 15 months will continue to be felt over the course of 2011-12, contributing to moderation in both growth and inflation rates.

45. Keeping in view the domestic demand-supply balance and the global trends in commodity prices and the likely demand scenario, the baseline projection for WPI inflation for March 2012 is placed at 6 per cent with an upward bias (Chart 2). Inflation is expected to remain at an elevated level in the first half of the year due to expected pass-through of increase in international petroleum product prices to domestic prices and continued pass-through of high input prices into manufactured products.

46. Notwithstanding the current inflation scenario, it is important to recognise that in the last decade, the average inflation rate, measured in terms of WPI and CPI, had moderated to around 5.5 per cent. More specifically, non-food manufacturing



inflation, which the Reserve Bank uses as an indicator of demand pressures and is the most responsive to monetary actions, averaged 4.0 per cent over this period. A period of low inflation preceded the high-growth phase in 2003-08, which was in turn characterised by high investment-GDP and declining fiscal deficit-GDP ratios. Inflation remained moderate in the early part of the high-growth phase, but increased in the period immediately preceding the global financial crisis, reflecting the emergence of domestic bottlenecks.

47. Based on cross-country as well as domestic experience, the Reserve Bank is strongly of the view that controlling inflation is imperative to sustaining growth over the medium-term. This is a critical attribute of a favourable investment climate, on which growth sustainability depends. Fiscal consolidation will also contribute to improving the investment climate. Accordingly, the conduct of monetary policy will continue to condition and contain perceptions of inflation in the range of 4.0-4.5 per cent, with particular focus on the behaviour of the non-food manufacturing component. This will be in line with the medium-term objective of 3.0 per cent inflation consistent with India's broader integration into the global economy. The achievement of this objective will be helped by concerted policy actions and resource allocations to address domestic bottlenecks, particularly on the food and infrastructure fronts.

Monetary Aggregates

48. Keeping in view the need to balance the resource requirements of the private sector and the budgeted government borrowings, M_3 growth for 2011-12, for policy purposes, is placed at 16.0 per cent. Consistent with this, aggregate deposits of SCBs are projected to grow by 17.0 per cent. Growth in non-food credit of SCBs is projected at 19.0 per cent. These monetary projections are consistent with the growth and inflation outlook. As always, the numbers are provided as indicative projections and not as targets.

Risk Factors

49. The indicative projections of growth and inflation for 2011-12 are subject to several risks as detailed below:

i) There are several downside risks to global growth at this stage such as (a) sovereign debt problem in the euro area periphery intensifying and spreading to the core; (b) high commodity prices, especially oil, impacting the global recovery; (c) abrupt rise in long-term interest rates in highly indebted advanced economies with implications for fiscal path; and (d) accentuation of inflationary pressures in EMEs. Should global recovery slacken significantly, it will impact the Indian economy through the trade, finance and confidence channels.

ii) Global commodity prices are a significant risk factor for both domestic growth and inflation. The future path of crude oil prices is uncertain. Brent crude crossed US$ 120 per barrel in April 2011. Metal prices, which witnessed some decline around mid-March 2011, reflecting the weakening of investor confidence due to the Japanese disaster, have resumed their upward trend.

iii) The budgeted fiscal deficit for 2011-12 gives some comfort on the demand front. However, achieving the fiscal consolidation targets for 2011-12 could be a challenge, given the subsidy burden arising out of high international prices, the effect of which has not been completely passed on. The Government, therefore, needs to focus on the quality of expenditure to sustain the fiscal consolidation process, which, in turn, will help contain aggregate demand.

iv) Food inflation, after remaining in double digits for more than two years, declined to a single digit rate in November 2010. However, despite normal monsoon in 2010, food price inflation did not show the usual moderation. Furthermore, vegetable prices also did not exhibit the usual seasonal pattern in 2010-11. This suggests that supply is not able to keep pace with the growing demand. Given the spike in international food prices even in significantly traded food items, imports do not provide an option to cushion domestic prices. Persistently high food prices are likely to exert sustained upward pressure on wages, thus transmitting through to wider cost pressure on prices.

v) If oil and commodity prices remain elevated, the CAD will remain significant. Financing of CAD is going to be a challenge as advanced countries begin exiting from their accommodative monetary policy stance. This could slow down capital inflows to EMEs, including India, as investors rebalance their portfolios.

III. The Policy Stance

50. The Reserve Bank began exiting from the crisis driven accommodative policy in October 2009. Since then, the cash reserve ratio (CRR) has been raised by 100 basis points. Policy rates have been raised eight times - the repo rate under the LAF by 200 basis points and the reverse repo rate by 250 basis points. The effective tightening in policy rates has been of 350 basis points as the liquidity in the system transited from a surplus to a deficit mode.

51. The monetary policy stance in 2010-11 was calibrated on the basis of the domestic growth-inflation dynamics amidst persistent global uncertainties. Against the backdrop of global and domestic

macroeconomic conditions, outlook and risks, the policy stance for 2011-12 has been guided by the following major considerations.

52. First, notwithstanding some moderation in the second half of the year, inflation has persistently remained much above the comfort level of the Reserve Bank. The sharp increase in non-food manufactured product inflation towards the latter part of the year suggests strong underlying demand pressures, which are helping producers to pass through input price increases. The uncertainty in global commodity prices poses a major risk to domestic inflation as the significant increase in global crude prices that has already taken place, is yet to be passed through to domestic prices. The impact of monetary tightening already undertaken by the Reserve Bank is still unfolding. However, considering the overall inflation scenario, there is a clear need to persist with the anti-inflationary stance.

53. Second, while the growth momentum remained relatively firm during 2010-11, signs of moderation emerged in the latter half of the year, particularly with respect to capital goods and investment activity. Growth is expected to decelerate from 8.6 per cent in 2010-11 to around 8 per cent in 2011-12, which should contribute to some easing of demand-side inflationary pressures, particularly in the second half, as the full impact of monetary tightening is realised. However, even as this trend unfolds, persistently high rates of inflation raise the risks of inflationary expectations becoming unhinged.

54. Against this backdrop, the stance of monetary policy of the Reserve Bank will be as follows:

- Maintain an interest rate environment that moderates inflation and anchors inflation expectations.
- Foster an environment of price stability that is conducive to sustaining growth in the medium-term coupled with financial stability.
- Manage liquidity to ensure that it remains broadly in balance, with neither a large surplus diluting monetary transmission nor a large deficit choking off fund flows.

IV. Monetary Measures

Report of the Working Group on Operating Procedure of Monetary Policy

55. Following the First Quarter Review of Monetary Policy for 2010-11 (July 2010), the Reserve Bank constituted a Working Group to Review the Operating Procedure of Monetary Policy in India (Chairman: Shri Deepak Mohanty). The Report of the Group was placed in public domain on March 15, 2011 for feedback and comments.

56. Based on the Group's recommendations and in the light of the feedback received, it has been decided to make the following changes in the extant operating procedures of monetary policy:

(i) The weighted average overnight call money rate will be the operating target of monetary policy of the Reserve Bank.

(ii) There will henceforth be only one independently varying policy rate and that will be the repo rate. The transition to a single independently varying policy rate is expected to more accurately signal the monetary policy stance.

(iii) The reverse repo rate will continue to be operative but it will be pegged at a fixed 100 basis points below the repo rate. Hence, it will no longer be an independent rate.

(iv) A new Marginal Standing Facility (MSF) will be instituted from which SCBs can borrow overnight up to one per cent of their respective NDTL. The rate of interest on amount accessed from this facility will be 100 basis points above the repo rate. A notification is being issued separately providing for a general waiver of default from SLR compliance, freeing banks from the obligation of seeking a specific waiver of default as is the case now. This facility is expected to contain volatility in the overnight inter-bank market.

(v) As per the above scheme, the revised corridor will have a fixed width of 200 basis points. The repo rate will be in the middle. The reverse repo rate will be 100 basis points below it and the MSF rate 100 basis points above it.

(vi) While the width of the corridor is fixed at 200 basis points, the Reserve Bank will have the flexibility to change the corridor, should monetary conditions so warrant.

57. The above changes in the operating framework other than at (iv) above will come into force with immediate effect. Change under (iv) will come into effect from the fortnight beginning May 7, 2011. Detailed guidelines in this regard are being issued separately.

58. On the basis of the policy stance as outlined in Section III, and changes in operating procedures as set out above, the Reserve Bank announces the following policy measures:

Repo Rate

59. It has been decided to:

- increase the repo rate under the liquidity adjustment facility (LAF) by 50 basis points from 6.75 per cent to 7.25 per cent with immediate effect.

Reverse Repo Rate

60. The reverse repo rate under the LAF, determined with a spread of 100 basis point below the repo rate, automatically adjusts to 6.25 per cent with immediate effect.

Marginal Standing Facility (MSF) Rate

61. The Marginal Standing Facility (MSF) rate, determined with a spread of 100 basis points above the repo rate, stands calibrated at 8.25 per cent. This rate will come into effect on operationalisation of the MSF.

Bank Rate

62. The Bank Rate has been retained at 6.0 per cent.

Cash Reserve Ratio

63. The cash reserve ratio (CRR) of scheduled banks has been retained at 6.0 per cent of their NDTL.

Savings Bank Deposit Interest Rate

64. As indicated in the Second Quarter Review of Monetary Policy 2010-11, the discussion paper delineating the pros and cons of deregulating the savings bank deposit interest rate was placed on the Reserve Bank's website on April 28, 2011 for feedback from the general public.

65. In the recent period, the spread between the savings deposit and term deposit rates has widened significantly. Therefore, pending a final decision on the issue of deregulation of savings bank deposit interest rate, it has been decided to :

- increase the savings bank deposit interest rate from the present 3.5 per cent to 4.0 per cent with immediate effect.

66. Detailed instructions in this regard to banks are being issued separately.

Expected Outcomes

67. The monetary policy actions in this review are expected to:

i) contain inflation by reining in demand side pressures, and anchor inflationary expectations; and

ii) sustain the growth in the medium-term by containing inflation.

Guidance

68. The Bank's baseline inflation projections, as indicated in Chart 2 (page 9), are that the inflation rate will remain close to the March 2011 level over the first half of 2011-12, before declining. These projections factor in an upward revision of petrol and diesel prices. While the persistence of inflation over the next few months has been incorporated in this policy, the Reserve Bank will continue to persevere with its anti-inflationary stance.

Mid-Quarter Review of Monetary Policy

69. The next mid-quarter review of Monetary Policy for 2011-12 will be announced through a press release on Thursday, June 16, 2011.

First Quarter Review of Monetary Policy 2011-12

70. The First Quarter Review of Monetary Policy for 2011-12 is scheduled for Tuesday, July 26, 2011.

Part B. Developmental and Regulatory Policies

71. This part of the Statement reviews the progress in various developmental and regulatory policy measures announced by the Reserve Bank in the recent policy statements and also sets out new measures.

72. The global financial crisis has exposed areas of vulnerability in the financial sector and policy initiatives are underway to strengthen financial stability. Some of the key issues that have arisen in the banking sector are inadequate loss-absorbing capital; insufficient liquidity buffers; excessive build-up of leverage; procyclicality of financial markets; focus on firm-specific supervision and neglect of macro-prudential supervision of system-wide risks; moral hazard from too-big-to-fail institutions; weak governance practices; poor understanding of complex products; and shortcomings in risk management. With a view to addressing these issues, various international bodies, national supervisors and policymakers are engaged in instituting various reform measures at the global and at the national levels. The Reserve Bank has been playing an active role in various international fora, including G-20, Basel Committee on Banking Supervision (BCBS) and Financial Stability Board (FSB), which are engaged in setting standards and formulating policies for safeguarding the financial system.

73. The Reserve Bank has already indicated that it would implement the reform measures under Basel III framework, which are applicable to banks in India. Apart from reforms in the banking sector, the Reserve Bank has also been pursuing reforms in several other areas. It has been actively pursuing the development of various segments of the financial market. In the recent period, financial inclusion has also been recognised as a key objective of policy. In addition, greater emphasis is being placed on the quality of service rendered by banks to their customers. Information technology and payment and settlement services have a crucial role in ensuring not only efficient banking services but also in financial stability, financial inclusion and customer service. It has, therefore, been the endeavour of the Reserve Bank to promote the use of information technology in banks and provide secure and efficient payment and settlement services in the country.

I. Financial Stability

Financial Stability Report

74. It was announced in the Second Quarter Review of Monetary Policy of November 2010 that the Financial Stability Report (FSR) would be regularly published in June and December every year. Accordingly, the second FSR was released by the Reserve Bank in December 2010. The report brought out that the financial sector remained stress-free notwithstanding intermittent volatility, especially in the equity and foreign exchange markets. Financial institutions remained healthy. The stress testing on credit, market and liquidity risks indicated a reasonable degree of resilience of the banking sector in India. The report also pointed to some discernible soft spots such as volatile capital flows, stretched fiscal conditions, persisting inflationary pressure, deterioration in asset quality of banks, regulatory gaps in the non-banking financial sector, and underscored the need for setting up a robust macro-prudential framework for identification of systemic risks.

II. Interest Rate Policy

Base Rate

75. The Reserve Bank introduced the Base Rate System from July 2010, which replaced the benchmark prime lending rate (BPLR) system. Banks were given time till end-December 2010 to select the appropriate benchmark and other cost parameters for computing the Base Rate. Subsequently, some banks requested for extension of time. Accordingly, banks were permitted to change the benchmark and methodology used in the computation of their Base Rates for a further period of six months, *i.e.*, up to June 30, 2011.

III. Financial Markets

Financial Market Products

Interest Rate Futures

76. It was indicated in the Second Quarter Review of November 2010 that exchange traded interest rate futures (IRFs) on 5-year and 2-year notional coupon bearing central government securities and 91-day Treasury Bills would be introduced after taking into account the experiences of cash-settled IRF regimes in other countries. The IRF trading on 91-day Treasury Bills with cash settlement in Indian Rupees was permitted by the Reserve Bank in March 2011. The guidelines for 5-year and 2-year IRFs are being finalised in consultation with the Securities and Exchange Board of India (SEBI).

Introduction of Credit Default Swaps

77. It was announced in the Second Quarter Review of October 2009 to introduce plain vanilla over-the-counter (OTC) single-name credit default swap (CDS) for corporate bonds for resident entities, subject to appropriate safeguards. Consequently, an internal Working Group was constituted to finalise the operational framework in consultation with market participants. The final report of the internal Working Group and draft guidelines on CDS were placed on the Reserve Bank's website in February 2011 for public comments. The guidelines are being finalised, based on feedback from the public, extensive consultations with the stakeholders and deliberations in the Technical Advisory Committee on Financial Markets. Accordingly, it is proposed:

- to issue the final guidelines on plain vanilla single-name CDS for corporate bonds for resident entities, after taking into consideration the feedback/ suggestions received from market participants, by end-May 2011.

78. The product will be launched once the necessary market infrastructure is in place.

Review of Short Sale in Government Securities

79. Based on the recommendations of the Technical Group on the Central Government Securities Market, intra-day short selling in central government securities was permitted in February 2006. Subsequently, based on the feedback received, the period of short sale was extended to five days in January 2007. With a view to providing a fillip to the IRF market and the term repo market, it is proposed:

- to extend the period of short sale from the existing five days to a maximum period of three months.

Extension of DvP III Facility to Gilt Account Holders

80. Consequent upon the announcement made in the Mid-term Review of Monetary and Credit Policy for the year 2003-04, the settlement of transactions in government securities through Clearing Corporation of India Ltd. (CCIL) was switched over to delivery versus payment (DvP) III mode with effect from April 2, 2004. However, the DvP III mode of settlement was not extended to gilt account holders who maintained their balances with the custodian bank/primary dealer who, in turn, held these securities in its constituent subsidiary general ledger (CSGL) account with the Reserve Bank. With the stabilisation of the transaction and settlement infrastructure, it is now proposed:

- to extend DvP III facility to transactions by the gilt account holders (excluding transactions between the gilt account holders of the same custodian) so that the gilt account holders get the benefit of efficient use of funds and securities.

81. Detailed guidelines in this regard will be issued shortly.

Guidelines on Over-the-Counter Forex Derivatives

82. It was proposed in the Second Quarter Review of November 2010 to issue final guidelines on OTC foreign exchange derivatives by end-November 2010. Accordingly, comprehensive guidelines on OTC foreign exchange derivatives and overseas hedging of commodity price and freight risks were issued in December 2010. The important elements of the revised guidelines, which became effective February 1, 2011, are (i) allowing embedded cross currency option in the case of foreign currency-rupee swaps; and (ii) permitting use of cost reduction structures, both under the contracted exposures and past performance routes, subject to certain safeguards.

Cancellation and Rebooking under the Portfolio Investment Scheme by FIIs

83. Currently, foreign institutional investors (FIIs) are permitted to cancel and rebook 2 per cent of the market value of the portfolio as at the beginning of the financial year. In view of the large positions held by the FIIs and considering the increased depth of the Indian forex market to absorb the impact on the exchange rate, it is proposed:

- to allow FIIs to cancel and rebook up to 10 per cent of the market value of the portfolio as at the beginning of the financial year.

84. Detailed guidelines in this regard will be issued separately.

Facilitating Rupee Trade – Hedging Facilities for Non-resident Entities

85. The provisions under the Foreign Exchange Management Act (FEMA), 1999 do not permit non-residents to hedge their currency exposure with authorised dealer (AD) banks in India, in respect of exports and imports invoiced in Indian Rupees. In order to facilitate greater use of Indian Rupee in trade transactions, it is proposed:

- that in respect of exports and imports invoiced in Indian Rupees, non-resident importers and exporters can hedge their currency risk with AD banks in India through their bankers having Rupee *vostro* accounts in India. The contracts would be on a deliverable basis.

86. The operational details will be finalised and notified in consultation with the stakeholders.

Financial Market Infrastructure

Committee for Review of Procedures relating to Facilities to Individuals – Residents/NRIs and PIOs

87. The Reserve Bank recognises the need for facilitating genuine foreign exchange transactions by individuals – residents/non-resident Indians (NRIs) and persons of Indian origin (PIOs) – under the current regulatory framework of FEMA. Keeping this in view, a Committee (Chairperson: Smt. K.J. Udeshi) comprising the representatives of various stakeholders has been set up. The Committee will identify areas for streamlining and simplifying the procedure so as to remove the operational impediments, and assess the level of efficiency in the functioning of authorised persons, including the infrastructure created by them. The Committee is expected to submit its report within three months.

IV. Credit Delivery and Financial Inclusion

Credit Flow to the Micro, Small and Medium Enterprises Sector

High Level Task Force on MSMEs

88. As indicated in the Second Quarter Review of November 2010, the Reserve Bank, based on the recommendations of the High Level Task Force on Micro, Small and Medium Enterprises (MSMEs), issued guidelines in June 2010, advising scheduled commercial banks that the allocation of 60 per cent of micro and small enterprises (MSEs) advances to the micro enterprises was to be achieved in stages, *viz.,* 50 per cent in the year 2010-11, 55 per cent in the year 2011-12 and 60 per cent in the year 2012-13. Further, banks were mandated to achieve a 10 per cent annual growth in the number of micro enterprise accounts and a 20 per cent year-on-year growth in credit to the MSE sector. The Reserve Bank is closely monitoring the achievement of targets by banks on a half-yearly basis, *i.e.*, March and September each year. A suitable format has been devised by the Reserve Bank to capture and monitor the achievement of the targets by banks and the same are regularly reviewed at the highest level. Banks, which lag behind in achieving the targets, have been mandated to submit an action plan to achieve the prescribed targets.

Rural Credit Institutions

Licensing of Co-operatives

89. In terms of the recommendations of the Committee on Financial Sector Assessment (Chairman: Dr. Rakesh Mohan and Co-Chairman: Shri Ashok Chawla) and as proposed in the Annual Policy Statement of April 2009, the work relating to licensing of unlicensed state and central co-operative banks in a non-disruptive manner, in consultation with National Bank for Agriculture and Rural Development (NABARD), was initiated. Subsequent to the issuance of revised guidelines on licensing of state co-operative banks (StCBs)/district central co-operative banks (DCCBs), 10 StCBs and 144 DCCBs were licensed, bringing down the number of unlicensed StCBs from 17 to 7 and unlicensed DCCBs from 296 to 152 as on March 31, 2011.

Revival of the Rural Co-operative Credit Structure

90. The Government of India, based on the recommendations of the Task Force on Revival of Rural Co-operative Credit Institutions (Chairman: Prof. A. Vaidyanathan) and in consultation with the State Governments, had approved a package for revival of the short-term rural

co-operative credit structure. As envisaged in the package, 25 States have entered into memorandum of understanding (MoU) with the Government of India and NABARD and 20 States have amended their respective State Co-operative Societies Acts. As on February 28, 2011, an aggregate amount of ₹8,460 crore was released by NABARD for recapitalisation of primary agricultural credit societies (PACS) in 16 States as the Government of India's share under the revival package.

Financial Inclusion through Grass-root Co-operatives

91. It was proposed in the Monetary Policy Statement of April 2010 to constitute a committee comprising representatives from the Reserve Bank, NABARD and a few State Governments to study the functioning of well-run PACS, large adivasi multi-purpose co-operative societies (LAMPS), farmers service societies (FSS) and thrift and credit co-operative societies set up under the parallel Self-Reliant Co-operative Societies Acts to gather information on their working and assess their potential to contribute to financial inclusion. The regional offices of the Reserve Bank have since given their inputs. Analysis, consolidation of data and preparation of State-wise reports are in progress and are expected to be completed by end-July 2011.

Malegam Committee Recommendations

92. In the wake of the Andhra Pradesh micro finance crisis in 2010, concerns were expressed by various stakeholders and the need was felt for more rigorous regulation of non-banking financial companies (NBFCs) functioning as micro finance institutions (MFIs). As indicated in the Second Quarter Review of November 2010, a Sub-Committee of the Central Board of the Reserve Bank (Chairman: Shri Y. H. Malegam) was constituted to study issues and concerns in the MFI sector. The Committee submitted its report in January 2011, which was placed in public domain. The Committee, *inter alia*, recommended (i) creation of a separate category of NBFC-MFIs; (ii) a margin cap and an interest rate cap on individual loans; (iii) transparency in interest charges; (iv) lending by not more than two MFIs to individual borrowers; (v) creation of one or more credit information bureaus; (vi) establishment of a proper system of grievance redressal procedure by MFIs; (vii) creation of one or more "social capital funds"; and (viii) continuation of categorisation of bank loans to MFIs, complying with the regulation laid down for NBFC-MFIs, under the priority sector. The recommendations of the Committee were discussed with all stakeholders, including the Government of India, select State Governments, major NBFCs working as MFIs, industry associations of MFIs working in the country, other smaller MFIs, and major banks. In the light of the feedback received, it has been decided:

- to accept the broad framework of regulations recommended by the Committee;
- that bank loans to all MFIs, including NBFCs working as MFIs on or after April 1, 2011, will be eligible for classification as priority sector loans under respective category of indirect finance only if the prescribed percentage of their total assets are in the nature of "qualifying assets" and they adhere to the "pricing of interest" guidelines to be issued in this regard;
- that a "qualifying asset" is required

to satisfy the criteria of (i) loan disbursed by an MFI to a borrower with a rural household annual income not exceeding ₹60,000 or urban and semi-urban household income not exceeding ₹1,20,000; (ii) loan amount not to exceed ₹35,000 in the first cycle and ₹50,000 in subsequent cycles; (iii) total indebtedness of the borrower not to exceed ₹50,000; (iv) tenure of loan not to be less than 24 months for loan amount in excess of ₹15,000 without prepayment penalty; (iv) loan to be extended without collateral; (v) aggregate amount of loan, given for income generation, not to be less than 75 per cent of the total loans given by the MFIs; and (vi) loan to be repayable by weekly, fortnightly or monthly instalments at the choice of the borrower;

- that banks should ensure a margin cap of 12 per cent and an interest rate cap of 26 per cent for their lending to be eligible to be classified as priority sector loans;
- that loans by MFIs can also be extended to individuals outside the self-help group (SHG)/joint liability group (JLG) mechanism; and
- that bank loans to other NBFCs would not be reckoned as priority sector loans with effect from April 1, 2011.

93. Detailed guidelines in this regard will be issued separately.

Redefining the Priority Sector

94. The Malegam Committee recommended that the existing guidelines on bank lending to the priority sector be revisited. Requests were also received from various quarters in the recent past to relook at the definition of the priority sector, especially when bank finance was being routed through other agencies. It is, therefore, proposed:

- to appoint a committee to re-examine the existing classification and suggest revised guidelines with regard to priority sector lending classification.

Financial Inclusion Plan for Banks

95. As indicated in the Second Quarter Review of November 2010, all public and private sector banks were advised to put in place a Board approved three-year financial inclusion plans (FIPs) and submit them to the Reserve Bank by March 2010. These banks have since prepared and submitted their FIPs containing targets for March 2011, 2012 and 2013, to the Reserve Bank. These plans broadly include self-set targets in respect of rural brick and mortar branches opened; business correspondents (BCs) employed; coverage of unbanked villages with population above 2,000 as also other unbanked villages with population below 2,000 through branches/BCs/other modes; no-frill accounts opened including through BC-ICT; kisan credit cards (KCCs) and general credit cards (GCCs) issued; and other specific products designed by them to cater to the financially excluded segments.

96. The implementation of these plans is being closely monitored by the Reserve Bank on a quarterly basis. The analysis of progress reports of above plans received from all public and private sector banks shows that during the period April 2010 to March 2011, banks opened 5,214 new branches, deployed 25,403 BCs/customer service providers (CSPs) and provided banking services in 43,337 villages. Out of these, 525 villages were covered through rural brick and mortar branches, 42,506 villages

through BCs and 306 villages through other modes such as ATMs and mobile vans. It is important to note that banks covered 24,066 villages with population above 2,000, in addition to covering 19,271 villages with population below 2,000.

Branch Authorisation Policy

97. Domestic scheduled commercial banks (excluding regional rural banks [RRBs]) were permitted in December 2009 to open branches in Tier 3 to Tier 6 centres (with population up to 49,999) without prior permission of the Reserve Bank. However, prior authorisation from the Reserve Bank was required for opening of branches in Tier 1 and Tier 2 centres which was granted based, *inter alia*, on the (i) number of branches opened in Tier 3 to Tier 6 centres under general permission; (ii) branches proposed to be opened in under-banked districts in under-banked States; and (iii) bank's performance in areas of financial inclusion and customer service. It was observed that on an average scheduled commercial banks (SCBs) opened about 20 per cent of the total number of new branches in rural centres (Tier 5 and Tier 6) in the last two years.

98. There is a need to step up the opening of branches in rural areas so as to improve banking penetration and financial inclusion rapidly and meet the targets set out for providing banking services in villages with population over 2,000. The FIPs submitted by banks indicate that banks propose to use BCs in a big way to reach out to unbanked villages. Keeping in view the goal of bringing banking services to identified 72,800 villages by March 2012 and thereafter progressively to all villages over a period of time, there is a need for opening of more brick and mortar branches, besides the use of BCs. Accordingly, domestic SCBs are being mandated:

- to allocate at least 25 per cent of the total number of branches to be opened during a year to unbanked rural (Tier 5 and Tier 6) centres.

Urban Co-operative Banks

Licenses for Setting up new Urban Co-operative Banks

99. As announced in the Monetary Policy Statement of April 2010, an Expert Committee (Chairman: Shri Y. H. Malegam) was constituted in October 2010 with representations from all stakeholders for studying the advisability of granting licenses for setting up new urban co-operative banks (UCBs) under Section 22 of the Banking Regulation Act, 1949 [as applicable to co-operative societies (AACS)]. The Committee will also look into the feasibility of an umbrella organisation for the UCB sector. The Committee is expected to submit its report by end-June 2011.

Financing of Self-Help Group/Joint Liability Group by UCBs

100. With a view to further expanding the outreach of UCBs and opening an additional channel for promoting financial inclusion, which would also help the UCBs in achieving the sub-target of lending to weaker sections, it is proposed:

- to permit UCBs to lend to SHGs/JLGs; and
- to keep lending to SHGs out of the norm on unsecured advances.

Exposure of UCBs to Housing, Real Estate and Commercial Real Estate

101. Pursuant to the announcements made in the Second Quarter Review of November 2010, UCBs were permitted to lend up to 10 per cent of their total assets

to housing, real estate and commercial real estate and an additional 5 per cent of total assets for purchase and construction of dwelling units costing up to ₹10 lakh. Keeping in view the representations received from UCBs and their associations that they are finding it difficult to use the additional limit of 5 per cent of total assets due to the high cost of dwelling units, it is proposed:

- to permit UCBs to utilise the additional 5 per cent of their total assets permitted earlier, for housing loans up to ₹15 lakh.

Internet Banking Facility

102. With increasing expectation of customers of UCBs for better products and services on par with commercial banks, the opening up of internet banking channel to UCBs will enable them to retain their customer base. It is, therefore, proposed:

- to permit scheduled UCBs satisfying certain criteria to provide internet banking facility to their customers.

103. Detailed guidelines will be issued separately.

Membership of Negotiated Dealing System

104. Pursuant to the Second Quarter Review of November 2010, all licensed UCBs were allowed the facility of Indian Financial Network (INFINET) membership, current and subsidiary general ledger (SGL) accounts with the Reserve Bank and real time gross settlement (RTGS) membership to well managed and financially sound UCBs having a minimum net worth of ₹25 crore. In order to further enable UCBs to serve their customers better, it is now proposed:

- to permit well managed and financially sound UCBs to become members of the negotiated dealing system (NDS).

105. Detailed guidelines are being issued separately.

Customer Service

106. Pursuant to the announcement made in the Monetary Policy Statement of April 2010, a Committee on Customer Service (Chairman: Shri M. Damodaran) was constituted to look into banking services rendered to retail and small customers, including pensioners. Apart from formal meetings, the Committee members have conducted meetings with various stakeholders across the length and breadth of the country. The report is in the process of being finalised.

V. Regulatory and Supervisory Measures for Commercial Banks

Strengthening the Resilience of the Banking Sector

107. After the financial crisis, the BCBS has taken a number of initiatives with a view to improving the banking sector's ability to absorb shocks arising from financial and economic stress and to reduce the risk of spillover from the financial sector to the real economy. It may be recalled that the BCBS had issued certain enhancements to Basel II Framework, including amendments to the market risk framework in July 2009, which were implemented by the Reserve Bank with effect from March 31, 2010. In December 2010, the BCBS released a comprehensive package of further reforms which, together with the July 2009 enhancements, is known as the Basel III framework. This reform package aims at (i) increasing the quality and

quantity of the capital with greater emphasis on common equity; (ii) increasing the risk coverage; (iii) introducing a leverage ratio as a back stop to the risk-based capital ratio; and (iv) introducing capital conservation and counter-cyclical capital buffers to ensure build up of additional capital in good times, thereby protecting banks from the dangers of excessive credit growth. Besides, the Committee has also introduced liquidity ratios with a view to ensuring that banks maintain adequate liquidity buffers and reduce maturity mismatches.

108. The Reserve Bank would adhere to internationally agreed phase-in period (beginning January 1, 2013) for implementation of the Basel III framework. The Reserve Bank is studying the Basel III reform measures for preparing appropriate guidelines for implementation. It is taking steps to disseminate information on Basel III and help banks prepare for smooth implementation of the framework.

Implementation of Advanced Approaches under Basel II Framework

109. The Reserve Bank had announced timeline for implementation of advanced approaches for computation of regulatory capital under the Basel II framework in India in July 2009. The guidelines for the standardised approach (TSA)/ alternate standardised approach (ASA) for operational risk were issued in March 2010 and those for internal models approach (IMA) for market risk in April 2010. Draft guidelines for advanced measurement approach (AMA) for operational risk were issued in January 2011 for public comments/ feedback, and final guidelines were issued in April 2011. Guidelines for internal rating based (IRB) approach for credit risk are under preparation.

Enhancement of Rates of Provisioning for Non-Performing Assets

110. In pursuance of the announcement made in the Second Quarter Review of October 2009, banks were advised in December 2009 to achieve a provisioning coverage ratio (PCR) of 70 per cent for their non-performing advances by end-September 2010. This coverage ratio was intended to achieve a counter-cyclical objective by ensuring that banks build up a good cushion of provisions to protect them from any macroeconomic shock in future. In April 2011, banks were advised to segregate the surplus of provisions under the PCR *vis-a-vis* as required as per prudential norms as on September 30, 2010, into an account styled as "counter-cyclical buffer". While the "counter-cyclical buffer" so created would be available to banks for making specific provisions during economic downturns, there is a need for banks to make higher specific provisions also as part of the prudential provisioning framework. Accordingly, It is proposed to enhance the provisioning requirements on certain categories of non-performing advances and restructured advances as under:

- advances classified as "sub-standard" will attract a provision of 15 per cent as against the existing 10 per cent (the "unsecured exposures" classified as sub-standard assets will attract an additional provision of 10 per cent, *i.e.,* a total of 25 per cent as against the existing 20 per cent);
- the secured portion of advances which have remained in "doubtful" category up to one year will attract a provision of 25 per cent (as against the existing 20 per cent);
- the secured portion of advances which have remained in "doubtful" category

for more than one year but upto 3 years will attract a provision of 40 per cent (as against the existing 30 per cent);

- restructured accounts classified as standard advances will attract a provision of 2 per cent in the first 2 years from the date of restructuring, or in cases of moratorium on payment of interest/principal after restructuring, for the period covering moratorium and 2 years thereafter (as against existing provision of 0.25-1.00 per cent, depending upon the category of advances); and
- restructured accounts classified as non-performing advances, when upgraded to standard category will attract a provision of 2 per cent in the first year from the date of upgradation (as against existing provision of 0.25-1.00 per cent, depending upon the category of advances).

111. Detailed guidelines in this regard will be issued separately.

Investments in Debt Oriented Mutual Funds

112. It has been observed that banks' investments in liquid schemes of debt oriented mutual funds (DoMFs) have grown manifold. The liquid schemes continue to rely heavily on institutional investors such as commercial banks whose redemption requirements are likely to be large and simultaneous. DoMFs, on the other hand, are large lenders in the over-night markets such as collateralised borrowing and lending obligation (CBLO) and market repo, where banks are large borrowers. DoMFs invest heavily in certificates of deposit (CDs) of banks. Such circular flow of funds between banks and DoMFs could lead to systemic risk in times of stress/liquidity crunch. Thus, banks could potentially face a large liquidity risk. It is, therefore, felt prudent to place certain limits on banks' investments in DoMFs. Accordingly, it is proposed:

- that the investment in liquid schemes of DoMFs by banks will be subject to a prudential cap of 10 per cent of their net worth as on March 31 of the previous year. However, with a view to ensuring a smooth transition, banks which are already having investments in DoMFs in excess of the 10 per cent limit, will be allowed to comply with this requirement in six months' time.

Presence of Foreign Banks in India

113. It was indicated in the Monetary Policy Statement of April 2010 that drawing lessons from the crisis, a discussion paper on the mode of presence of foreign banks through branch or wholly owned subsidiary (WOS) would be prepared by September 2010. Accordingly, a discussion paper on presence of foreign banks in India was placed on the Reserve Bank's website in January 2011 soliciting views/comments from all stakeholders, including banks, non-banking financial institutions, and the public at large by March 7, 2011. The comprehensive guidelines on the mode of presence of foreign banks in India are being formulated, keeping in view the suggestions/ comments on the discussion paper, received from all concerned.

Licensing of New Banks in the Private Sector

114. Following the announcement made by the Hon'ble Finance Minister in the Union Budget 2010-11 and as indicated in the Monetary Policy Statement of April 2010, the Reserve Bank released a discussion paper

on licensing of new banks on its website in August 2010, seeking views/comments of banks, NBFCs, industrial houses, other institutions, and the public at large. The discussion paper reviewed the international and Indian experience on various issues and also indicated possible approaches with the pros and cons of each of the approaches. Detailed discussions were held with various associations of stakeholders from the industry, banks, NBFCs, and MFIs and some consultants in October, 2010. In addition, diverse comments, including relating to granting of banking license to industrial houses/business houses have been received from a large number of respondents, which include parties interested in setting up new banks, industry associations, banks, academia, eminent personalities associated with banking and finance, and the members of the general public. Certain issues, which would require amendments to the Banking Regulation Act, 1949, have also been brought to the notice of the Government of India. A gist of comments on various issues received from important stakeholders and eminent people on the discussion paper was placed on the Reserve Bank's website in December 2010. All these comments have been examined and the draft guidelines on the entry of new banks are being finalised in consultation with the Government of India.

Compensation Practices

115. It was indicated in the Second Quarter Review of October 2009 that in line with the steps taken by the global community, particularly the initiatives taken by G-20 nations, the Reserve Bank would issue guidelines to private sector banks and foreign banks with regard to sound compensation policy. It was proposed to issue comprehensive guidelines based on the FSB principles on sound compensation practices, which would cover, among others, effective governance of compensation, alignment of compensation with prudent risk-taking and disclosures for whole time directors/chief executive officers as well as risk takers of banks. Accordingly, draft guidelines on sound compensation policy were framed and placed on the Reserve Bank's website in July 2010 for public comments. A large number of comments/suggestions were received on the draft guidelines and it was proposed in the Second Quarter Review of Monetary Policy for 2010-11 to issue final guidelines on compensation practices by end-December 2010. However, in October 2010, the BCBS brought out a consultative paper titled 'Range of Methodologies for Risk and Performance Alignment of Remuneration', for public comments. As the paper provides guidance on important methodological issues, it has been decided to await the final version of this paper for formulating our guidelines. Accordingly, the implementation of the Reserve Bank guidelines on compensation policy has been deferred till 2012-13. This will also give sufficient time to banks to formulate their policies. Banks, in the meantime, should refer to the BCBS consultative paper on 'Range of Methodologies for Risk and Performance Alignment of Remuneration' of October 2010, and begin the preparatory work.

Convergence of Indian Accounting Standards with International Financial Reporting Standards

116. As indicated in the Second Quarter Review of November 2010, a Working Group (Chairman: Shri P. R. Ravi Mohan) was constituted in July 2010 to address the implementation issues and facilitate formulation of operational guidelines in the context of convergence of Indian

Accounting Standards with the International Financial Reporting Standards (IFRSs). Six sub-groups, constituted under the aegis of this Working Group, are closely monitoring the developments at the international level, especially the progress made by the International Accounting Standard Board (IASB) in finalising the accounting standards relating to financial instruments, and fair value accounting, among others, and attempting to prepare operational guidelines within the framework of IFRS for the Indian banking sector. The Ministry of Corporate Affairs placed on its website 35 Indian Accounting Standards (IND AS), converged with IFRS in February 2011. It also stated that it would implement them in a phased manner after various issues, including tax related issues, were resolved with the concerned departments. The Reserve Bank is also endeavouring towards skill development at the level of banks and supervisors with a view to ensuring smooth and non-disruptive migration to the IFRS.

Amendments to the Banking Regulation Act, 1949

117. A comprehensive legislation for the amendment of the Banking Regulation Act, 1949 and the Banking Companies (Acquisition & Transfer of Undertakings) Act, 1970 & 1980 was introduced in the Parliament in March 2011. The important amendments relating to the Banking Regulation Act include insertion of a new section to override the provisions of the Competition Act, 2002 and exempt the applicability of such provisions to amalgamations/reconstitutions/mergers/acquisitions, *etc.* of different categories of banks; removal of the restrictions on voting rights; enabling banking companies to issue preference shares subject to regulatory guidelines by the Reserve Bank; formation of a depositor education and awareness fund; facilitating consolidated supervision; and a provision for supersession of boards of directors by the Reserve Bank; and increase in the quantum of penalties. The proposals relating to the amendment of the Banking Companies (Acquisition & Transfer of Undertakings) Act, 1970 & 1980 include raising the authorised capital of nationalised banks; enabling them to raise capital through "rights issue" or by issue of bonus shares; and raising the restrictions on voting rights. These amendments will have implications for the regulation and supervision of various types of banks by the Reserve Bank.

Introduction of Bank Holding Company/ Financial Holding Company Structure in India

118. In pursuance of the announcement made in the Monetary Policy Statement of April 2010, a Working Group (Chairperson: Smt. Shyamala Gopinath) was constituted to examine the introduction of a holding company structure for banks and other financial entities together with the required legislative and regulatory framework. The Group is expected to submit its report by end-May 2011.

Information Technology and Related Issues: Enhancement to the Guidelines

119. A Working Group on Information Security, Electronic Banking Technology Risk Management and Cyber Frauds (Chairman: Shri G. Gopalakrishna) was set up by the Reserve Bank to strengthen the Reserve Bank's guidelines relating to the governance of IT information security measures, apart from enhancing independent assurance about the effectiveness of IT controls. The report, which was submitted by the Group in January 2011, covers

various areas such as IT governance, information security (including electronic banking channels like internet banking, ATMs, cards), IT operations, IT services outsourcing, information system audit, cyber frauds, business continuity planning, customer education and legal issues. The report was placed on the Reserve Bank's website for public comments/feedback. Keeping in view the feedback/comments received, detailed guidelines are being issued to banks. While major recommendations of the Group are to be implemented by banks within a period of six months, other recommendations/guidelines are required to be implemented within a period of one year from the date of issue of the circular.

Supervisory Policies, Procedures and Processes: A Comprehensive Review

120. The operating environment with regard to supervision of banks has undergone significant changes with considerable increase in size, number and complexities of banks' businesses over the last decade. There have been extensive innovations in financial products, processes, strategies and risk management techniques at the institutional level. In the recent period, banks have also emerged as financial conglomerates in order to exploit economies of scale and scope. In view of the widening gap between growing supervisory responsibilities and available supervisory resources, it was considered expedient to conduct a review of the supervisory processes followed by the Reserve Bank. A High Level Steering Committee (Chairman: Dr. K. C. Chakrabarty) was set up by the Reserve Bank to review the existing supervisory processes in respect of commercial banks in India. The Committee, among others, will include a leading industry expert, one sitting and one retired chairman and managing director (CMD) of public sector banks as members. The Committee will lay down the terms of reference for review of the supervisory processes in the Reserve Bank and select one domestic or international agency for reviewing the supervisory processes and giving its recommendations for implementation.

VI. Institutional Developments

Non-Banking Financial Companies

Review of the Existing Regulatory Framework for NBFCs

121. There has been significant transformation in the NBFC sector in India in the past few years and the sector has come to be recognised as a systemically important component of the financial system. The recent global financial crisis has highlighted the risks arising from the non-banking financial sector because of regulatory gaps, arbitrage and systemic inter-connectedness. A need was, therefore, felt to reflect on the broad principles that underpin the regulatory architecture for NBFCs, keeping in view the economic role and heterogeneity of this sector and the recent international experience. The Reserve Bank has constituted a Working Group (Chairperson: Smt. Usha Thorat) to examine a range of emerging issues pertaining to the regulation of the NBFC sector. The Group will also focus on the definition and classification of NBFCs, keeping in view the need for addressing regulatory gaps and regulatory arbitrage, maintaining standards

of governance in the sector and adopting appropriate approach to NBFC supervision. The Committee is expected to submit its report by end-June 2011.

Setting up of Central Electronic Registry under the SARFAESI Act, 2002

122. The Government of India has set up a company, incorporated under section 25 of the Companies Act, 1956, as the Central Registry of Securitisation Asset Reconstruction and Security Interest of India (CERSAI) to give effect to the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002. The objective of the central registry is to prevent frauds in loan cases involving multiple lending from different banks on the same immovable property. The registry became operational from March 2011 and its jurisdiction covers the whole of India.

Payment and Settlement Systems

Mobile Banking in India

123. Considering the importance of mobile phone channels for banking services, the Reserve Bank issued guidelines on mobile banking in October 2008. Since then a number of relaxations in the guidelines have been made. In all, 39 banks were granted approval for mobile banking, of which 34 banks have launched the mobile banking services. On an average, 6,80,000 transactions amounting to ₹61 crore in a month are settled through this channel.

124. Non-bank entities were permitted by the Reserve Bank to issue mobile-based semi-closed prepaid instruments in August 2009. To start with, these instruments were considered as a separate category and a cap of ₹5,000 was imposed on such prepaid instruments. Considering the potential of such mobile-based prepaid instruments for promoting non-cash based transactions and the interest evinced by non-bank entities in promoting these products, it is proposed:

- to treat mobile-based semi-closed prepaid instruments issued by non-banks on par with other semi-closed payment instruments and raise the limit from ₹5,000 to ₹50,000, subject to certain conditions.

125. Banks were permitted by the Reserve Bank in December 2009 to provide their customers the mobile-based transaction facility up to ₹1,000 without end-to-end encryption. Taking into consideration the feedback from banks for increasing the limits for such transactions, it is proposed:

- to enhance the limit of such transactions from ₹1,000 to ₹5,000.

Working Group for Card Present Transactions

126. Card present transactions [transactions at points of sale (PoS) and ATMs] constitute a major proportion of the card based transactions in the country. For increasing the confidence of customers in this channel, it is necessary to secure these transactions through implementation of additional security/authentication in the short run and prevent counterfeiting of cards by migrating to chip-based and PIN-based cards in the long run. Considering the importance of this process, a Working Group comprising representatives from various stakeholders was constituted to recommend action plan for enabling additional authentication for transactions at PoS using existing cards in a cost effective manner and propose a timeframe

for migrating the card infrastructure to enabling issuance and acceptance of chip-based and PIN-based cards. The Working Group is expected to submit its recommendations by end-May 2011.

Performance of National Electronic Funds Transfer System

127. All the refinements to the national electronic funds transfer (NEFT) have been well accepted by the stakeholders and the product is growing from strength to strength in terms of acceptability, reach and volumes handled. As at end-February 2011, around 75,000 branches of 100 banks participated in the NEFT system and the volume of transactions processed increased to 13.5 million in February 2011. Efforts have also been initiated to extend NEFT facility to the branches and customers of RRBs. A few banks have since successfully and seamlessly brought the RRBs sponsored by them under the NEFT ambit. Further, full assistance was provided to the Royal Monetary Authority of Bhutan; the electronic clearing service (ECS) and the NEFT were successfully replicated in Bhutan.

IT Vision Document for 2011-17

128. A High Level Committee (Chairman: Dr. K. C. Chakrabarty) was constituted by the Reserve Bank to prepare an IT vision document for the period 2011-17, taking into account requirements and expectations of the banking system in general and those of the Reserve Bank, in particular. The report of the Committee was placed on the Reserve Bank's website in February 2011. The document contained a number of recommendations, including the Reserve Bank transforming itself into an information intensive knowledge organisation and commercial banks moving forward from their core banking solutions to enhanced use of IT in areas such as management information system (MIS), regulatory reporting, overall risk management, financial inclusion and customer relationship management. The recommendations related to both the Reserve Bank and commercial banks. The Reserve Bank has drawn a roadmap for implementation of the vision document over short-term (2 years), medium-term (2-4 years) and long-term (4 years and more). The Reserve Bank will, in association with the Indian Banks' Association (IBA), follow up on implementation of the recommendations by commercial banks.

Automated Data Flow from Banks

129. A Core Group consisting of experts from banks, the Reserve Bank, the Institute for Development and Research in Banking Technology (IDRBT) and the IBA was constituted for preparing an approach paper on automated data flow (a straight through process) from the core banking solution (CBS) or other IT systems of commercial banks to the Reserve Bank. It was indicated in the Second Quarter Review of November 2010 that the Core Group had finalised the approach paper and the timeline of the entire project would be determined in consultation with banks. It has been decided to implement the project in a phased manner taking into account the technology and process maturity of individual banks. Banks have been advised to submit a roadmap clearly indicating the returns which can be sourced directly from the banks' systems for submission to the Reserve Bank without manual intervention. It has also been decided to prescribe a quarterly monitoring format in which the banks will be advised to certify the list of returns which have been

internally generated from the IT source systems without manual intervention. The Reserve Bank is in touch with the banks and the solution providers for implementing the recommendations over a period of two years.

Real Time Gross Settlement System

130. As indicated in the Monetary Policy Statement of April 2010, a Working Group was constituted for preparing an approach paper for implementing the next generation real time gross settlement (NG-RTGS) system. The Group has since submitted the approach paper, the suggestions of which have been taken as a basis for preparing the blueprint for the NG-RTGS system. First, the Reserve Bank has initiated steps to enhance the capacity of the hardware system in the short-term by rationalising the use of the resources during peak and non-peak periods. Second, the process for enhancing the capacity in the medium-term has already begun. Third, several new features are being envisaged in the NG-RTGS system such as advanced liquidity management facility; extensible mark up language (XML) based messaging system conforming to ISO 20022; and real time information and transaction monitoring and control system.

Currency Management

131. Banks were mandated to use note sorting machines in all their branches having average daily cash receipts of ₹1 crore and above by March 2010. As of now, 1,323 branches (other than currency chest branches) have been identified having average daily cash receipt of ₹1 crore and above. Banks have reported that note sorting machines have been installed and made operational in 1,012 branches. For the remaining branches, banks have made arrangements with the nearest currency chest branch/currency administration branch. It was also indicated in the Second Quarter Review of October 2009 that banks should use such machines in all their branches having average daily cash receipts between ₹50 lakh and ₹1 crore by March 2011. Banks have reported that they have identified 3,000 branches with daily cash receipt between ₹50 lakh and ₹1 crore, out of which 413 branches have installed note sorting machines. Another 517 branches have put in place arrangements for processing of high denomination notes. Banks are expected to enhance their efforts to have note sorting machines in all such identified branches.

Second Quarter Review

132. The next review of the developmental and regulatory policies will be undertaken as part of the Second Quarter Review of Monetary Policy on October 25, 2011.

Mumbai

May 3, 2011