3

MONEY AND FINANCE

The current financial year witnessed several major initiatives in the field of financial sector reforms. The Government of India entered into an agreement with the Reserve Bank of India, to place a ceiling on its borrowing from the latter through ad hoc Treasury Bills, so as to curb automatic monetisation of the fiscal deficit (and the resultant growth of reserve money) and thereby strengthen the effectiveness of monetary management by the Reserve Bank. Another major step was the deregulation of the interest rate on bank advances of over Rs.2 lakh, which is expected to spur healthy competition and cost-consciousness among scheduled commercial banks. Amendments in the Banking Companies Act have been made to permit public sector banks to raise capital through public issue. The Oriental Bank of Commerce has already raised about Rs.360 crore from the market. Six new private sector banks started operations. These measures to promote competition in the banking system were complemented by the setting up of the Board for Financial Supervision by RBI. This should ensure that competition functions within a prudent and sound legal environment. A comprehensive regulatory framework including prudential norms was also announced for non-bank financial companies.

2. The overhang of past problems continued to receive attention. The Special Debt Recovery Tribunals established for the purpose of dealing with non-performing assets and loan recoveries have already been set up in Calcutta, Delhi, Jaipur, Ahmedabad and Bangalore. An Appellate Tribunal has also been established at Bombay. The ill effects of past policies remain and are manifested in a 21.7 per cent fall in the net profits of public sector banks in 1993-94. Though their income increased by about 33 per cent, provisioning (for bad debts) and contingencies increased even faster by 47.9 per cent. Much, therefore, remains to be done to increase the efficiency and profitability of public sector banks.

3. A significant development on the monetary front has been the large accumulation of foreign exchange reserves on account of equity flows, which also had an impact on monetary growth. Historically, reserve money growth has been overwhelmingly driven by the monetisation of the fiscal deficit. Starting from about the third quarter of 1993-94, this has been almost completely replaced by net foreign reserve accumulation by the RBI as the principal source of reserve money growth. For perhaps the first time in decades, capital inflows from abroad have become a significant monetary phenomenon. The counterpart of this development was that growth in net RBI credit to the Government has been negative for many months and for the first time in many years, the budget was in surplus for six successive months in 1994-95. This has helped in sterilising to some extent the monetisation of foreign exchange reserves.

4. Reserve money growth more than doubled to 25.1 per cent in 1993-94, and has continued to be at high rates in 1994-95. Money supply (M_3) growth has however remained lower than the growth in reserve money from 1993-94 onwards. Money supply growth accelerated to 18.2 per cent in 1993-94, and continues to remain strong in 1994-95. There is, therefore, a fall in the money multiplier.

5. An important development in 1994-95 has been the recovery in bank credit for production from the low growth of the previous year. Bank credit to the private sector has grown by 13.6 per cent in 1994-95 till January 20, 1994, more than doubling from 6.3 per cent in the corresponding period of the previous year. Non-food credit by scheduled commercial banks has shown greater acceleration, growing by 17 per cent compared to 4.4 per cent in the previous year. Lending for investment by Financial Institutions also shows a strong recovery. Sanctions by Development Finance Institutions (DFIs) during the first ten months of 1994-95 have grown by 82 per cent over the corresponding period of 1993-94. Though the growth of disbursement has lagged behind sanctions, the growth rate of 39.5 per cent is quite encouraging.

6. Money markets generally ruled easy in the last quarter of 1993-94 and the first six months of 1994-95. This applied to virtually all instruments, namely, inter bank call money, Certificates of deposits and Treasury Bills. Cut off rates on auctioned 364 day Treasury Bills showed a clear down trend till September 1994. Though interest rates on 91-day Treasury Bills bottomed out at the turn of 1993-94, they remained below levels of a year ago till the middle of September 1994. There were, however, temporary increases in call money rates in September and December 1994, raising rates above 40 per cent. This has been followed by an upturn in 91-day treasury bill rates.

7. The capital market underwent another phase of reforms. The National Stock Exchange of India (NSEI) commenced operations in June 1994 with its wholesale debt segment, and subsequently has begun to conduct operations in equities as well. Guidelines were issued for Euro Issues . Share prices bottomed out in July 1993 and were on a rising path till February 1994. After some ups and downs, the Bombay Stock Exchange Sensitive Index (SENSEX) peaked in September 1994. Among other changes, signs of industrial recovery, companies' half yearly results, market reforms and inflow of funds from Foreign Institutional Investors (FII) have influenced the share prices. The funds mobilised through Euro Issues and Euro Convertible Bonds (ECBs) increased sharply in the first half of 1994-95. This was, however, partly offset by a decline in the amount raised through domestic issues, compared to the first half of 1993-94. Clearances by SEBI suggest that the shortfall will be made up in the second half of 1994-95.

Monetary Trends And Developments

Monetary Trends in 1993-94

8. Weak industrial growth in the first quarter of 1993-94 and slowing inflation had led, by the third quarter of 1993-94, to readjustment of monetary concerns from inflation to promoting production. The monetary growth projection set by RBI for 1993-94 was consequently revised upwards. These and other measures were followed by a revival of industrial production in 1993-94. Inflation also bottomed out and began to rise in the second and third quarters of 1993-94, partly because of special supply side factors. The acceleration in inflation and a significant increase in the rate of growth of money supply in the second half of 1993-94 had rekindled concern about inflation by the end of 1993-94.

Money Growth

9. Money supply (M3) growth accelerated to 18.2 per cent in 1993-94 and exceeded the 14 per cent projection of RBI. There was an even more rapid acceleration in the growth of narrow money (M1) to 21.1 per cent in 1993-94. This acceleration reflected a sharp change in the growth of demand deposits. Growth of demand deposits accelerated to over 20 per cent in 1993-94. To some extent, the recovery in growth of demand deposits and M1 was related to the incipient recovery in industrial production. An acceleration in the growth of currency to 20.4 per cent in 1993-94 also contributed to M1 growth (Table 3.1). This may have reflected the high levels of food procurement and associated expansion in food credit (61.8 per cent) and the generally positive state of the agricultural economy (Table 3.9).

Money Supply

10. As in the earlier years, monetary growth was largely driven by the expansion in Reserve money. Reserve money growth more than doubled to 25.1 per cent in 1993-94. There was, however, a remarkable transformation in the factors driving reserve money growth. Net RBI Credit to the Government (NRCG), which had grown by about 12 per cent by the end of the third quarter of 1993-94, decelerated sharply. The result was a growth rate of only 0.9 per cent in 1993-94. There was also a declining trend in the growth rate of Net RBI credit to Government from 20.6 per cent in 1990-91 to 5.8 per cent in 1991-92 and 4.7 per cent in 1992-93. What was noteworthy in 1993-94 was that a sharp decline in NRCG took place, despite a rise in the fiscal deficit.

11. Reserve money growth was fuelled in 1993-94 by the accumulation of Net Foreign Exchange Assets (NFEA) with RBI. There was an almost tenfold increase in the rate of growth of Net Foreign Exchange Assets of RBI to 127 per cent in 1993-94. As a result, the share of growth of Net Foreign Exchange Assets of RBI in reserve money growth increased to 97 per cent in 1993-94, while the share of increase in NRCG in reserve money growth declined to 3 per cent in 1993-94 (Table 3.2).

12. Though the build up of foreign exchange reserves was primarily responsible for this transformation, the decline in direct monetisation linked to budget deficits was a harbinger of the future. The budget deficit was 26.4 per cent lower in 1993-94.

Money Multiplier

13. In 1993-94 money supply (M3) grew by only 18.2 per cent, despite a growth of over 25 per cent in reserve money, indicating a sharp fall in the money multiplier in that year. The cautious approach to lending followed the introduction of new prudential and provisioning norms. This led to a preference for zero risk government securities offering market related yields. Low credit demand from the corporate sector

TABLE 3.1
Sources of Change in Money Stock

	Variations during[1]					
	1993-94 Mar.31 to Mar.31	**1993-94 Mar.31 to Jan.21**	**1994-95 Mar.31 to Jan.20**	**1993-94 Mar.31 to Mar.31**	**1993-94 Mar.31 to Jan.21**	**1994-95 Mar.31 to Jan.20**
1	2	3	4	5	6	7
		(Rs. crore)			*(Per cent)*	
I. M1 (Money supply with the public)	26234	18334	24570	21.1	14.8	16.3
II. M3 (Aggregate monetary resources)	66741	53565	64816	18.2	14.6	14.9
i) Currency with the public	13925	11215	15401	20.4	16.4	18.7
ii) Demand deposits with banks	11094	6756	8511	20.4	12.4	13.0
iii) Time deposit with banks	40507	35231	40246	16.7	14.5	14.2
iv) Other deposits with RBI	1215	363	658	92.5	27.6	26.0
III Sources of change in M3 (1+2+3+4-5)						
1. Net bank credit to Government (A+B)	27548	28311	11703	15.6	16.1	5.7
A) RBI's net credit to Government (i+ii)[2]	851	7245	-3983			
i) Central Government	260[3]	8587	-1886			
ii) State Governments	591	-1342	-2097			
B) Other banks' credit to Government	26697	21066	15686			
2. Bank credit to commercial sector (A+B)	17068	13804	32217	7.8	6.3	13.6
A) RBI's credit to commercial sector[4]	225	62	127			
B) Other banks' credit to commercial sector	16843	13742	32090			
3. Net foreign exchange assets of the banking sector[5]	28775	12490	12926	115.3	50.1	31.5
3a. Excluding revaluation of gold	26904	10670	17055	107.8	42.8	31.7
4. Government's currency liabilities to the public	114	132	151	6.3	7.2	7.8
5. Banking Sector's net non-monetary liabilities other than time deposits(a+b)	6764	1172	-3819	12.0	2.1	-6.1
a) Net non-monetary liabilities of RBI	-2212	-2317	-2830			
b) Net non-monetary liabilities of other banks (residual)	8976	3489	-989			

1 *Variations in respect of scheduled commercial banks are based on data for last reporting Friday of March. Data for RBI and others are for March 31. All figures are provisional.*
2 *Includes special securities.*
3 *Includes Rs. 751.64 crore (equivalent of SDRs 211.95 million) incurred on account of Reserve Asset subscription to the IMF towards the quota increase.*
4 *Excludes, since the establishment of NABARD, its refinance to banks.*
5 *Inclusive of appreciation in the value of gold following its revaluation close to international market price since October 17, 1990. Such appreciation has a corresponding effect on RBI's net non-monetary liabilities.*

which had raised ample funds from the capital market, was also a contributory factor.

Demand for Money and Credit

14. The demand side has been subject to two important shifts. Government financing of the fiscal deficit has been deliberately and consciously shifted away from automatic lending by RBI (or deficit financing) and below market rate statutory (SLR) lending by banks, to market based borrowing. The result is a jump in the growth of other banks' credit to Government to 15.6 per cent in 1993-94. The fact that this is market based lending, is attested by commercial bank liquidity ratio being higher than the Statutory Liquidity Ratio and by rising average interest rates on Government domestic debt (Chapter 2). Though the increase in Government borrowing from the private sector was accelerated by an increase in the fiscal deficit and overall Government borrowing, market interest rates did not rise because of the inflow of foreign savings into the economy. Secondly, the surge in the flow of foreign private savings into the economy and mobilisation of large funds from the domestic capital market also partly explain the low demand for bank credit from the corporate sector. There may also have been some increase in the holding of money and a shift in the money demand function following large foreign funds inflow.

Monetary Policy and Systemic Reform

Monetary Objective

15. The inflation rate accelerated from 7.2 per cent at the end of March 1993 to 10.8 per cent at the end of March 1994. The basic objective of monetary policy for 1994-95 was, therefore, to bring about a reduction in the inflation rate. This was, however, subject to the provision of adequate flow of credit for exports, agriculture, small scale industries and weaker sections. Phenomenal expansion in net foreign exchange assets of the banking sector also came to underline the need for a harmony between external sector policies and monetary policy. The build up of RBI's external

Box No. 3.1
Financial Sector Reforms : 1991-92 to 1994-95

- Statutory Liquidity Ratio (SLR) on incremental net domestic demand and time liabilities (NDTL) reduced from 38.5 per cent in 1991-92 to 25 per cent. SLR on outsatanding domestic NDTL has been reduced from 38.5 per cent in 1991-92 to 31.50 per cent. Expected to fall to 29.5 per cent by March 1995.
- Incremental Cash Reserve Ratio (CRR) of 10 per cent removed and one-third of the impounded cash balances under incremental CRR released, implying a reduction in CRR by 0.6 per cent.
- The prime rate of SBI and most other banks on general advances of over Rs. 2 lakh has come down by 4 percentage point to 15 per cent between 1991-92 and 1994-95.
- Interest rates on deposits and advances of all co-operative banks (except urban co-operative banks) deregulated, subject to a minimum lending rate of 12 per cent.
- Number of administered interest rates on bank advances reduced from 20 in 1989-90 to 2 in 1994-95. Interest rate on loans above Rs. 2 lakh fully decontrolled.The ceiling interest rate on Non-Resident (External) Rupee Account term deposits reduced from 11 to 8 per cent.
- State Bank of India Act amended to enable the bank to access the capital market and allow 10 per cent voting rights to share holders. SBI raised over Rs. 2400 crore from public issue and bonds. The RBI shareholding is now 67 per cent as against 99 per cent earlier.
- Nationalised banks enabled to access the capital market for debt and equity, through amendment of Banking Companies Act. Oriental Bank of Commerce raised about Rs.360 crore through its first issue.
- Six private banks have already started functioning. 'In principle' approval also given to six other proposals for setting up of new private sector banks. Banks allowed to raise capital contribution from foreign institutional investors upto 20 per cent and from Non-resident Indians upto 40 per cent.
- Prudential norms for income recognition, classification of assets and provisioning for bad debts introduced.
- Provisioning requirement for non-performing advances of less than Rs.25,000 raised to be 10 per cent in 1995-96.
- Capital adequacy of 4 per cent attained by all banks by March 31, 1993. Full norm of 8 per cent attained by foreign banks in India and Indian banks with branches abroad, while rest must attain the norm by end March 1996.
- Recapitalisation of less strong public sector banks assisted by budgetary support of Rs.5,700 crore in 1993-94 and Rs.5,600 crore in 1994-95. These banks simultaneously agreed with RBI to strengthen bank management and improve efficiency.
- Banks given freedom to open new branches and upgrade extension counters on attaining capital adequacy norms and prudential accounting standards. They are permitted to close non-viable branches other than in rural areas.
- New Bank of India merged with Punjab National Bank.
- A Board of Financial Supervision has been set up with an Advisory Council to strengthen the supervisory system of banks and financial institutions. A separate Department of Supervision was also established in RBI in December 1993 for assisting the Board.
- Recovery of Debts due to Banks and Financial Instituions Act, 1993 passed to set up Special Recovery Tribunals to facilitate quicker recoveries of loan arrears. Five tribunals started functioning at Calcutta, Delhi, Jaipur, Ahmadabad and Bangalore and an Appellate Tribunal has been set up at Bombay.
- Banking Regulation Act, 1949 amended to enable a banking company to have a non-executive Chairman and upto three Directors from among the Directors of promoting institutions, and to raise the ceiling for the exercise of voting rights for a shareholder upto 10 per cent, and to raise the penalities for contravention of the Act.
- Union agreement in October 1993 paved way for faster computerisation in banks.
- Bank lending norms liberalised and banks given freedom to decide levels of holding of individual items of inventories and receivables.
- Scope of mandatory consortium arrangement narrowed to 76 large borrowal accounts in place of 934 accounts hitherto borrowers allowed to induct new banks into a consortium and banks permitted to leave consortium after two years.
- Guidelines issued to banks to ensure qualitative improvement in banks' customer service as a follow-up on the recommendations of the committee on customer service in banks.
- IFCI converted into a company and its maiden public issue raised over Rs.600 crore as equity (including premium).
- Convertibility clause no longer obligatory for assistance sanctioned by term lending institutions.
- Floating interest rate on financial assistance (linked to interest rate on 364 day treasury bills) introduced by some all India development banks.
- Financial institutions' access to SLR funds reduced and they are encouraged to approach capital market for funds.

TABLE 3.2
Sources of Change in Reserve Money

	Outstanding as on March 31, 1993	Variations[1] 1993-94 Mar.31 to Mar.31	1993-94 Mar.31 to Jan, 21	1994-95 Mar.31 Jan, 20	1993-94 Mar.31 to Mar.31	1993-94 Mar.31 to Jan, 21	1994-95 Mar.31 to Jan, 20
1	2	3	4	5	6	7	8
		(Rs.crore)				(Per cent)	
1. Net RBI credit to Government[2]	98449	851	7245	-3983	0.9	7.4	-4.0
2. RBI credit to banks[3]	9885	-4334	-2894	3106	-43.8	-29.3	56.0
3. RBI credit to commercial sector[4]	6220	225	62	127	3.6	1.0	2.0
4. Net foreign exchange assets of RBI [5]	22647	28775	13060	17496	127.1	57.7	34.0
4a. Excluding revaluation of gold		26904	11240	17625	118.5	49.6	34.3
5. Government's currency liabilities to the public	1824	114	132	151	6.3	7.2	7.8
6. Net non-monetary liabilities of RBI	28246	-2212	-2317	-2830	-7.8	-8.2	-10.9
7. Reserve Money (1+2+3+4+5-6)	110779	27843	19922	19727	25.1	18.0	14.2

[1] *Variations are worked out on the basis of March 31 data after closure of Government accounts. Figures for 1994-95 are provisional.*
[2] *Includes special securities.* [3] *Includes claims on NABARD*
[4] *Excludes, since the establishment of NABARD, its refinance to banks.*
[5] *Variations are inclusive of appreciation in the value of gold following its revaluation close to the international market price since October 17,1990. Such appreciation has a corresponding effect on RBI's net non-monetary liabilities.*

reserves posed a challenge to monetary management. Inflation in turn, affected the real exchange rate.

System Reform Objective

16. Reform of monetary mechanisms is an essential element of financial sector reforms. As the economy becomes more market driven, mechanisms for monetary management have to be modernised. This move from physical control instruments to market based ones continued during 1994-95 (Box 3.1). Two fundamental decisions have been taken in this direction. Automatic monetisation of the Centre's deficit has been sought to be contained and banks were given freedom to determine their interest rate on higher size loans i.e. above Rs. 2 lakh. The challenge of capital inflows was addressed by taking a more active stance of policy, in particular, through open market operations.

Monetisation of Fiscal Deficits

17. The central budget for 1994-95, set a fiscal deficit target of 6 per cent of GDP and a budget deficit of Rs.6000 crore. More significant was the Government's declaration to limit its borrowing from RBI through ad-hoc Treasury Bills to Rs.6000 crore for the financial year 1994-95. It is not unusual for such borrowing to exceed the end year target, during the year, because of the variations in the flow of revenues and expenditures during the year. Hence it was also agreed that such borrowings would not exceed Rs.9000 crore for more than ten consecutive working days. If these conditions are not met, RBI will be entitled to auction Treasury Bills or sell fresh Government of India securities in the market to bring down ad-hoc borrowing below Rs.9000 crore. A formal agreement was subsequently signed between the RBI and the Ministry of Finance [Box 3.2].

Interest Rate Policy

18. The floor interest rate on bank advances of over Rs.2 lakh was eliminated in October, 1994. This represents a major deregulation of bank interest rates

Box 3.2
Agreement to Limit ad hoc Treasury Bills

An agreement was signed on September 9, 1994 between the Finance Secretary, Government of India and the Governor, Reserve Bank of India to implement the proposal made by the Finance Minister in his budget speech for 1994-95 to limit borrowing through ad-hoc treasury bills. As per this agreement the net issue of ad hoc treasury bills for the year 1994-95 whould not exceed Rs.6,000 crore. Similar ceilings will be stipulateo also for the net issue of ad hoc treasury bills for the years 1995-96 and 1996-97 and from 1997-98 the system of ad hoc treasury bills will be totally discontinued.

This step has been taken by the Government to contain direct and automatic monetisation of budget deficits and thereby strengthen the efficacy of monetary management by RBI. The present agreement will phase out automatic monetisation of the budget deficit of the Government over a three year period, put an end to a major source of instability in monetary management, and help control inflation in the economy.

[Box 3.3]. With effect from October 18, 1994, the interest rate for credit limits of over Rs.2 lakh can be determined by scheduled commercial banks themselves [Table 3.3]. The regulatory anomaly in which banks were purchasing commercial paper of companies at coupon rates of 12-14 per cent, while they could not lend to the same set of borrowers below 15 per cent, thus stands removed. Interest rates will now have to be more sensitive to the demand and supply conditions for funds in the market. This poses a challenge to banks to reduce operational and intermediation costs. The increase in competitive pressures on banks should lead to better systems and procedures for judging risk and returns from loans, and better monitoring and follow up of borrower performance. This would help in minimising non-performing assets (NPAs), representing loans on which interest and/or principal repayment are not being received. There is a corresponding challenge to the RBI in managing the monetary system, by further developing and using market instruments such as the discount rate and open market operations to affect bank liquidity and interest rates.

Box 3.3
Lending Rate Deregulation

Effective October 18, 1994 lending rates of the scheduled commercial banks for credit limits of over Rs. 2 lakh has been deregulated, with abolition of the "mininum lending rate." Banks' boards can now set their own prime lending rate. This will act as the minimum rate charged by banks for credit limits of over Rs.2 lakh. It will have to be declared and made uniformly applicable at all branches.

Deregulation of the lending rate for bank advances of over Rs.2 lakh marks a major step in the process of reform/rationalisation of lending rates of scheduled commercial banks that commenced in April 1992. Six tier lending rate structure was replaced in April 1992 by a four tier one and the number of lending rates was further reduced from four to three in April 1993. At the same time, between April 1992 and September 1994 the floor interest rate on bank advances over Rs.2 lakh was also reduced from 19 per cent to 15 per cent. Banks have previously been given the freedom to fix interest rate on their term deposits subject to a cap, which is now 11 per cent.

The deregulation of interest rate on the highest slab of bank advances will stimulate healthy competition among the banks and encourage their operational efficiency. It will also help banks better adjust their lending rates to the track record and risk-perception with regard to their customers. As in other modern economies, aggregate liquidity and interest rates would continue to be influenced and affected by RBI's open market operations and other monetary measures.

Open Market Operations

19. To address the problem of excess liquidity engendered by the surge in capital inflows, the Reserve Bank undertook large scale open market operations [Box 3.4]. This helped absorption of excess liquidity by outright sales of Government of India rupee securities from its portfolio of Rs.9,047 crore during 1993-94. The open market operations undertaken by the Reserve Bank in 1993-94 will be equivalent to a 2.8 percentage point increase in the cash reserve ratio. During the current fiscal year 1994-95 (up to January 20, 1994), there has been a sharp increase of Rs.17,496 crore in Net Foreign Exchange Assets of RBI. But this has been partly countered by a decline of Rs.1,886 crore in net RBI credit to the Central Government. Open market operations have been so timed that they do not conflict with the borrowing programme of the Government. In the current financial year, open market operations have led to a net sale of Rs.1,032 crore.

Bank Rate

20. The role of the bank rate as an instrument of monetary policy has been very limited in India, because of a number of factors like the administered structure of interest rates, sector specific refinance facilities for commercial banks and underdeveloped bill market. Only a few other rates are linked to the bank rate at present. These are (a) penal interest charged on Cash Reserve Ratio defaults and Statutory Liquidity Ratio (SLR) shortfalls (b) the interest rate on Rupee advances by authorised dealers against the security of foreign currency denominated India Development Bonds (issued by SBI) (applicable both to non-resident holders of these bonds and to resident individuals/firms/companies in India) and (c) interest rate on RBI credit to State Governments. The bank rate rose gradually from 3 per cent in November 1951 to 10 per cent in July 1981. There were only 10 changes during this period. The bank rate has remained unchanged for ten years till 1991. It was revised upwards to 11 per cent in July 1991 and further to 12 per cent in October 1991.

21. The Bank rate or the Central Bank rediscount rate is an important monetary instrument in modern economies. Its most useful role is to signal and/or clarify the Central Bank's monetary and interest rate stance to all participants in the financial sector and particularly to banks. If monetary policy is effective and credible, a change in the rate will result in a change in the prime lending rate of banks and thus act as an independent instrument of monetary management. By reducing the refinance rate for exports and thus reducing its link to a particular form of refinancing, the potential effectiveness of this instrument is being increased.

TABLE 3.3
Changes in Lending Rates[1] of Scheduled Commercial Banks

Credit limit	Rates effective: Before April 8 1993	April 9,	June 24, 1993	Sept.2, 1994	March 1,1994: Term loan[2] (3 yr & above)	March 1,1994: Other advances	October 18, 1994
1	2	3	4	5	6	7	8.
i) Up to and including Rs. 7500	11.5 }						
ii) Over Rs.7500 and up to Rs.25000	13.5 }	12.0	12.0	12.0	12.0	12.0	12.0
iii) Over Rs. 25000 and up to Rs. 2 lakh	16.5	16.5	16.0	15.0	14.0	15.0	13.5
iv) Over Rs. 2 lakh (minimum)	17.0	17.0	16.0	15.0	14.0	15.0	Free[3]

[1] *Other than those for export credit*
[2] *With effective from September 2, 1993 structure of lending rates is the same for both term loans and working capital advances*
[3] *Banks have only to take the approval of their board of directors for fixing and declaring their prime lending rate which will be the same for all the branches.*

The rules and procedures for general access to RBI rediscount facility will also have to be reviewed to increase its effectiveness as a monetary instrument.

Short term Money Management

22. Call money rates reached very high levels in September 1994, averaging around 15 per cent. The degree of volatility was also phenomenal, with the coefficient of variation exceeding 0.7 for both the daily minimum and daily maximum. This highlighted the urgent need for more efficient asset- liability management by banks and financial institutions and closer monitoring of short term markets by RBI. Day-to-day monitoring of money market conditions, could also be supplemented by use of instruments such as 1 to 14 day repos to smoothen out the fluctuations in call money rates. Reserve Bank continued with its policy of evening out short-term liquidity in the banking system through periodic repo auctions in Central Government dated securities. With the expansion of outright sales of Government securities, the average volume of repos bids accepted has declined from Rs.1,853.57 crore in 1993-94 to Rs 321 crore in this financial year (up to December 1994).

Monetary Management

23. The Outlook section in the Economic Survey, 1993-94 had noted that the greatest challenge for monetary policy would be to manage the large increase in capital inflows. The challenge was two fold: to manage the policy in such a way as to increase the productive use of foreign exchange, and to sterilise the remaining build-up to restrain inflationary pressures without raising real interest rates.

24. The steps taken in this direction with a view to moderating inflationary potential over the medium term included (a) a reduction in the interest rate on Non-Resident External (Rupee) Accounts (NRER) by two percentage points to "not exceeding 8 per cent", (b) discontinuation of Foreign Currency (Non-Resident) Accounts (FCNRA) of 3 year maturity, (c) freedom to repatriate interest accruing on Non-Resident Non-Repatriable deposits (NRNR) and on Foreign Currency Ordinary Non-Repatriable Deposits (FCON) beginning October 1, 1994, (d) discontinuation of new deposits under FCON from August 20, 1994, (e) new and tighter guidelines for Euro issues by Indian firms, (f) encouragement to the corporate sector to repay expensive external debt, and (g) liberalisation of limits and procedures for Indian investment abroad, to facilitate productive use of foreign exchange and encourage formation of export linkages.

Export Credit refinance

25. Refinance given to the banks by RBI, against their rupee export credit and post-shipment export credit denominated in US dollars, is a source of change in reserve money. Total export credit refinance outstanding as on March 18, 1994 was Rs.8713 crore. As per normal practice, the base for determining export credit refinance limit has again been shifted by a year for export credit (Rupee). Banks can obtain 60 per cent of the increase in outstanding export credit over the monthly average level (MAL) of 1990-91 up to the MAL of 1991-92, plus 100 per cent of the increase in such credit over the MAL of outstanding export credit in 1991-92. In the case of post-shipment export credit denominated in US dollars, eligibility percentage was brought down from 90 per cent to 80 per cent of such outstanding export credit given by banks. These measures will reduce the export credit refinance limit by Rs.1505 crore.

Box 3.4
Open Market Operations

Open market operations involve the sale or purchase of Government securities by the Central Bank. When the Central Bank sells Government securities in the market it withdraws a part of the deposit resources of the banking sector thereby reducing resources available with the bank for lending. At any given time the banks' capacity to create credit (give fresh loans) depends upon its surplus cash, i.e the amount of cash resources in excess of the statutory cash reserve ratio (stipulated by the Central Bank). Open market sale of Government securities reduces the surplus cash resources of banks, contracting the base for credit creation. Once free reserves are eliminated banks have to contract their credit supply so as to generate some cash reserves to meet the statutory CRR. The supply of bank credit which involves the creation of demand deposits falls, and money supply contracts. The opposite happens when the Central Bank undertakes open market purchase of government securities from the market. The stock of securities with the seller bank is reduced and the free surplus cash expands, thus augmenting their credit creation capacity. The result is therefore an expansion in the supply of bank credit and an increase in money supply.

Open market sale involves sale of Government securities owned by RBI and the proceeds eventually appear as a reduction in the banks'cash balances and other deposits held by RBI (a decrease in balance sheet deposits). Open market operations do not alter the total stock of Government securities but change the proportion of securities held by the Central Bank and commercial and co-operative banks. Open market sales will result in a fall in Net RBI Credit to Government (NRCG) and an increase in other (commercial and co-operative) banks' credit to Government (OBCG) without affecting the budget (or fiscal) deficit in any way.

The Central Bank as the manager of the issue of public debt also sells Government securities in the market on behalf of the Central Government. As a public debt manager the RBI is merely selling securities owned by the Government. The total supply of government securities expands in this case.

Cash Reserve Ratio (CRR)

26. The cash reserve ratio (CRR) was brought down from 15 per cent to 14 per cent in two phases in April and May, 1993. However, short term changes in macro conditions, namely the build up of RBI's foreign exchange reserves, resulting in an increase in primary liquidity, necessitated a temporary deviation from the medium term strategy. To sterilise a part of the foreign exchange inflow, the CRR was raised from 14 per cent to 15 per cent in three phases from June 11 to August 6, 1994. As the interest spreads under the facility of Foreign Currency (Non-Resident) Accounts (Banks) (FCNR (B)) scheme) were extremely high and the forward cover charges moderate under a stable dollar-rupee rate, the total exemptions of such deposits from reserve requirements needed to be reassessed. Besides, with the abolition of the FCNRA Scheme, while there was a large reduction in deposits under this scheme, there was a corresponding growth in deposits mobilised under other Non-Resident Deposits Schemes, leading to attenuation of the overall CRR. In view of this, as well as on a review of monetary trends, for the first time a CRR of 7.5 per cent was required to be maintained by banks on liabilities under FCNR (B) from October 29, 1994. CRR was subsequently raised to 15 per cent for FCNR (B) scheme and a CRR of 7.5 per cent was introduced for the first time for the Non-Resident Non-Repatriable Rupee Accounts (NRNR) Scheme, with effect from January 21, 1995. Together, these two measures are likely to freeze Rs.1155 crore of lendable resources of scheduled commercial banks with a consequent moderating effect on money supply growth.

Statutory Liquidity Ratio

27. The move towards market related yields on Central Government securities has made such securities attractive, on commercial considerations. Their zero risk weight makes it unnecessary to provide capital support under the capital adequacy norms (capital to risk weighted asset ratio system). The SLR, therefore, has become largely redundant as far as the Central Government is concerned. The dependence of State Governments on this source has, however, led to a cautious approach to the elimination of SLR. The objective is to bring down the total Statutory Liquidity Ratio to 25 per cent by 1996-97. In 1993-94, the incremental Statutory Liquidity Ratio (SLR) was brought down to 25 per cent, made applicable to the increase in net demand and time liabilities (NDTL) over their level as on September 30, 1993. The SLR for outstanding NDTL was reduced also to 34.75 per cent. In 1994-95, the SLR was reduced in a phased manner to 34.25 per cent in August, 1994 and to 33.75 per cent in September, 1994. In October 1994, the effective date for calculating average and incremental SLR was shifted from September 17, 1993 to September 30, 1994. The SLR to be maintained on outstanding net DTL on this date was reduced to 31.50 per cent. Since banks hold Government securities much above SLR (excess being about Rs.29,804 crore), this reduction in SLR will not effect the structure of bank lending. The average SLR is expected to decline from 37.4 per cent at end March, 1992 to 29.5 per cent by March end, 1995. Thus the programme of reducing SLR to 25 per cent by 1996-97 as part of the financial sector reform is on course.

Monetary Trends in 1994-95

Money Supply

28. The monetary trends observed in the second half of 1993-94 continued in 1994-95. Money Supply (M3) growth during the fiscal year 1994-95 has reached 14.9 per cent by January 20, 1995 compared to a growth of 14.6 per cent in the corresponding period of last year. Consequently, the annual growth rate of M3 had reached 18.6 per cent by this date. M1 growth at 16.3 per cent during the financial year is similarly higher than 14.8 per cent in the previous year (Table 3.1). There has been continuous acceleration in M1 growth, starting from the second half of 1993-94. The annual growth rate seems to have peaked however, at 28 per cent on October 28, 1994, and declined thereafter to 22.8 per cent by January 20, 1995.

Reserve Money

29. As in earlier years, there is a close relationship between acceleration in annual rates of growth of money and reserve money. Because of variable lags however, this is not apparent from comparing the financial year growth rate, which was marginally lower during this financial year. Reserve money growth till January 20, 1995 in this financial year was 14.2 per cent, compared to 18.0 per cent during the corresponding period last year (Table 3.2). Acceleration in reserve money growth started during the second quarter of 1993-94, well before the acceleration in M1 but seems to be reversing. The annual rate of growth is still running at 21.2 per cent on January 20,1995, after having peaked at 30.2 per cent on June 24, 1994.

30. The transformation in the forces driving reserve money growth continued and deepened during the year. Reserve money growth was clearly driven by the accumulation of net foreign exchange assets with the Reserve Bank of India. These have grown by 34.0 per cent during 1994-95 (as of January 20, 1995) compared to a growth of 57.7 per cent in the corresponding period last year. As a result, the accumulation of net foreign exchange assets by Reserve Bank of India contributed 89.3 per cent of the total growth of reserve money during the financial year. This is also reflected in an annual growth of 93 per cent as of January 20, 1995. Unlike last year, the remaining growth in reserve money has come from an increase in net Reserve Bank of India credit to commercial and cooperative banks. This mainly represents refinance of export credit given by banks. As of January 20, 1995, this has grown by 25.9 per cent over the past twelve months.

31. The second important structural change is a decline in net RBI credit to the Government by Rs. 3983 crore during 1994-95 (upto January 20, 1995), as against an increase of Rs. 7245 crore in the corresponding period of the last financial year. The decline is significant in that there has been a negative annual growth rate for a period of six months (since July 29, 1994). This is a reflection of a change in the structure of borrowing by the Central Government to finance its fiscal deficit, away from borrowing from the RBI to borrowing from the market, and also the fact that there was a budget surplus over the same six months. Such a thing has not happened for decades.

Credit

32. A shift in the structure of Government borrowing was only temporarily reflected in a faster growth of other banks' credit to Government. The annual growth rate after rising to about 50 per cent in May 1994 had fallen to 21.6 per cent by January 20, 1995. During the current financial year, the growth rate was 15 per cent as of January 20, 1995, compared to 27.1 per cent over the corresponding period of 1993-94. This has been accompanied by an increase in the growth of other banks' credit to the commercial sector. The growth rate of 13.9 per cent in the current financial year was more than double that of 6.4 per cent in the previous year. Consequently the annual growth rate as of January 20, 1995, exceeded the rate of inflation of 11.1 per cent thus showing a real increase in credit to this sector. Non food credit by scheduled commercial banks has shown a greater acceleration. During the current financial year till January 20, 1995, it had grown by 17 per cent, compared to a growth of 4.4 per cent in the corresponding period last year. The expansion of credit to the commercial sector, along with faster growth of M1 relative to M3, is indicative of the revival of economic activity during the calendar year 1994.

Banking Policy and Trends

Systemic Problems

Provision and Profits

33. The problem of non-performing assets (NPAs) facing most banks remained. It manifested itself in the banks' accounts in the form of provisions against their non-performing assets. Banks were allowed to phase in the provision required to be made for the year ended March 31, 1993 by making not less than 30 per cent provision against outstanding non-performing assets in that year and balance along with the fresh provisioning required in respect of non-performing assets identified in the year could be made in the next financial year. Table 3.4 indicates the provisions made and profits / losses for the SBI group and for other public sector banks in 1992-93 and 1993-94. Only the SBI Group managed to attain higher profits in 1993-94.

TABLE 3.4
Profits of Public Sector Banks : 1992-93 and 1993-94

(Rupees Crore)

	1992-93			1993-94		
	SBI Group	Other Public Sector banks	All Public Sector Banks	SBI Group	Other Public Sector Banks	All Public Sector Banks
1	2	3	4	5	6	7
1. Income	13963	22126	36089	13909	34686	48595
2. Expenditure, of which	13683	25774	39457	13553	39111	52664
Provisions & contingencies	1984	4453	6437	1680	7832	9512
3. Profits (Net of appropriation)	280	-3648	-3368	357	-6889	-6532

Working Results

34. Working results of scheduled commercial banks for 1992-93 and 1993-94 are presented in Table 3.5, separately for SBI Group and other public sector banks, private sector banks and foreign banks. In 1993-94, expenditure (and in particular interest expenses) as a percentage of working funds declined for all categories of banks. Though income as a percentage of working funds also fell, the fall is more noticeable in respect of expenditure. For the SBI Group and private banks profits as percentage of working funds also improved, while other public sector banks incurred greater percentage of loss to working funds, because of larger provisioning and other operating expenses.

Legal Framework

35. Financial sector reforms have made it necessary to review the legal framework in which banks function. As with the general economic system, banks require a good legal system with rational laws and a judicial delivery system to settle issues speedily, efficiently and impartially. Among the laws which need review are the Negotiable Instruments Act, Contracts Act and Securities Contract Act. Changes in Companies Act and Negotiable Instruments Act are also necessary for setting up an electronic clearing settlement and depository system. Similar revision may be required in the Transfer of Property Act, Registration and Stamp Law. Procedures applicable for dealing with claims of recovery of dues also need review. In many cases, the basic structure of the law was framed in colonial times and has not undergone an overhaul since independence, despite far reaching changes in technology, institutions and markets. Unless attended to on an urgent basis, infirmities and delays in the legal system may keep growth of output and employment below their potential, and reduce the benefits which should accrue to the people because of the economic reforms.

Regulatory Burden

36. Commercial banks are required to fill various statutory and control returns of different periodicities with RBI, along with returns needed under internal control and monitoring systems. RBI has a Committee of Direction on Banking Statistics, which seeks to ensure the collection of key information with minimum strain on the banks. As a result of its efforts, the periodicity of various statutory returns has been reduced and duplication reduced. The number of internal control and monitoring returns has similarly been brought down through reviews at bank level. The total number of returns is, however, still of the order of 100 in some banks. Filling of such a large number of returns has both time and cost implications. Though reporting to and monitoring by regulatory authorities is essential for the health of the banking system, the cost of regulations must also be kept in mind. Further simplification and integration of these returns to increase the social cost effectiveness of monitoring is essential. The internal reports of banks must also be geared towards information which increases the effectiveness of analysis, monitoring and performance appraisal, so that managers can focus on cost reduction, loan performance and increased profitability. This may also require wider and deeper mechanisation and upgradation of technology at different organisational tiers of the bank.

System Reforms

Recapitalisation of Banks

37. The Government has earmarked Rs.5,600 crore in the 1994-95 budget for recapitalisation of the less profitable nationalised banks. The allocation of Rs.5700 crore for recapitalisation in 1993-94 budget was released on the condition that the recipient banks would draw up restructuring plans. Recipients were to become viable over a period of 2-3 years, so that recapitalisation was a sustainable operation. Banks were required to invest the sum received in 10 per cent Recapitalisation Bond 2006, which will yield an annual interest income with gradual amortisation of the principal. These bonds have also now been made transferable (also see Box 3.5 on capital structure of banks).

Provisioning

38. Banks are required to make an immediate 100

TABLE 3.5
Working Results of Scheduled Commercial Banks for 1992-93 and 1993-94

	SBI group		Other public sector banks		Private sector banks		Foreign banks		All banks	
	1992-93	1993-94	1992-93	1993-94	1992-93	1993-94	1992-93	1993-94	1992-93	1993-94
1	2	3	4	5	6	7	8	9	10	11
A. Rupees crore										
A Income	13963	13909	22126	34686	1879	2353	4009	4085	41977	41125
i) Interest	12166	11901	19945	30188	1677	2051	3700	3841	37489	35581
ii) Other income	1797	2008	2181	4499	202	302	309	744	4489	5544
B. Expenditure	13683	13553	25774	39111	1879	2203	4851	3511	46127	44825
i) Interest	8416	8119	15696	21923	1154	1354	2570	1939	27836	25216
ii) Other operating expenses	3283	3754	5625	9356	482	564	858	885	10148	10804
iii) Provisions and contingencies	1934	1680	4453	7832	183	285	1423	687	8043	8805
C. Profit	280	357	-3648	-6589	60	153	-842	1092	-4150	-5287
D. Working Funds	124567	140917	211614	353474	17883	22976	31678	33418	385742	550785
B. Per Cent of Working Funds										
A. Income	11.2	9.9	10.5	9.8	10.5	10.2	12.7	12.2	10.9	7.5
i) Interest income	9.8	8.4	9.4	8.5	9.4	8.9	11.7	11.5	9.7	6.5
ii) Other income	1.4	1.4	1.0	1.3	1.1	1.3	1.0	2.2	1.2	1.0
B. Expenditure	11.0	9.6	12.2	11.1	10.2	9.6	15.3	10.5	12.0	8.1
i) Interest expenses	6.8	5.8	7.4	6.2	6.5	5.9	8.1	5.8	7.2	4.6
ii) Other operating expenses	2.6	2.7	2.7	2.6	2.3	2.5	2.7	2.6	2.7	2.0
iii) Provisions and contingencies	1.6	1.2	2.1	2.2	1.0	1.2	4.5	2.1	2.1	1.6
C. Profit	0.2	0.3	-1.7	-1.9	0.3	0.7	-2.7	3.3	-1.1	-1.0

per cent provision with regard to loss assets. For sub-standard and doubtful advances of Rs.25,000 and above, they were to complete provisioning by end March, 1994. For advances with balances below Rs.25,000, the provisioning percentage was raised from 2.5 per cent (March 31, 1993) to 5 per cent of the aggregate amount outstanding as on March 31, 1994. In consideration of the proportion of non-performing assets (NPAs) in this category and the need for adequate provisioning, the percentage was raised to 7.5 per cent of the aggregate amount outstanding for the year ending March 31, 1995. It will rise further to 10 per cent for the year ending March 31, 1996.

Special Debt Recovery Tribunals

39. In the last financial year, the passage of the Recovery of Debts due to Banks and Financial Institutions Act, 1993 paved the way for establishment of Debts Recovery Tribunals for expeditious adjudication of recovery cases within six months. The Act is applicable to debt amounts of not less than Rs.10 lakh due to any bank, financial institutions or consortium of banks or such other debt amounts of not less than Rs.1 lakh as may be notified by the Government of India. It also provides for an Appellate Tribunal with powers to waive or reduce adjudicated debt amounts. Before filing an appeal, 75 per cent of the debt amount has to be deposited by the appellant. Five tribunals started functioning at Calcutta Delhi, Jaipur, Ahmedabad and Bangalore. An appellate tribunal has also been set up at Bombay.

Board for Financial Supervision

40. RBI has constituted the Board for Financial Supervision (BFS) under the chairmanship of its Governor, RBI. It started functioning from November 16, 1994 with a term of two years. The Board consists of a Vice-Chairman (a Deputy Governor of RBI) and six members, two of whom are Deputy Governors, while four others are also members of the Central Board of Directors of RBI. This Board will work to strengthen supervision and surveillance over the entire financial system and provide a sharper focus to supervisory policy and skills. It will exercise integrated supervision and surveillance over commercial banks, financial institutions, non-banking financial intermediaries and other para-banking financial institutions. An Advisory Council has also been constituted for the Board under the chairmanship of former Chief Justice of the Supreme Court of India, also for a term of two years. In the last financial year itself, a new Department, viz., Department of Supervision was created in RBI to service the Board.

Access to Capital Market

41. The amendment of the Banking Companies (Acquisition and Transfer of Undertakings) Acts, 1970/1980 has enabled the nationalised banks to access the market for capital funds through public issues. This is

Box 3.5
Capital Adequacy and Tier I and Tier II Capital

Banks are required to maintain unimpaired minimum capital funds equivalent to the prescribed ratio on the aggregate of the risk weighted assets and other exposures. A new capital framework has been introduced for Indian scheduled commercial banks, based on the Basle Committee recommendations which prescribes two tiers of capital for the banks :-

(a) Tier I or Core capital (the most permanent and readily available support against unexpected losses) includes paid up capital, statutory reserves, share premium, capital reserve (representing surplus on sale of assets and held in a separate account only to be included) and other disclosed free reserves (if any) minus equity investments in subsidiaries, intangible assets, losses in the current period and those brought forward from previous periods, and

(b) Tier II Capital, which may include,
 (i) undisclosed reserves and fully paid up cumulative perpetual preference shares,
 (ii) revaluation reserves arising out of revaluation of assets that are undervalued on the bank's books (like bank premises and marketable securities).
 (iii) general provisions and loss reserves, not attributable to the actual dimunition in value or indentifiable potential loss in any specific asset and are available to meet unexpected losses;
 (iv) hybrid debt capital instruments which combine characteristics of equity and debt, and
 (v) subordinated debt which is fully paid up, unsecured, subordinated to the claims of other creditors, free of restrictive clauses and not redeemable at the initiative of the holder or without the consent of the supervisory authority of banks. If subordinated debt carries a fixed maturity it should be subject to progressive discount and have initial maturity of not less than five years.

Tier II capital should not be more than 100 per cent of Tier I capital and subordinated debt instruments more than 50 per cent of Tier II capital. Revaluation reserve should be applied a discount of 55 per cent for inclusion in Tier II capital. General provisions/loss reserves should not exceed 1.25 per cent of the total weighted risk assets.

subject to the provision that the holding of the Central Government will not fall below 51 per cent of the paid up capital. The Oriental Bank of Commerce was the first nationalised bank to approach the capital market. It has raised about Rs.360 crore through a public issue. Other profit making nationalised banks are also planning to approach the capital market in the near future.

Defaulting Borrowers' List

42. In April 1994 RBI announced a scheme for disclosing the names of defaulting borrowers, of banks and financial institutions. This is applicable to borrowers with total outstanding of Rs.1 crore and above, as on March 31 and September 30 each year. The list of names will be circulated to alert banks and financial institutions about large defaulters. The scheme is expected to improve discipline among borrowers and the climate for loan recovery. The first such list has since been circulated. Reserve Bank has also published a list of borrowal accounts against which banks have filed suits for recovery of funds.

Decontrol and competition

Interest Rate Structure

43. Effective October 18, 1994, for credit limits of over Rs.2 lakh, the prescription of a minimum lending rate has been abolished and banks have been granted freedom to fix the lending rate for such credit limits. Banks are required to obtain the approval of their respective Boards for the prime lending rate, which is the minimum rate charged by them for credit limits over Rs.2 lakh. Each bank's prime lending rate needs to be declared and made uniformly applicable at all its branches. Further, for limits over Rs.25,000 and up to Rs.2 lakh, the rate of interest for all advances including term loans has been reduced to 13.5 per cent per annum. For limits up to Rs.25,000 rate of interest remained unchanged at 12.0 per cent per annum. The stipulation that effective rate of interest on discounting of bills for borrowers in the category of over Rs.2 lakh should be at one percentage point below the rate charged for this category, has been withdrawn. The banks have also been granted freedom to fix lending rates for (a) commodities coming within the purview of selective credit control, (b) post-shipment credit beyond six months from the date of shipment and (c) export credit not otherwise specified.

44. On finance granted by banks to intermediary agencies for on lending to ultimate beneficiaries and agencies providing input support, following rates were made applicable, effective May 20, 1994:-

(i) a fixed rate of 12.5 per cent per annum, for term loans of three years and above and

(ii) a fixed rate of 13.5 per cent per annum, for all other advances.

Private Sector Banks

45. UTI Bank became the first bank to be set up in the private sector under new guidelines issued by RBI. It was followed by five more private banks. Six more proposals for setting up banks in the private sector have received 'in principle' approval from RBI.

Pre-shipment credit in foreign currency

46. Only exporters of gems and jewellery used to enjoy a running account facility under the pre-shipment credit scheme. In the current financial year, this has been extended to all commodities, subject to good track records of exporters.

Export credit facility for sub-suppliers

47. As against a target of 10 per cent of outstanding net bank credit which banks are required to meet in the field of export credit, aggregate outstanding export credit formed 12.1 per cent at the end of June 1994. The viability of export credit was made easier by allowing banks to extend pre-shipment credit to sub-suppliers of export orders within the overall permissible pre-shipment export credit. This will provide useful support to the export effort.

Interest rate on deposits

48. Effective May 16, 1994, the maximum term deposit rate under Non-Resident (External) Rupee Accounts (NRE accounts) scheme was reduced by one percentage point to not exceeding 10 per cent per annum, in order to bring the deposit rates on these accounts in harmony with domestic term deposit rates. Furthermore, the minimum maturity of a term deposit under this scheme was raised from 46 days to 6 month. Effective November 1, 1994, the interest rate on savings deposits under the NRE accounts scheme was brought down to 4.5 per cent. The term deposit rate under this scheme was also reduced by two percentage points to not exceeding 8 per cent per annum, effective October 18, 1994. [Table 3.6]

49. Effective November 1, 1994, the interest rate on domestic savings deposits was reduced by 0.5 percentage point from 5.0 per cent per annum to 4.5 per cent per annum. As a large proportion of savings deposit

TABLE 3.6
Selected Interest Rates of Scheduled Commercial Banks

(Per cent per annum)

	Rates[1] as on March 1,1993	Rates[1] as on Febuary 10,1995
1	2	3
A Domestic deposits		
i) Savings deposits	5.00	4.50
ii) Term deposits	Not exceeding 11.00	Not exceeding 11.00
B Non-Resident (External) Rupee Accounts		
i) Savings deposits	6.00	4.50
ii) Term deposits[2]	Not exceeding 13.00	Not exceeding 8.00
I. Export credit (Rupee)		
i) Credit against duty drawback receivable up to 90 days	0.00	0.00
ii) Pre-shipment credit up to 180 days	13.00	13.00
iii) Post-shipment credit		
(a) Demand bills	13.00	13.00
(b) Usance bills (46 - 90 days)	13.00	13.00
iv) Credit against Govt. incentives (upto 90 days)	13.00	13.00
v) Pre-shipment credit (181 - 270 days)[3]	15.00	15.00
vi) Post-shipment credit		
(a) Usance bills (91 - 180 days)	17.00	15.00
(b) Beyond six months from date of shipment	22.00	Free
vii) All other export credit not listed (minimum)	17.00	Free
II. Post-shipment export credit (US Dollar) (Demand bills for transit period specified by FEDAI and usance bills for a total period comprising usance period specified by FEDAI plus grace period up to six months from date of shipment)	6.50	6.50
III. DRI Advances	4.00	4.00

[1] The rates are exclusive of interest tax, effective October 1,1991. Export credit is exempted from interest tax from April 1,1993.
[2] Maximum interest rate payable on NRE term deposits was reduced to 12 per cent,effective April 8,1993 to 11 percent effective October 12,1993 and further to 10 percent effective May 16,1994. [3] With prior approval of RBI.

accounts are utilised essentially as current accounts, interest rates needed to better reflect the nature of such accounts. To reduce the reliance of banks on money market resources and on RBI as also to evolve a more stable asset-liability balance and ensure attractiveness of term deposit rates, RBI revised upwards the ceiling interest rate on domestic term deposits, effective February 10, 1995, by one percentage point to not exceeding 11.0 per cent per annum.

Investment in shares and debentures

50. Acquisition of shares and debentures of corporate bodies, including devolvement arising out of the underwriting obligation by banks, is limited to 5 per cent of the previous year's incremental deposits. There was also a sub-ceiling of 1.5 per cent for investment in corporate shares. PSU bonds are, however, not subject to any ceiling. The sub-ceiling of 1.5 per cent was abolished during the year. Banks were given freedom to hold shares (including PSU equity) or debentures within the overall ceiling of 5 per cent. The investments by banks in equities/bonds issued by All India Finance Institutions would be outside the above ceiling of 5 per cent prescribed for investments in shares and debentures of corporate bodies.

Abolition of ceiling on term loans

51. Considering the available lendable resources with banks and the need for higher participation of the banking system in term finance, the ceiling on term finance/loan, which was set at Rs.50 crore for each bank, was abolished. Banks can now sanction individually term finance/loan subject to compliance with the prudential exposure norms. Simultaneously, the ceiling on term finance/loan exposure of the banking system was raised from Rs.200 crore to Rs.500 crore.

Finance for Infrastructure

52. In view of the importance of infrastructure development and need for funds in such projects involving large capital outlays, banks were permitted to extend term finance/loan for creation/expansion/modernisation of infrastructure projects to both private and public sector undertakings, subject to certain conditions.

Housing loans

53. RBI has raised the ceiling on housing loans to individuals in cities from Rs.3 lakh to Rs.10 lakh. The ceiling on the proportion of investment that banks can make in bonds of recognized housing finance institutions has also been raised from 40 per cent to 50 per cent. This will increase the flow of credit into housing and help bridge the gap between demand and supply of housing stocks.

Margin Requirement

54. RBI stipulation requiring a margin of not less than 25 per cent on loans and advances against fixed deposits were removed. From October 18, 1994, each bank is free to determine its own margin requirement.

Selective Credit Controls

55. Selective credit controls have a role in inflation control in a closed economy with short run inelasticity of supply. By increasing the cost and reducing the availability of credit for stock accumulation, the build up of inflationary expectations can be moderated. Delicensing of imports, along with appropriate tariffs can, however, be more effective and also more efficient as it increases the supply. During 1994-95, the evolution of prices and output led to a tightening of selective credit controls on a number of goods from May 16, 1994. Minimum margins on bank advances against pulses, oilseeds and vegetable oils and cotton and kapas were raised by 15 percentage points. The credit ceiling on them was reduced from 100 per cent to 85 per cent of the peak level (of credit given to any party) during the three year period ending October 1993. The concessional margin of 10 per cent for bank advances (with State guarantee) to State level cooperative institutions was raised from 10 per cent to 25 per cent.

56. The mid year review of the price-output situation showed that expectations of a bumper kharif crop had led to a substantial improvement in the paddy/rice price situation. Selective credit controls on bank advances against paddy/rice were, therefore, eliminated. There was also some improvement in price-output trends in cotton/kapas. Minimum margins on bank advances against these commodities were, therefore, reduced by 15 percentage points, and the credit ceiling raised from 85 per cent to 100 per cent of each borrower's peak level of credit during the three year period ending October 1993. However, with effect from December 27, 1994, the minimum margins on bank advances against stock of cotton and kapas to 'others' (other than cotton mills including spinning mills) and against warehouse receipts were raised by 15 percentage points on a further review of their price-output trends [see Table 3.7 and Box 3.6].

Priority Sector Advances

57. The performance of scheduled commercial banks in priority sector advances has been marginally lower than target. This is partly due to writing-off of agricultural debts under Agricultural Debt Relief Scheme of 1990 and partly because of various factors like the vitiated recovery climate and the unsatisfactory recovery performance, lack of requisite infrastructure and inadequate support and cooperation from the concerned development agencies of the State Government and banks' hesitation in lending to high risk borrowers due to the introduction of prudential norms relating to

TABLE 3.7
Selective Credit Controls on Bank Advances
(Effective December 27, 1994)

	Minimum Margins			(Per cent) Credit Ceiling Nov. 1991-Oct. 1992
	Mills/ processors	Others	Warehouse receipts	
1	2	3	4	5
1. Pulses	60	75	60	85
2. Other foodgrains(other than paddy/ rice ,wheat and pulses)	45	60	45	100
3. Oilseeds (viz. groundnut, rapeseed/ mustard, cottonseed, linseed, castorseed and all imported oilseeds)	60	75	60	85
4. Vegetable oils (viz. groundnut oil, rapeseed/mustard oil, cottonseed oil, linseed oil, castor oil vanaspati and all imported oils)	60[1]	75	60	85
5. Sugar				
a) Buffer	0	-	-	-
b) Unreleased stock	20	-	-	-
c) Released	75	75[3]	60	-
6. Gur and khandsari	45	75	60	-
7. Cotton & kapas	[2]	60	45	100[4]

[1] Applicable to registered oil mills and vanaspati manufacturers *- Not applicable*
[2] Exempt from the stipulations. *[3] Applicable other than cotton mills including spinning mills.*
[4] A concessional minimum margin of 25 per cent was available from May 27 to the end of November 1994 for advances against stocks of sugar imported on cash basis for a period of not exceeding 8 weeks (reduced to 6 weeks from September 3, 1994).

income recognition, assets classification, provisioning and capital adequacy.

58. Some changes have been introduced in the scope of priority sector advances. Direct and indirect advances to agriculture can now be clubbed for meeting the agricultural sub-target of 18 per cent. Advances up to Rs.5 lakh for financing the distribution of inputs for agriculture and allied sectors now count as indirect agricultural advances. Allied activities include dairy, poultry and piggery, and consequently, poultry feed and cattle feed are eligible for this purpose. The ceiling on loans for professional and self-employed persons has also been raised to Rs.5 lakh. Banks can now grant loans up to Rs.10 lakh to professionally qualified medical practitioners under the category of priority sector advances.

Rural Credit

59. The General Line of Credit given by RBI to National Bank for Agriculture and Rural Development (NABARD) for credit support to seasonal agricultural operations was enhanced by Rs.400 crore to Rs.4,100 crore. The General Line of Credit II for the non-farm sector was also increased by Rs.100 crore to Rs.750 crore. This increase of Rs.500 crore is in addition to an earlier increase of Rs.1,000 crore between January 1993 and October 1993.

60. To avail refinance from NABARD, State Cooperatives banks and RRBs were required to have a minimum recovery rate of at least 40 per cent. Application of this eligibility condition was deferred to June 30, 1995. This will help many areas in which credit is constraining agricultural production. Public sector banks were also asked to prepare by June 1994, specific action plans to enhance agricultural lending in 1994-95 and to meet the agricultural credit sub-target. Banks were asked to consider setting up of at least one specialized branch for agriculture in order to focus on areas such as aqua-culture, floriculture and tissue culture, which require more technical knowledge for investment appraisal.

Cash credit facility for agriculture

61. Banks have also been advised by RBI in October 1994 to introduce a flexible line of credit in the form of cash credit facility for farmers to meet their composite credit requirements. The cash credit facility is to be extended to farmers who have satisfactory track record in the previous two years and have irrigation facilities and/or who undertake allied activities like dairy, poultry etc. and/ or other non-farm activities. Cash credit facility is hoped to encourage adequate and timely flow of rural credit for meeting the composite needs of the farmers, by removing to the extent possible, the rigidity of the existing crop loan system.

Small Scale Industry

62. To provide flexibility to banks and make available funds to the State Industrial Development Corporations/State Financial Corporations that assist small

Box 3.6
Monetary Policy and Credit Control Measures 1994-95

- Cash Reserve Ratio (CRR) raised in three phases from 14 to 15 per cent between June and August 1994.
- Cash reserve ratio of 15 per cent introduced in two phases on Foreign Currency Non Residents Accounts scheme (Banks) and CRR of 7.5 per cent imposed on Non Resident Non Repatriable Rupee Deposit (NRNR) scheme
- The base for determining the export credit (Rupee) refinance limits shifted by a year and eligibility percentage reduced from 90 to 80 per cent for post-shipment credit denominated in US dollar.
- Minimum margin on bank advances against pulses, oilseeds, vegetable oil and cotton and kapas raised by 15 percentage points and level of credit ceiling reduced by 15 percentage points.
- The maximum term deposit rate on Non-Resident (external) rupee accounts reduced by one percentage point and minimum maturity for new deposits raised to six months.
- Banks allowed to hold shares (including PSU equity) or debentures within the overall ceiling of 5 per cent of incremental deposits of the previous year
- Running account facility under pre-shipment credit in foreign currency extended to all exporters with good track record.
- General Line of Credit I from RBI to NABARD for seasonal agricultural operations raised to Rs. 4,100 crore from Rs.3,700 crore
- Scope of priority sector advances extended to include (a) net funds provided by sponsor banks to RRBs (b) advances upto Rs 5 lakh for distribution of inputs for agriculture and allied activities and (c) advance granted to a qualified medical practitioner for purchase of one motor vehicle.
- Domestic Savings deposit interest rate reduced from 5 0 per cent annum to 4 5 per cent per annum.
- Savings deposit rate reduced from 5 0 per cent to 4.5 per cent per annum for Non-Resident (External) Rupee Accounts The maximum term deposit rates for NRE accounts for maturity of 6 months to 3 years and above reduced from 10 0 per cent to 8 0 per cent from October 1994
- Bank advances against paddy/rice to all borrowers exempted from all the provisions of selective credit controls
- Banks directed to maintain on first 13 days a minimum level of 85 per cent of the required fortnightly average CRR balances On the 14th day of the reporting fortnight banks will be allowed to maintain less than 85 per cent so as to adjust the average of daily balances to the required level.
- The facility of stand-by arrangement against commercial paper (CP) was abolished. After issuance of CP, if the issuer wishes to revive the earlier level of credit limit, it would have to approach the bank for enhancement afresh
- Banks advised to extend cash credit facility to farmers with irrigation facilities and also to other farmers undertaking off farm/allied activities
- The ceilings of Rs 50 crore for each bank abolished and the limit of Rs.200 crore for finance from the banking system as a whole raised to Rs 500 crore, for any project.
- Banks allowed to provide lines of credit/term loans to State Industrial Development/Financial Corporation (for extending loans to small scale industrial units) as part of priority sector lending
- The ceiling on direct individual housing loans raised to Rs.3 lakh to Rs 10 lakh, and the proportion of investment by way of purchase of bonds of recognised housing finance institutions raised from 40 per cent to 50 per cent
- Banks given the freedom to determine their own policy on margins for loans granted against deposits
- Sub-suppliers of export orders to be provided credit within the overall permissible pre-shipment export credit

TABLE 3.8
Scheduled Commercial Banks - Selected Indicators

	Items	Variations during 1992-93 March 20 1992 to March 19 1993	1993-94 March 19 1993 to March 18 1994	1993-94 March 19 1993 to Jan.21 1994[1]	1994-95 March 18 1994 to Jan.20 1995[1]
	1	2	3	4	5
			(Rs. crore)		
1.	Aggregate deposits (a+b)	37814	46560	38822	44876
	a) Demand deposits	1373	10111	6899	8479
	b) Time deposits	36441	36449	31923	36397
2.	Borrowings from RBI	1042	194	330	982
3.	Cash in hand and balances with RBI	-5359	19215	17134	5839
	a) Cash in hand	285	-10	33	191
	b) Balances with RBI	-5644	19225	17101	5648
4.	Net Balances with RBI (3b-2)	6686	19031	16771	4666
5.	Money at call and short notice	1293	-564	-842	1349
6.	Bank credit (a+b)	26390	12436	10404	28968
	a) Public food procurement credit	2073	4164	3967	2860
	b) Non-food bank credit,	24317	8272	6437	26108
	of which to priority sector[4]	4407	4043	21[2]	560[3]
7.	Investments in approved securities	15460	26866	21605	15534
	a) Government securities	13218	25256	19940	15411
	b) Other approved securities	2242	1610	1665	123
8.	Balances with other banks in current account	-192	-350	-219	148
			(Per cent)		
9.	Credit-Deposit Ratio	56.6	52.2	52.8	53.7
10.	Investment-Deposit Ratio	39.3	42.1	41.4	41.1

[1] Provisional [2] Up to July, 1993 [3] Up to July, 1994
[4] Data are provisional and relate to 48 banks from August 1990 and 47 from September 1993, which account for 90-95 per cent of bank credit. Variations relate to last reporting Friday of March.

scale industrial units, banks were permitted to consider on merit the proposals for sanction of term finance/ loan in the form of line of credit to these institutions. The extent to which such term finance/loan was utilised by these institutions for sanction of credit to small scale units, would be treated as part of priority sector lending of the concerned banks.

Trends in Bank Credit and Business

63. Selected indicators (Table 3.8) of the operations of scheduled commercial banks revealed a marginal decline in growth of aggregate deposits (14.2 per cent) during 1994-95 (up to January 20, 1995), from the 14.5 per cent growth, in the corresponding period of 1993-94. Demand deposits have grown by 15 per cent as against 14.8 per cent growth in the corresponding period of 1993-94. Bank credit growth of 17.6 per cent is more than twice the growth of 6.8 per cent in the corresponding period of 1993-94. The higher expansion is especially noticeable in non-food credit at 17 per cent. It is more than three times the growth of 4.4 per cent in the corresponding period of 1993-94. This reflects a significant recovery of industrial activity. The rise of 26.2 per cent in food credit, though lower than the 58.8 per cent growth in the corresponding period of 1993-94, is still high. The 15.2 per cent growth of investment in Government securities has barely exceeded deposit growth, while the stock of 'other approved securities' with banks has remained almost stationary.

Sectoral Deployment of bank credit

64. For the current financial year, sectoral deployment of gross bank credit data are available up to July 1994. During April-July 1994, gross bank credit has shown a somewhat higher increase of 1.2 per cent as against an increase of 0.8 per cent during the comparable period of 1993-94, mainly on account of higher credit expansion to priority sector and other sectors including exports (Table 3.9). There was a substantially lower growth in credit to agriculture.

All India Financial Institutions

Trends in Lending

65. Sanctions and disbursements by All India Financial Institutions (AIFIs) give an indication of the degree of intermediation between saving and investment taking place through these institutions. This consists of two parts, direct lending for production and investment in debt instruments, financing of primary market activities, etc. The proportion of direct lending

TABLE 3.9
Sectoral Deployment of Gross Bank Credit

On the last reporting Friday	1992-93	1993-94	April-July 1993-94	April-July 1994-95	Variations during[1] 1992-93	1993-94	April-July 1993-94	April-July 1994-95
1	2	3	4	5	6	7	8	9
			(Rs.crore)				(Per cent)	
I Gross bank credit	21134	9697	1107	1915	16.8	6.6	0.8	1.2
1. Public food procurement	2073	4164	2808	1102	44.4	61.8	41.6	10.1
2. Gross non-food credit (a+b+c+d)	19061	5533	-1701	813	15.7	3.9	-1.2	0.6
a) Priority sector (i+ii+iii)	4407	4043	21	560	9.7	8.1	0.0	1.0
i) Agriculture	1806	1245	159	16	9.9	6.2	0.8	0.1
ii) Small scale industry	1876	2594	83	94	10.3	13.0	0.4	0.4
iii) Other priority sectors	725	204	-221	450	8.0	2.1	-2.2	4.5
b) Medium & large	11546	-764	-969	-323	24.5	-1.3	-1.7	-0.6
c) Wholesale trade (excluding food procurement)	815	365	-421	-230	13.2	5.2	-6.0	-3.1
d) Other sectors	2293	1889	-332	806	10.1	7.6	-1.3	3.0
II. Export credit[2]	5062	1738	1091	1539	49.2	11.3	7.1	9.0
Priority sector advances as proportion of net bank credit.[3]					35.1	35.3	34.6	35.0

[1]*All figures after 1992-93 are provisional.* [2]*Also included in non food credit.* [3]*As on last Friday of the period.*
Note: Data relate to 47 scheduled commercial banks which account for 90-95 per cent of the banks credit of all scheduled commercial banks. Gross bank credit data include bills rediscounted with RBI, IDBI, Exim Bank and other approved financial institutions.

in sanctions/disbursements is much higher for the Development Finance institutions (DFIs) than for Investment Institutions (IIs) namely UTI, LIC, GIC. Historically, the sanctions and disbursements by Development Finance Institutions have been a good indicator of long term lending for project finance. Consequently, they were also indicative of investment trends. Though the degree of short term lending and investment by DFIs is increasing under the pressure of competition, the changes in sanctions and disbursement, still give an indication of changes in term lending.

66. Financial sanctions by all India financial institutions (AIFIs) recorded a growth of 26.8 per cent, while their disbursements of assistance showed a more modest growth of 15.1 per cent in 1993-94. This shows that the growth of intermediation through AIFIs has slowed. Sanctions by nine development finance institutions (DFIs), viz., IDBI, IFCI, ICICI, SIDBI, IRBI, SCICI, RCTC, TDICI and TFCI increased by 44.4 per cent in 1993-94. Disbursements by DFIs which is a better indicator of direct lending grew by 28.6 per cent (Table 3.10).

67. In the first ten months (i.e. April 1994 to January 1995) of the current financial year, there are clear signs of pick up in financial sanctions and disbursements by financial institutions. Sanctions of DFIs grew by 82 per cent, while those of investment institutions declined marginally by 1.3 per cent. As a result, sanctions by AIFIs as a whole increased by 55 per cent.

TABLE 3.10
Assistance by All India Financial Institutions

(Rs.Crore)

	1992-93	1993-94	Apr.93-Jan.94	Apr. 94 Jan. 95
1	2	3	4	5
	A. Sanctions			
All IndiaFinancial Institutions	32674.8 (46.5)	41444.1 (26.8)	32264.7	50014.2 (55.0)
a) Development finance Institutions	21845.7 (29 8)	31554.1 (44.4)	23020.4	41893.1 (82.0)
b) Investment Institutions	12601.6 (92.9)	10765.0 (-14.6)	9444 3	9321.1 (-1.3)
	B. Disbursements			
All IndiaFinancial Institutions	22268.8 (41.6)	25631.9 (15.1)	18792.6	23353.9 (24.3)
a) Development finance Institutions	14486.0 (23.9)	18630.2 (28.6)	12768.1	17813.7 (39.5)
b) Investment Institutions	9400.4 (105.1)	7876.7 (-16.2)	6124.5	5540.2 (-9.6)

a) Development finance Institutions -IDBI, IFCI, ICICI, SIDBI, IRBI, SCICI, RCTC, TDICI and TFCI.
b) Investment Institutions-LIC, GIC and UTI.
Note : (i) Data for 1993 and 1994 are provisional.
(ii) Figures in brackets indicate percentage changes.
(iii) Figures for AIFIs are net of inter-institutional flows.
Source: Industrial Development Bank of India

Disbursements by DFIs have however, lagged behind sanctions with a growth of 39.5 per cent, while disbursements by investment institutions were lower by 9.6 per cent. Combined disbursements by All India Financial Institutions as a whole, also moved up by 24.3 per cent over April 1993 to January 1994. There are a variety of reasons why disbursements have remained at a much lower level than sanctions, particularly for Development Finance Institutions (about 40 per cent of sanctions). Many companies have raised equity and debentures in domestic and international markets, in advance of projected investments, thus making it unnecessary to draw upon sanctioned assistance at this stage. Companies may also have expected a fall in the interest rates charged by financial institutions, and postponed utilisation of sanctioned loans.

Policy Reform

68. In October 1994, an ordinance was promulgated to amend IDBI Act, 1964. This envisaged restructuring of IDBI's share capital, and empowering IDBI to raise equity from the capital market. The bill is to be considered by Parliament in its Budget session.

Prudential Norms

69. In March 1994, RBI issued guidelines on prudential norms to be followed by the five all India Development Finance Institutions, namely, IDBI, ICICI, IFCI, IRBI and EXIM Bank. The norms are broadly similar to those prescribed earlier for scheduled commercial banks with some modifications, taking into consideration the nature of operations of DFIs. These DFIs were required to achieve a 4 per cent capital adequacy ratio by March 31, 1994. Institutions dealing with official or non-official agencies abroad, are required to achieve an 8 per cent capital adequacy ratio by March 31, 1995, whereas others have been permitted time up to March 31, 1996. In case of mergers of healthy and sick units, DFIs were advised to separately classify facilities of both units for a period of three years. Thereafter, the combined performance may be taken for the purpose of asset classification. From the year ending March 1995, DFIs were also granted a concession of reckoning time over-runs up to 50 per cent of the anticipated project completion time, before downgrading the asset. The norms also allow profits on the sale of securities to be taken either in the Profit and Loss Account or in the Capital Reserve Account. Banks have to book the loss on the sale of their investments to Profit and Loss Account and take only profits to the Capital Reserve Account.

70. In tune with the changing environment, the DFIs have been diversifying their operations and reorienting their business strategies. IDBI has expanded the scope of its venture capital scheme to include a wider spectrum of projects. Both new technology and new products and processes with a high element of risk and high potential returns will be covered. It took the lead in setting up the National Stock Exchange, with equity participation by financial institutions and banks. It has also promoted Investor Services Limited (ISL), a company providing share registry services and acting as transfer agent. It has initiated steps for promoting a commercial bank, a mutual fund and a stockbroking firm. UTI has floated a bank viz. UTI Bank, which has commenced operations.

71. ICICI has started project advisory services, and has also promoted a new company for providing share registry and transfer services to investors. It has floated a mutual fund and started a commercial bank in the private sector.

72. With the private sector entering the field of infrastructure, SCICI is focusing on credit for port facilities, transportation, power generation and telecommunications. IRBI has for the first time ventured into management of public issues. It has also envisaged the setting up of a Reconstruction Assistance Fund. This fund will meet the special financial needs of units for salvage and rehabilitation which are not met by banks and FIs. During 1993-94, SIDBI took new initiatives such as the extension of foreign currency loans to Export Oriented Units (EOUs) and support to Non-Governmental Organisations (NGOs) for promoting self help by the rural poor. SIDBI has also signed MOUs with 5 public sector banks for jointly extending direct assistance to small scale units.

73. The DFIs have rationalised their interest rate structure in line with the overall economic environment. IDBI, ICICI and IFCI have introduced a variable interest rate loan scheme for the first time in the country. The minimum term lending rates of DFIs were fixed at 13.5 per cent with effect from October 19, 1994, following the credit policy announced by RBI. However, with effect from February 20, 1995 IDBI has revised its minimum term lending rate upwards to 15 per cent.

74 On the resources front, DFIs continued their efforts to widen their resource base and mobilise funds from domestic as well as international markets. IDBI made a private placement of Floating Rate Notes for US $ 100 million. ICICI and SCICI tapped the international capital markets through Euro-Issues. IDBI, ICICI and SCICI have also accessed the domestic markets with floating rate bonds.

Non-Banking Financial Companies

75. Non-banking financial companies (NBFCs) have grown in number and volume of business by entering areas which banks were not allowed to enter due to regulatory restrictions. They are mobilising public savings and investing them in the market. The attention of monetary authorities has been drawn to the need for regulation of these companies. RBI constituted a working group on financial companies, whose recommendations are being implemented in a phased manner. Non-Banking financial companies with net owned funds of Rs.50 lakh and over are now required to register with RBI. On June 13, 1994 RBI issued guidelines for these companies covering prudential and income recognition norms, accounting standards, provisioning for bad and doubtful debts, capital adequacy ratio and concentration of credit/investments. They will have to achieve a minimum capital adequacy norm of six per cent, on their risk weighted assets and off-balance sheet exposures, by March 31, 1995 and a ratio of 8 per cent will have to be attained by March31, 1996. Inter-corporate deposits have also been brought within the discipline of the regulatory framework.

76. The registered non-banking finance companies will have to obtain a rating by one of the credit rating agencies, at least once a year. This will provide objective information to depositors and creditors and help in protecting their interests. Companies with net owned funds of Rs.2 crore and above have to get their first rating by the end of 1994-95, while companies with net owned funds of Rs. 50 lakh to Rs.2 crore must obtain the first rating by March 31, 1996. The existing RBI directions will continue to apply till the new norms are implemented. Their half yearly returns will be used for monitoring compliance with the prudential norms. The deposit limits for registered Loan and Investment Companies have, however, been raised from forty per cent of net owned funds to 100 per cent. Deposits are defined inclusive of non-convertible debenture/bond issues. With the new regulations, the assets side of the operations of financial companies will come under regulatory framework and due attention will also be given to the quality of assets. This is expected to strengthen the companies and help ensure orderly development of the financial sector.

Money Market Developments and Trends

77. Money markets play an important role in the deployment of short-term funds, and in signalling trends in liquidity and interest rates. These markets, therefore, provide information for monetary policy formulation and management. During the current financial year so far, money markets reflected a fairly steady trend, but for some turbulence witnessed in the months of September and December 1994 and February 1995 during which there were very sudden and large increases in call money rates. This highlighted the urgent need for better monitoring as well as broad basing, deepening and integrating money markets.

Inter-bank call money market

78. The strong growth in primary liquidity arising from the growth in Reserve Money was the underlying factor responsible for the low level of inter-bank daily average call money rate (2.5 - 6 per cent) during the calendar year 1994 till August. Average daily inter bank call money rates shot up to 53 per cent towards the end of September 1994. The call money rates subsequently came down to 2 per cent by the end of September 1994. Spurts in rates was, witnessed in both December 1994, and February 1995.

79. The stringent conditions in the call money market in September and December 1994 were partly attributable to flotation of six State Government loans and advance tax payments. Since the coupon rate of 12.5 per cent offered on State Government loans was attractive, the aggregate subscriptions received for these loans were as high as Rs.3,991.43 crore, as against the notified amount of Rs.613.43 crore. Banks did not correctly anticipate the volume of refunds of over subscription on State Governments loans and the cash needed for meeting the statutory CRR. This led to shooting up of call money rates in September, 1994. In December, call money rate rose sharply because during the fortnight December 10-23, 1994, the Government also siphoned off about Rs.4,200 crore of liquidity through the PSU equity sale, advance tax payments and the second instalment on the partially paid Government security. Yet during this fortnight, there was a very mild tightening of liquidity in the market and the money market rates rose moderately, possibly because of RBI injecting additional liquidity through Discount and Finance House of India (DFHI) and Securities Trading Corporation of India (STCI). Another factor leading to fluctuations in call money rates was that some banks had been chronic large borrowers in the call/notice money market for maintaining their Cash Reserve Ratio. These banks had invested in medium and long-term assets by borrowing in the call money market, hoping to be able to roll over their requirements in the future. Ostensibly such borrowing was profitable because of low call money rates. Some banks had run down their cash balances with the Reserve Bank to as low a level as 10 per cent of required cash reserves. This asset-liability mismatch, magnified the volatility in the call/notice money market in September and December 1994 (Fig. 3.1).

80. To ensure more orderly conditions in the Call/ Notice Money market and also to reduce volatility, banks have been directed by RBI to ensure that their cash balances with RBI does not fall below 85 per cent of the prescribed CRR on each of the first 13 days of the reporting fortnight. This measure is effective from the fortnight beginning January 7, 1995, and is expected to greatly attenuate the fortnightly swings in call rates.

Certificates of Deposit (CDs)

81. There has been a lack of interest among banks in issuing fresh CDs since 1993-94. Secondary market activity in CDs also was non-existent, because every holder sought to keep CDs till maturity. The stock of outstanding CDs declined sharply from Rs. 9803 crore on March 19, 1993 to 5571 crore on March 18, 1994. The number of issuing banks also declined from 51 to 48 over the same period. Interest rates which had ranged from 12.5 to 16.5 per cent, were down to the 7 to 12.2 per cent range. There is no bank-wise limit for issue of CDs and banks are free to issue CDs depending upon their requirements. This is tantamount to freeing of CD rates at the wholesale end of the deposit market. The activity has marginally picked up, with outstandings rising to Rs.5385 crore (by 44 banks at 7.5 to 12.5 per cent interest rate) as on January 8, 1995. The easy conditions in the CD market were, therefore, largely due to the comfortable liquidity position of banks.

Commercial Paper

82. Rates offered on Commercial papers (CPs) showed a gradual decline in 1993-94. They were in the range 9.35 to 9.50 per cent during November-December 1993. The Indian Banks' Association advised banks in 1993-94 not to subscribe to CPs with a yield below 12.5 per annum. This advice was reportedly not effective, as CPs were being taken up at lower rates of 10.5 - 11.5 per cent. Outstanding stocks of CPs were Rs.3,264 crore at the end of March, 1994 and expanded to Rs. 4511.05 crore at the end of August, 1994. The level of outstanding CP came down significantly to Rs. 1393.25 crore as on February 15, 1995. Banks are the principal holders of such paper, and to some extent, lending to well rated companies through CPs was a substitute for direct bank credit in 1993-94.

83. Issuance of CPs used to result in a reduction of the cash credit limit and vice versa. This assured repayment of CPs on maturity, since the issuer company could automatically draw on the cash credit limits, in case of non roll-over. Companies could also obtain a high credit rating because of this arrangement. RBI has recently stopped this system by abolishing the stand-by arrangement. When a CP is issued, banks will have to effect a pro-tanto reduction in the cash credit limit. Subsequently, if the issuer wants a higher cash credit limit, he will have to approach the bank afresh and the bank will then take a decision, based on market conditions at that time. This will make Commercial paper a more independent money market instrument, with its rating reflecting the intrinsic strength of the company.

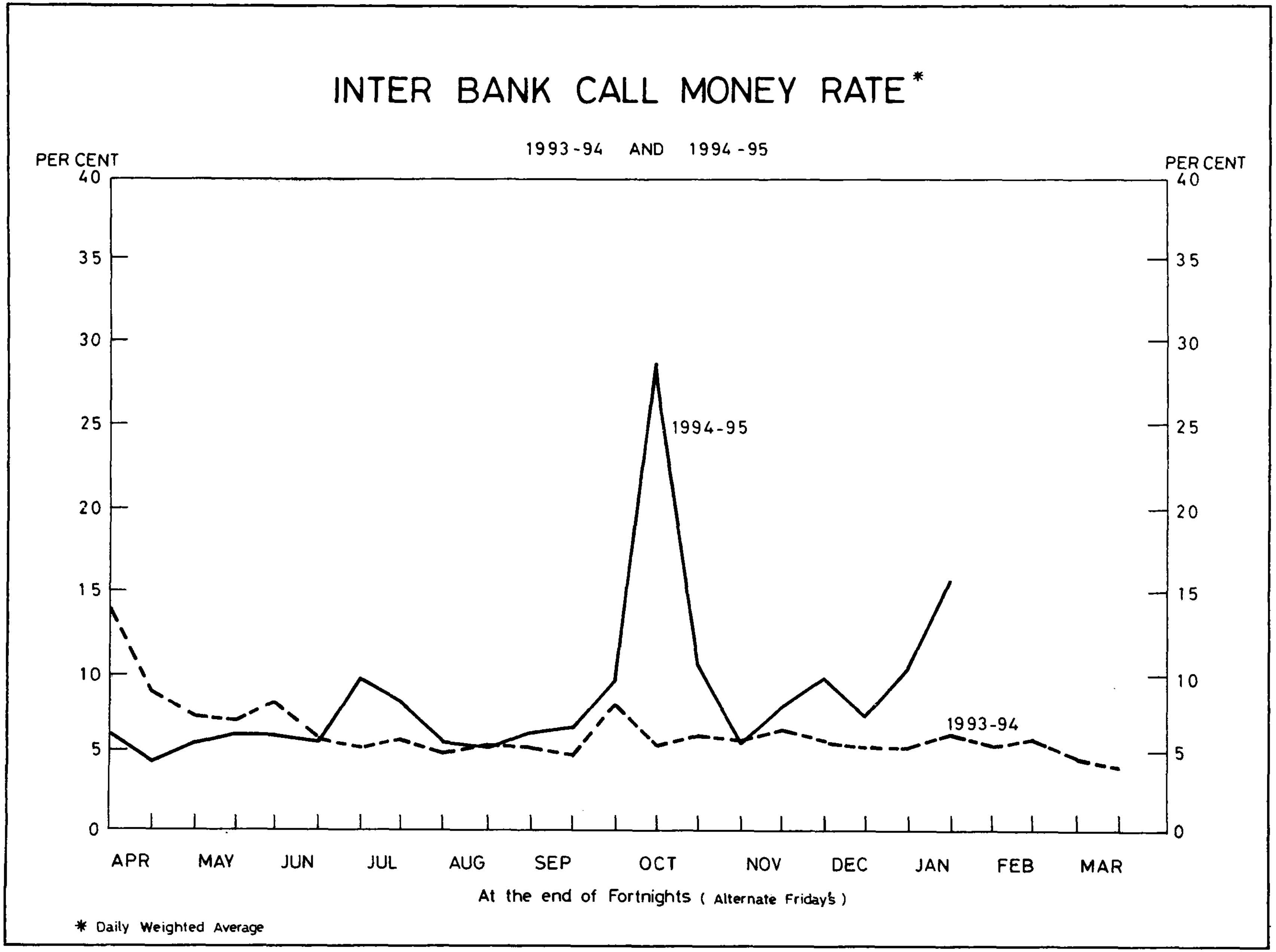
91 day Treasury Bills

84. In the weekly auctions for 91 day Treasury Bills conducted since January 1993, a gross amount of

TABLE 3.11
Implicit Yield of 91 Day T-Bills at Cut off Price
(Per cent per annum)

Month	1993-94	1994-95
1	2	3
April	11.10	7.45
	10.76	7.33
	9.50	7.25
	9.50	7.25
	9.84	7.25
May	9.75	7.21
	9.63	7.50
	9.71	7.58
	9.75	7.75
June	9.92	7.75
	9.96	8.00
	10.05	8.46
	10.09	8.75
July	10.05	9.08
	10.00	9.08
	9.84	8.91
	9.84	8.58
	9.75	8.75
August	9.46	8.25
	9.33	8.00
	9.25	8.00
	9.17	8.08
September	9.08	8.08
	8.91	8.08
	8.71	8.41
	8.37	9.08
October	8.37	9.21
	8.16	9.21
	8.08	8.50
	8.25	8.33
	8.16	
November	8.25	8.29
	8.16	8.25
	8.50	8.58
	8.62	8.75
December	8.58	9.00
	8.04	9.37
	7.96	9.75
	7.83	9.84
	7.79	10.26
January	8.08	10.51
	8.32	10.85
	8.58	10.93
	8.5	11.10
February	8.46	11.10
	8.37	11.23
	8.37	11.40
	8.25	
March	7.83	
	7.46	
	7.08	
	7.33	

Figure 3.1



INTER BANK CALL MONEY RATE*
1993-94 AND 1994-95
PER CENT
PER CENT
40
35
30
25
20
15
10
5
0
1994-95
1993-94
APR
MAY
JUN
JUL
AUG
SEP
OCT
NOV
DEC
JAN
FEB
MAR
At the end of Fortnights (Alternate Friday's)
* Daily Weighted Average

Rs.15,850 crore was raised in 1993-94 and Rs.11,650 crore (up to December 24, 1994) in 1994-95. The implicit yield at cut off prices ranged between 7.15 per cent and 11.40 per cent in 1994-95 (up to February 1995), compared to 7.08 per cent to 11.10 per cent in 1993-94 (Table 3.11). The stock of auctioned Treasury Bills outside the Reserve Bank has increased progressively to Rs.5,245 crore on March 31, 1994 from Rs. 203 crore on March 31, 1993, but declined to Rs.1,646 crore as on December 24, 1994. The outstanding stock of Treasury Bills is affected not just by the issue of new bills and by their maturity, but also by the somewhat unique Indian practice of conversion of Treasury Bills into dated securities. 91 day auction Treasury Bills of face value of Rs.4,088.31 crore were converted on October 15, 1993 into 2 year Government stock, carrying a coupon rate of 12 per cent. Again, on April 7, 1994, 91 day auctioned Treasury Bills were converted into 5 year Government stock at the same coupon rate of 12 per cent. Regular weekly auctions have been held in these bills, in which there has been very encouraging participation. The number of bids received for 91 day auction Treasury Bills varied in the range of 4 and 65 during 1993-94 and between 6 and 82 during 1994-95 (up to December 23, 1994). The amount of bids received varied in the range of Rs.20 crore to Rs.2,350 crore during 1993-94 and from Rs.28 crore to Rs.1,838 crore during 1994-95 (up to February 25, 1995). While RBI subscription was practically nil between May 1993 to January 1994, RBI subscribed in many auctions during the subsequent period up to February 25, 1995, for amounts ranging from Rs.16 crore to Rs.477 crore.

85. Demand for these bills is no longer solely governed by SLR considerations and the secondary market transactions in them are being increasingly driven by the felt need for effective management of short-term liquidity by the participants. The value of secondary market transactions as given in SGL Account was Rs. 17,987 crore during September to November, 1994.

364 Day Treasury Bills

86. In the fortnightly auctions for 364 day Treasury Bills, a gross amount of Rs.20,323 crore was raised during 1993-94 and an amount (gross) of Rs.16, 469 crore (up to December 23, 1994) during 1994-95. This has not only become an important instrument of Government borrowing, but also a leading money market instrument in the sense that its yield is most reflective of market conditions. It has been recognised as an anchor rate by the financial institutions for floating interest rate instruments. The fortnightly offerings of these bills are not pre-announced and the RBI does not subscribe to these bills, which are entirely held by the market. The yield on 364 day Treasury Bills is, therefore, sensitive to market liquidity trends. The implicit cutoff yield of 364 day Treasury Bills gradually declined from a peak of 11.36 per cent in June 1994 to 9.41 per cent in September 1994 and thereafter moved upwards again to 11.48 per cent in February 1995 (Table 3.12). 364 day Treasury Bills have also been funded twice, in 1993-94 and once in 1994-95. The outstanding balance amount has risen from Rs.8,385.97 crore (after funding) as on March 31, 1994 to Rs.9749.15 crore (after another funding) on February 17, 1995.

87. The number of bids received for 364 day Treasury Bills varied in the range of 15 to 162 in 1993-94 and 9 to 165 in 1994-95 (up to February 17, 1995). The amount of bids received range from Rs.77 crore to Rs.5,147 crore during 1993-94 and from Rs.11 crore to Rs.4,028 crore up to February 17, 1995 during 1994-95. Conversion of 364 day Treasury Bills was undertaken thrice, amounting to Rs.6,946 crore at 12.75 per cent for a three year government stock, Rs.11,226 crore at 12.5 per cent for a ten year government stock and Rs.8,078 crore at 11.75 per cent for a six year government stock on April 19, 1993, March 23, 1994 and August 25, 1994 respectively.

TABLE 3.12
Implicit Yield of 364 Day T-Bills at Cut off Prices

(Per cent per annum)

Month	1993-94	[illegible]
1	2	3
April	10.99 10.99	9.97 9.94 9.86
May	11.05 11.23	9.82 9.77
June	11.27 11.36	9.82 9.99
July	11.36 11.36	10.04 9.82
August	11.36 11.33	9.71 9.51
September	11.32 11.26 11.23	9.41 9.41 9.42
October	11.20 11.21	9.42 9.47
November	11.19 11.17	9.49 9.54
December	11.15 11.02	9.83 9.91
January	10.96 10.86	10.56 10.86
February	10.75 10.63	11.23 11.48
March	10.44 9.97 9.97	

Discount and Finance House of India

88. The success rate of the Discount and Finance House of India (DFHI) in the Treasury Bills auctions (accepted to total bids) has improved from 40 per cent in 1993-94 to 50 per cent in the current year and its Treasury Bills' turnover has increased by 45.5 per cent, compared to turnover in the corresponding period of the last financial year. The total turnover in Government dated securities has however, come down in the current financial year. The maturity structure of lending has shifted from long to short term (call and notice money markets). The shrinking trend in lendings started in 1993-94 and has continued in 1994-95 (Table 3.13).

Credit Rating

89. Reforms in the financial sector have greatly enhanced the role of credit rating agencies. Credit Rating Information Services of India Ltd. (CRISIL), which is a pioneer in credit rating not only rates debt instruments of banks, financial institutions and companies (non-banking financial and non-financial), but also makes credit assessment of companies and provides various information products like CRISILVIEW and CRISIL RATINGSCAN. Its Credit Assessment is used by State Bank of India and other banks as an input in their decision making process on advances. During the current financial year up to December 31, 1994, CRISIL rated 278 debt instruments with a total volume of Rs.13742 crore. This means a cumulative total of 1284 debt instruments with a debt volume of over Rs.61,049 crore rated since its inception. During the current financial year, CRISIL developed a methodology for rating development projects, fixed income mutual funds and chit funds.

90. The other important credit rating institution namely, Investment Information and Credit Rating Agency of India (ICRA) which rates Bonds, debentures, preference shares, CDs and CPs, rated a cumulative total of 420 instruments for Rs. 14,713 crore, as on December 31, 1994. In the current financial year, up to December 31, 1994, it rated a total number of 147 debt instruments for Rs. 2,419 crore.

TABLE 3.13
Business of Discount and Finance House of India

	1993-94 (up to Feb. 18, 1994)	1994-95 (up to Feb.17, 1995)
1	2	3
I. **Lendings**		
i) Call money market	482,199	467,108
(Daily average)	(1493)	(1446)
ii) Notice money (2-14 days)	5,121	4,519
iii) Term money (15-90 days)	1,526	19
II. **Turnover**		
i) Treasury bills	15,8926	23,123
ii) Commercial bills	26	75
iii) Certificates of deposits	187	-
iv) Commercial paper	211	-
v) Govt. dated securities	14,194	11,385

Government Securities Market

Market Borrowing

91. As noted earlier, the Central Government has shifted much of its borrowing to the market. The main instruments used for this purpose are dated securities, 364 day and 91 day Treasury Bills. There is also a small proportion of conventional market borrowing. Total market borrowing at market rates of interest, excluding 91 day Treasury Bills, during the first nine months of this financial year has been of the order of about Rs. 17,000 crore. This is 12 per cent higher than the market borrowing of about Rs. 15000, crore in the first nine months of last financial year. The structure of net borrowing has also undergone a transformation. Last year, 89 per cent of net market borrowing was in the form of medium and long term loans, while amount raised through 364 day Treasury Bills actually declined. In the current year, medium and long term loans constitute only 66 per cent of net market borrowing. The proportion of 364 day Treasury Bills has increased to almost 16 per cent (Table 3.14).

Institutional Development

92. With the setting up of the National Stock Exchange, the institutional market for trading in debt instruments has now become available. The NSE started operations in June 1994 by first activating trading in debt instruments. The volume of trading in debt instruments though currently very low has reached Rs. 244.22 crore in the week ended January 21, 1995. The type of instruments traded have included Units of Unit '64 Scheme, Government Securities, Treasury Bills, PSU bonds, Commercial Paper and Certificates of Deposit. The recording of transactions has improved with

TABLE 3.14
Net Market Borrowings of Central Government[1]
(Rs. Crore)

Instruments	1992-93	1993-94	1993-94	1994-95
	April-March		April-December	
1	2	3	4	5
a) Conventional Market borrowing	3670	3700	3972	3700
b) Other medium and long term borrowing	nil	23842	10992	13597
c) 182/364 day treasury bills	4791	(-)391	4070	3189
TOTAL	8641	27151	19034	20486

[1]*Actuals as per RBI records.*

computerisation of Subsidiary General Ledger (SGL) accounts at RBI's six public debt offices. It has also started releasing on a daily basis, particulars of transactions in Government securities and Treasury Bills put through the SGL accounts. This will provide useful market information, dissemination of which is expected to foster improvement in market efficiency by providing reference rates/prices to all market participants. The Securities Trading Corporation of India was set up in 1993-94 to develop the secondary market in Government securities. It received the certificate of incorporation in May, 1994. It has a fully issued paid up capital of Rs.100 crore and started operations in June, 1994.

Primary Dealers

93. To strengthen the market for Government securities, RBI is launching a system of primary dealers. These dealers are to function as underwriters for the auction of Government securities to final investors and thereby broaden and develop the Government securities market. They are expected to act as market makers, and RBI will provide credit facilities to them to impart liquidity to their operations. They will also have certain obligations in terms of their presence in auctions, and offer of two way quotes for these securities, besides being subject to prudential norms. The system of primary dealers is necessary for deepening and expanding the market for Government securities and for strengthening the effectiveness of monetary operations.

Partly Paid Government Stock

94. The Government recently introduced a new dated security called "partly paid Government stock", with standard auction procedures. It has an innovative feature, in that payment can be made in four equal instalments. Rs.2000 crore of securities of eight year maturity were auctioned and then allotted on partly paid basis to successful bidders on November 15, 1994. One-fourth of the face value plus premium, if any, was payable on the allotment date and the balance would be payable in three equal instalments on December 15,1994, January 16, 1995 and February 15, 1995.

Inter-Bank Security Transactions

95. Reserve Bank of India reviewed inter-bank transactions in securities against Bank Receipts (BRs) after the report of the Joint Parliamentary Committee (JPC) and has introduced a number of restrictions on the use of BRs in them. The validity period of BRs has been reduced from 30 days (as stipulated earlier in June 1992) to 15 days. It has further advised banks that BRs should be redeemed only by actual delivery of scrips and not by cancellation of transactions/set-off against another transaction within the stipulated period. Otherwise, they should be deemed as dishonoured. In case of default, the bank issuing BR has to refer the case to RBI, explaining the reasons for non-delivery of scrips and the proposed manner of settlement of the transaction. Banks have been warned that any violation of the instruction relating to BRs will invite penal action. This includes raising of reserve requirements, withdrawal of refinance from RBI and denial of access to the money market, or such other penalty as the RBI may deem fit.

96. On December 21, 1992, banks had been advised, *inter alia,* to ensure that transactions in securities entered into through individual brokers during a year should not exceed five per cent of total transactions (both purchases and sales) entered into by a bank during that year. If for any reason it had become necessary to exceed this limit for any broker, the specific reason thereof should be recorded in writing by the authority empowered and the Board should be informed of this post-facto.

97. Following the Joint Parliamentary Committee report, the need for continuance of the services of brokers was examined by RBI. It has been decided that securities transactions should henceforth be undertaken directly between banks and no bank should engage the services of any broker in these transactions. Banks may however, undertake securities transactions among themselves or with non-bank clients through members of the National Stock Exchange (NSE), wherein transactions are transparent. Transactions by banks in securities with non bank clients, can be done either through the NSE or directly without the use of brokers. Any violation or circumvention of these instructions will also invite penal action, similar to that stipulated for violation of instructions regarding the use of BRs.

Developments in the Capital Market

98. Capital markets play a key role in the economy as the source of investible funds for the corporate sector. The Primary market, which was subdued in the first quarter of 1994-95, regained its buoyancy in the second quarter. The secondary market also exhibited considerable activity, with foreign institutional investors and domestic mutual funds, strengthening the process of institutionalisation of the market. The process of capital market reform continued and coupled with an effective regulatory framework, aimed at improving market efficiency, making stock market transactions more transparent, curbing unfair trade practices, and bringing the capital market upto international standards. The National Stock Exchange of India, which started functioning this year with its screen based and scripless trading system, can be regarded as a milestone in the development of the Indian capital market. Besides, Bombay and other stock exchanges speeded

up the pace of automation in their trading systems. These steps taken together will help facilitate the emergence of a strong and vibrant domestic capital market.

Strengthening of SEBI

99. The Government has, on 25 January, 1995, promulgated an Ordinance to amend the Securities and Exchange Board of India Act, 1992 so as to arm the Securities and Exchange Board of India (SEBI) with additional powers for ensuring the orderly development of the capital market and to enhance its ability to protect the interests of the investors.

100. To enable SEBI to respond speedily to market conditions and to reinforce its autonomy, SEBI has also been empowered to file complaints in courts without the prior approval of the Central Government, and to notify its Regulations without the prior approval of the Central Government.

101. The amendments provide SEBI with regulatory powers over corporates in the issuance of capital, the transfer of securities and other related matters. It has also been empowered to impose monetary penalties on capital market intermediaries and other participants for a listed range of violations. Hitherto, the SEBI Act provided for the suspension and cancellation of registration and for the prosecution of intermediaries. As suspension and cancellation lead to the stoppage of business, often adversely affecting others who have had business with the affected intermediary, monetary penalties constitute an alternative mechanism for dealing with capital market violations. It is proposed to create an adjudicating mechanism within SEBI for levying penalties and it is also proposed to constitute a separate Tribunal to deal with cases of appeal against orders of the adjudicating authority. The appellate authority against orders of the Tribunal will be High Courts.

102. The amendments also provide for deletion of the existing provisions relating to disqualification of a member of the Board of SEBI on his being appointed as Director of a company. This amendment will enable the Government to appoint Directors with expertise and experience of the capital market.

103. SEBI has also been empowered to summon the attendance of, and call for documents from, all categories of market intermediaries, including persons in the securities market, in order to enable SEBI to investigate irregularities. SEBI will now also have powers to issue directions to all intermediaries and persons associated with the securities market with a view to protecting investors or securing the orderly development of the securities market.

Options trading

104. An Ordinance was promulgated on January 25, 1995 for amending the Securities Contract (Regulation) (SCR) Act, 1956 which deletes Section 20 of the SCR Act. This includes the reference to 'prohibition of option' and consequently paves the way for trading in options, which will enhance liquidity in the market. The amendments also reduce the time limit from six months to two months for Stock Exchanges to amend their bye-laws, if so directed by SEBI, and provide for a Stock Exchange to establish additional trading floors with the prior approval of SEBI. It is also specifically provided that any corporate seeking listing on a Stock Exchange would have to comply with the provisions of the listing agreements of the Stock Exchange, with violations of the listing agreements being punishable under the Act.

Primary Market Reforms

105. The SEBI has introduced various guidelines and regulatory measures for capital issues for healthy and efficient functioning of the market. Firms are required to make material disclosure about the risk factors in their offer prospectus and get debt instruments rated. Efforts have been made to reduce the cost of raising capital. Merchant bankers now have a greater degree of accountability in the offer document and issue process. Steps have been taken to ensure that continuous disclosures are made by firms which will enable shareholders to make comparisons between promises and performance. The minimum application size has been increased, and the number of mandatory collection centres reduced. The proportion of each issue allowed for firm allotment to institutions such as mutual funds, has been raised; besides, underwriting which was hitherto mandatory, has been made optional subject to several conditions.

Secondary Market Reforms

106. Since 1992, decade old trading systems in Indian Stock Exchanges have been under constant review. The main deficiencies have been identified in two broad areas: (i) the clearing and settlement system in stock exchanges, whereby delivery of shares by the seller and payment by the purchaser is made, and (ii) procedures for transfer of shares in the name of the purchaser by the company. Current procedures result in excessive paper work, delays in settling transactions, and non-transparency in costs and prices at which customer's orders are executed. Measures have been initiated by the Government and SEBI for the setting up of depositories. By immobilisation of securities, this will help eliminate paper work and add impetus to the growth of markets (See Box 3.7 for summary of the reforms measures).

Badla System

107. The prevalence of "badla" in the stock market

had often been identified as a factor encouraging speculative activity. As part of the process of establishing transparent rules for trading, the "badla" system was discontinued by SEBI in December 1993. The SEBI directed the Stock Exchanges at Bombay, Calcutta, Delhi and Ahmedabad on December 13, 1993 to enforce that all transactions in securities are concluded by delivery and payment and not to allow any carry forward of transactions. Besides, they were also asked to direct members to liquidate their carry forward positions in a phased manner. This was done in order to ensure the safety of the market in the context of the building up of excessive speculative positions.

108. On March 11, 1994, SEBI decided to permit carry forward facility in specified shares in these exchanges under a framework of transparency and effective regulation. The new trading system proposed by SEBI envisaged that all stock brokers would be required to pay and settle their net positions at the end of a settlement period. The Stock Exchanges were however supposed to introduce the new system of trading with carry-forward facility only after they satisfied SEBI that they were in a position to implement the system as proposed.

109. As the major Stock Exchanges could not set up the necessary mechanism for implementing the new trading system in specified shares as formulated by SEBI, trading in specified shares has been taking place without carry-forward of transactions. Accordingly, transactions in securities in the major Stock Exchanges moved to a system of settlement characterised by delivery and payments. Such a shift in the pattern of trading has strengthened the cash market in securities. The settlement periods have been shortened and settlement on delivery basis attempted. The renewal (postponement of settlement or delivery of scrips) of transactions in 'B' group securities have been prohibited. The various stock exchanges have however indicated their inability to reduce the accounting period from 14 to 7 days. Among the reasons given are procedural requirements, and the delay in receipt of shares/payment from outstation clients.

110. SEBI's decision to ban the traditional system of "badla" has, however, been criticised in some quarters on the ground that it has adversely affected liquidity and the volume of trading in the market. Both SEBI and the Government are aware of this argument and hold that trading in stock exchanges should largely be guided by principles of safety of the market, transparency and investor protection.

Depositories' Legislation

111. The settlement of transactions in securities in stock exchanges of the country involves physical delivery of scrips along with duly filled in transfer deeds. The substantial growth in the volume of business in stock exchanges during recent years has rendered the traditional system of settlement of transactions obsolete and made it necessary to replace it by a new and modern Depositories system. The new system will eliminate paper work, facilitate electronic book-entry of the transfer of securities, permit automatic and transparent screen based trading in securities permit shorten settlement periods and improve liquidity in investment in securities. Work on bringing forward the necessary legislation for the establishment of Depositories is currently at an advanced stage.

National Stock Exchange of India

112. Many secondary market problems can only be completely solved by introducing scripless trading and de-materialisation of scrips in depositories. A beginning has been made with the establishment of National Stock Exchange of India (NSEI). Though formally inaugurated in July 1994, NSEI commenced operations in the Wholesale Debt Market (WDM) in June 1994, and trading in equities has been started in the Capital Market (CM) segment in November 1994. A large number of members are successfully trading from their respective offices through NSE's Very Small Aperture Terminal (VSAT) based satellite network. The exchange has opened membership to 13 cities, including Bombay, and operations from other cities are expected to commence shortly using the satellite network.

113. As a national exchange, it has set fairly stringent criteria for membership in terms of net worth, education and experience, to ensure that trading members are well capitalised and can provide other professional services to investors. The main participants in the Wholesale Debt Market (WDM) segment (Government Securities, Treasury Bills, PSU bonds, CDs, CPs and corporate debentures) are banks, financial institutions and large corporates. RBI has recently directed banks to use only the NSE for all transactions in debt securities done earlier through brokers to ensure transparency and facilitate regulation (in place of the unregulated telephone market). This has raised the volumes on NSE's debt trade substantially.

114. In the capital market segment, the number of securities admitted to trading expanded from 200 to start with to 525 by December 1994. Trading volumes have been gradually increasing since then. An NSE - 100 Interim Index was launched in November 1994, covering 100 equities selected on the basis of their market capitalisation and trade volumes. In the absence of a depository, an accounting period and settlement cycle - running from Wednesday to Tuesday is operated by NSE. In order to streamline settlement, intra and

inter-custodian settlement are maximised. Strict penalties imposed for delayed settlement have resulted in timely settlement and delivery of cash or securities with a low proportion of bad/short delivery. The Over the Counter Exchange of India (OTCEI) (1992) has also introduced an electronic trading system for stocks of relatively smaller firms and it had reached a monthly turnover of Rs.45 crore in December, 1994. /

Stock Exchange

115. The functioning of the NSE needs to be viewed as an important step in providing efficient and transparent services to investing public, and not as an attempt to weaken the Bombay Stock Exchange or other Exchanges in the country. In fact, the operations of NSE is expected to act as a spur for the modernisation of the Bombay Stock Exchange Online Trading (BOLT) system for introducing screen based trading. The Bombay Stock Exchange has also taken the initiative for the establishment of a National Stock Market System (NSMS) for providing improved services to investors all over the country. Eventually, the NSE and other Stock Exchanges should compete in minimizing transaction costs and in providing fair services to investors.

116. The shift from individual to institutional investors added another dimension to the secondary market, while creating some problems. Given the volume of trade and antiquated systems, custodians of the FIIs were unable to cope with post contract paper work in the Stock Exchanges. The Bombay Stock Exchange, therefore , proposed a new system of high denomination share certificates and a modification of the software used in the settlement process to reduce the interface between institutions and the retail market.

117. SEBI continuously monitors the market, including the BSE. During 1993-94, the interests of participants were safeguarded through a series of measures. These included, (a) imposition of daily margins on both purchases and sales, (b) limit on jobbing in specified shares, (c) prohibition of speculative deals with transactions being restricted to delivery basis, (d) regulation of purchase and sales, even on delivery basis, (e) contraction of outstanding business carried forward from one settlement to another, (f) ban on floor (over the counter) trades outside trading hours, and (g) application of circuit breakers.

Primary market developments

118. Primary market activity in terms of the number of issues, as well as total capital raised through approved launches, has shown improvement in the past two years. The total number of issues launched at 1143 in 1993-94 was 10.5 per cent higher than during 1992-93. The total capital raised in 1993-94 was 31.24 per cent higher than in 1992-93 (as per SEBI approved launches). The increase was 48.7 per cent for rights issue and 21 per cent for public issues. Total launches aggregated at Rs. 21982.4 crore. The average size of public issues was around Rs. 18 crore (Rs. 24 crore in 1993-94) and for rights issues the average size was Rs. 9 crore (Rs. 17 crore in 1993-94).

119. During April-December 1994, a total of 1032 public and rights issues were launched, raising an amount of Rs. 11381.45 crore. The amount raised through 813 public issues was Rs. 7241.4 crore and that raised through 219 rights issues was Rs. 4140.05 crore. During April -December 1993, Rs. 9795.98 crore was raised through public issues and Rs. 6479.75 crore through rights issues (Table 3.15).

Secondary Market Developments

120. The Bombay Stock Exchange Sensitive Index of equity prices (1978-79=100) had started rising from November, 1993 and it stood at 3346 on December 24, 1993 compared to 2622 at the beginning of November, 1993. The rising trend in the index continued during January and February 1994 and the index reached the level of 4286 on February 28,1994. Subsequently, the index generally declined during March to May 1994. The index started rising from June, 1994 and reached a peak of 4630 during September 1994. Thereafter, the index generally showed a declining trend reaching a low of 3411 on January 24, 1995. The declining trend seems to have been reversed on January 27,1995 and

TABLE 3.15
Issues Launched

(Rs.crore)

Type	1992-93 No.	1992-93 Amount	1993-94 No.	1993-94 Amount	1993 Apr-Dec No.	1993 Apr-Dec Amount	1994 Apr-Dec No.	1994 Apr-Dec Amount
1	2	3	4	5	6	7	8	9
Rights	488	6000.8	370	8922.6	287	6479.7	219	4140.0
Public	546	10748.3	773	13059.8	466	9795.9	813	7241.4
Total	**1034**	**16749.1**	**1143**	**21982.4**	**753**	**16275.6**	**1032**	**11381.4**

Box 3.7
Capital Market Reforms : 1992-93 to 1994-95

- Capital issues (Control) Act, 1947 repealed and the office of Controller of Capital issues abolished; control over price and premium of shares removed. Companies are now free to approach capital market after clearance by SEBI.
- Securities and Exchange Board of India armed with necessary authority and powers for regulation and reform of capital market.
- Through a notification issued under the Securities Contract (Regulation) Act, 1956 the power to regulate stock exchanges was delegated to SEBI. This includes recognition, rules, articles, voting rights, delivery contracts, stock exchange listing and nomination of public representatives.
- Merchant banking brought under SEBI regulatory framework and a code of conduct issued.
- SEBI notified regulations for primary and other secondary market intermediaries, bringing them within the regulatory framework.
- The 'Banker to the issue', brought under purview of SEBI for investor protection.
- The due diligence certificate by lead managers regarding disclosures made in the offer document, has been made a part of the offer document itself for better accountability and transparency on the part of the lead managers.
- New reforms by SEBI in the primary market included improved disclosure standards, introduction of prudential norms and simplifications of issue procedures.
- Companies required to disclose all material facts and specific risk factors associated with their projects while making public issues.
- The Stock exchanges required to ensure that the companies concerned have a valid acknowledgment card issued by SEBI. SEBI vets the offer document, to ensure that all disclosures have been made by the company, in the offer document, at the time the company applies for listing of its securities to the stock exchange.
- Stock exchanges advised to amend the listing agreement to ensure that a listed company furnishes annual statement to the stock exchanges showing variations between financial projections and projected utilisation of funds made in the offer documents and actuals. This will enable shareholders make comparisons between performance and promises.
- To discourage the use of stock-invest by institutional investors, the facility has been restricted to mutual funds and individual investors.
- SEBI introduced a code of advertisement for public issues for ensuring fair and truthful disclosures.
- To reduce cost of issue, underwriting by issues made optional, subject to the condition that if an issue was not underwritten and was not able to collect 90 per cent of the amount offered to public, the entire amount collected would be refunded to the investors.
- Redressal of complaints of investors is to be encouraged sharing it with recognised investor associations. This will facilitate filing of class action suits in consumer courts against erring companies.
- The extant guidelines for the bonus shares have been relaxed.
- SEBI introduced regulations governing substantial acquisition of shares and takeovers and lays down the conditions under which disclosures and mandatory public offers are to be made to the shareholders.
- SEBI reconstituted the governing boards of the stock exchange, introduced capital adequacy norms for brokers and made rules for making the client/broker relationship more transparent, in particular, segregating client and broker accounts.
- "Renewal" of transactions in 'B' group securities prohibited, so that transactions could be settled within 7-days.
- Private mutual funds permitted and a few such funds have already been set up. All mutual funds allowed to apply for firm allotment in public issues.
- UTI brought under the regulatory jurisdiction of SEBI.
- Fresh guidelines for advertising by mutual funds issued by SEBI and the requirement of pre-vetting of advertisements removed by SEBI.
- To improve the scope of investments by mutual funds, mutual funds were permitted to underwrite public issues and the guidelines for investment in money market instruments were relaxed.
- Over the Counter Exchange of India (OTCEI) and the National Stock Exchange of India with nationwide stock trading and electronic display, clearing and settlement facilities commenced operations.
- The practice of making preferential allotment of shares at prices unrelated to the prevailing market prices was stopped and fresh guidelines were issued by SEBI.
- Foreign Institutional Investors (FII) allowed access to Indian capital markets on registration with SEBI. 286 FIIs have been registered by the end of January 1995.
- The procedures for lodgement of securities for transfer was considerably eased for domestic and FII's through the introduction of 'jumbo' transfer deeds and consolidated payment of stamp duty.
- Indian Companies permitted to access international capital markets through Euro equity shares.
- Investment norms for NRI's liberalised, so that NRI's and Overseas corporate bodies can buy shares and debentures without prior permission of RBI.

TABLE 3.16
Trends in Selected Stock Market Indicators

Indicators	1993 April	1993 December	1994[1] April	1994[1] December
1	2	3	4	5
a) Index				
i) SENSEX	2205.37	3301.85	3824.75	3949.78
ii) National Index	993.63	1589.25	1855.81	1876.13
b) Price /Earning Ratio (P/E)				
i) SENSEX [2]	27.19	40.02	46.43	34.50
ii) National Index[3]	24.98	40.28	46.45	38.58
c) Average Daily Turnover (Rs. crore)	173	438	196	423[4]
d) Market Capitalisation (Rs. crore)	175083	305000	364868	400000

[1] *Provisional as at the end of the month*
[2] *Monthly average relating to 30 scrips of BSE Sensex*
[3] *Monthly average relating to 100 scrips of BSE National Index*
[4] *Approximate average of both (A+B) group of shares.*

the index closed at 3618 on January 31,1995 (Fig. 3.2 and Table 3.16).

121. The movement of the share prices were closely monitored by SEBI and the government. Various factors such as corporate financial results, expectations of the investors, changes in economic policies, other reforms in trading introduced by SEBI and investments by the Foreign Institutional Investors (FIIs) and Mutual Funds influenced the movement of the share prices and their index. FII behaviour is also contingent on the behaviour of other emerging markets and conditions in world capital and currency markets, as well as domestic portfolio shifts in developed countries (particularly the impact of rising interest rates in USA leading to shift of funds from equity to bonds market).

122. The turnover ratio (defined as the ratio of total turnover to the market capitalisation)is not only very low compared to emerging economies but its inter-temporal movement has also not been encouraging. The ratio fell from a high of 57.2 per cent during 1989-90 to 47.8 per cent during 1990-91 and came down steeply to 23.4 per cent in 1991-92 and 24.3 per cent in 1992-93. During 1994-95, there has been some reversal, and the trend is more encouraging, indicating the positive impact of capital market reforms.

International comparison

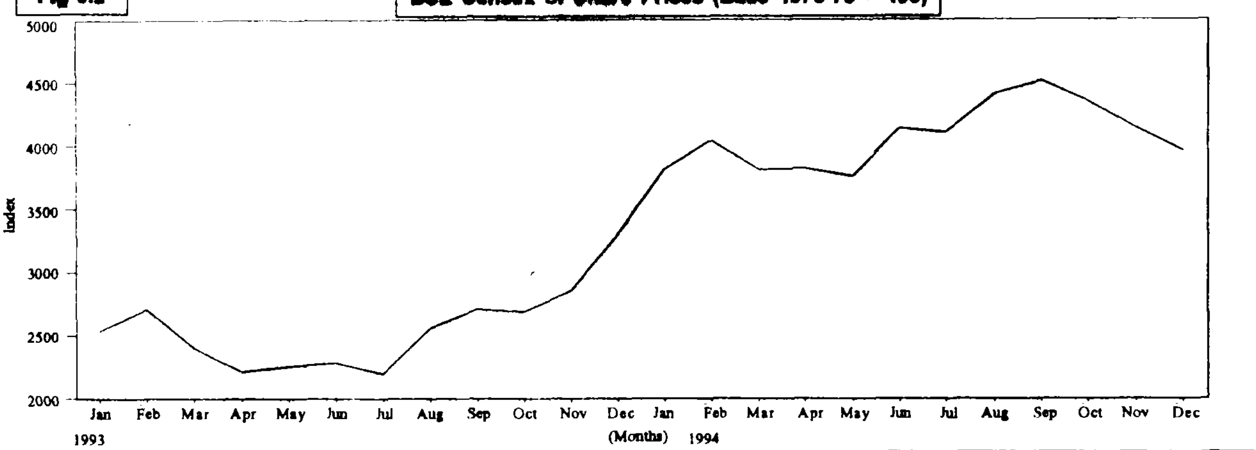
125. The number of companies listed on the Bombay Stock Exchange at the end of December 1993 was 358. This was more than the aggregate total of companies listed in nine emerging markets (Malaysia, S Africa, Mexico, Taiwan, Korea, Thailand, Brazil, Chile, and Argentina). The number of listed companies was also larger than in the developed country markets of Japan, UK, Germany, France, Hong Kong, Canada, Australia and Switzerland. The turnover ratio of the Bombay Stock market (23 per cent) was also greater than that of Chile (6.3 per cent) and South Africa (6 per cent). It was however less than that of seven other emerging markets such as Thailand (66.6 per cent), Malaysia (69.7 per cent), Taiwan (177.5 per cent) and Korea (151.9 per cent).

Mutual funds

124. One of the ingredients of capital market reforms in 1994-95 has been the shift in focus from the individual to the institutional investor. Institutional investors such as mutual funds constitute a very important component of the capital market in developed countries. These have been brought under a common regulatory framework and this has helped in raising standards of disclosure for better protection of the interests of customers.

125. The total number of mutual funds registered, including UTI, is 21. The aggregate funds under all mutual funds is around Rs. 64820 crore, through 155 schemes, with UTI accounting for 81 per cent of these funds. The non-UTI mutual funds have so far launched 28 schemes, raising over Rs. 3109 crore. Private

Fig 3.2 **BSE Sensex of Share Prices (Base 1978-79 = 100)**



6. Money markets generally ruled easy in the last quarter of 1993-94 and the first six months of 1994-95. This applied to virtually all instruments, namely, inter bank call money, Certificates of deposits and Treasury Bills. Cut off rates on auctioned 364 day Treasury Bills showed a clear down trend till September 1994. Though interest rates on 91-day Treasury Bills bottomed out at the turn of 1993-94, they remained below levels of a year ago till the middle of September 1994. There were, however, temporary increases in call money rates in September and December 1994, raising rates above 40 per cent. This has been followed by an upturn in 91-day treasury bill rates.

7. The capital market underwent another phase of reforms. The National Stock Exchange of India (NSEI) commenced operations in June 1994 with its wholesale debt segment, and subsequently has begun to conduct operations in equities as well. Guidelines were issued for Euro Issues . Share prices bottomed out in July 1993 and were on a rising path till February 1994. After some ups and downs, the Bombay Stock Exchange Sensitive Index (SENSEX) peaked in September 1994. Among other changes, signs of industrial recovery, companies' half yearly results, market reforms and inflow of funds from Foreign Institutional Investors (FII) have influenced the share prices. The funds mobilised through Euro Issues and Euro Convertible Bonds (ECBs) increased sharply in the first half of 1994-95. This was, however, partly offset by a decline in the amount raised through domestic issues, compared to the first half of 1993-94. Clearances by SEBI suggest that the shortfall will be made up in the second half of 1994-95.

Monetary Trends And Developments

Monetary Trends in 1993-94

8. Weak industrial growth in the first quarter of 1993-94 and slowing inflation had led, by the third quarter of 1993-94, to readjustment of monetary concerns from inflation to promoting production. The monetary growth projection set by RBI for 1993-94 was consequently revised upwards. These and other measures were followed by a revival of industrial production in 1993-94. Inflation also bottomed out and began to rise in the second and third quarters of 1993-94, partly because of special supply side factors. The acceleration in inflation and a significant increase in the rate of growth of money supply in the second half of 1993-94 had rekindled concern about inflation by the end of 1993-94.

Money Growth

9. Money supply (M3) growth accelerated to 18.2 per cent in 1993-94 and exceeded the 14 per cent projection of RBI. There was an even more rapid acceleration in the growth of narrow money (M1) to 21.1 per cent in 1993-94. This acceleration reflected a sharp change in the growth of demand deposits. Growth of demand deposits accelerated to over 20 per cent in 1993-94. To some extent, the recovery in growth of demand deposits and M1 was related to the incipient recovery in industrial production. An acceleration in the growth of currency to 20.4 per cent in 1993-94 also contributed to M1 growth (Table 3.1). This may have reflected the high levels of food procurement and associated expansion in food credit (61.8 per cent) and the generally positive state of the agricultural economy (Table 3.9).

Money Supply

10. As in the earlier years, monetary growth was largely driven by the expansion in Reserve money. Reserve money growth more than doubled to 25.1 per cent in 1993-94. There was, however, a remarkable transformation in the factors driving reserve money growth. Net RBI Credit to the Government (NRCG), which had grown by about 12 per cent by the end of the third quarter of 1993-94, decelerated sharply. The result was a growth rate of only 0.9 per cent in 1993-94. There was also a declining trend in the growth rate of Net RBI credit to Government from 20.6 per cent in 1990-91 to 5.8 per cent in 1991-92 and 4.7 per cent in 1992-93. What was noteworthy in 1993-94 was that a sharp decline in NRCG took place, despite a rise in the fiscal deficit.

11. Reserve money growth was fuelled in 1993-94 by the accumulation of Net Foreign Exchange Assets (NFEA) with RBI. There was an almost tenfold increase in the rate of growth of Net Foreign Exchange Assets of RBI to 127 per cent in 1993-94. As a result, the share of growth of Net Foreign Exchange Assets of RBI in reserve money growth increased to 97 per cent in 1993-94, while the share of increase in NRCG in reserve money growth declined to 3 per cent in 1993-94 (Table 3.2).

12. Though the build up of foreign exchange reserves was primarily responsible for this transformation, the decline in direct monetisation linked to budget deficits was a harbinger of the future. The budget deficit was 26.4 per cent lower in 1993-94.

Money Multiplier

13. In 1993-94 money supply (M3) grew by only 18.2 per cent, despite a growth of over 25 per cent in reserve money, indicating a sharp fall in the money multiplier in that year. The cautious approach to lending followed the introduction of new prudential and provisioning norms. This led to a preference for zero risk government securities offering market related yields. Low credit demand from the corporate sector

Joint Parliamentary Committee Report

130. The report of the Joint Parliamentary Committee (JPC) to enquire into irregularities in securities and banking transactions was examined and an Action Taken Report on the Observations/conclusions/Recommendations was submitted in the Parliament on 26th July, 1994. Subsequently, in the light of comments and suggestions received from various Opposition Parties in Parliament, revised paragraphs of the Action Taken Report in respect of 147 of the 273 items covered in the ATR were also submitted in the Parliament on 28th December 1994.

Insurance Sector

131. In Economic Survey 1993-94, a mention was made of the report of the Committee on reforms in the Insurance Sector set up in April 1993, to study the working of Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC) and its four subsidiaries and make recommendations for reforms in the insurance sector. The recommendations of the Committee, including the need for privatisation of the insurance industry (both LIC and GIC) were discussed in a series of consultative meetings taken by the Finance Secretary with the Chief Executives of the Insurance industry, major unions of LIC/GIC and subsidiaries and the consumers/academicians/ press. This facilitated the evolution of a broad consensus on the parameters and direction of reform. The matter has also been discussed by the Finance Minister in the Consultative Committee of the Ministry of Finance, at length, in an exclusive meeting on the subject.

132. Based on the above discussions, the views of the Government on the recommendations of the Committee have been crystallised and a decision on major policy changes, including allowing entry of private insurance companies into the industry, is at an advanced stage of formulation.

Outlook

133. Given the decisions taken during the year, the link between the fiscal deficit and monetary growth through the budget deficit will be completely broken in the next few years. This will make monetary policy independent of the Government, and thus devolve much greater responsibility on the RBI. The interaction between the Finance Ministry and the central bank will therefore focus on the target growth of money supply, with a view to balancing the twin objectives of inflation control and output growth, as is the practice in developed countries.

134. Another dimension of the changing relationship between the Finance Ministry and the central bank is the Market Borrowing Programme. In earlier years, the SLR was an instrument of forced borrowing by the Centre from the banks. In this context, the market borrowing programme was the credit counterpart of the budget deficit. With a virtually complete switchover by the Central Government to market rates of interest, the Central Government becomes just like any other borrower in the financial market (though a riskless one). The Public Debt Office (PDO) of the RBI is merely the debt/financial manager of the Central Government, a function performed by the Treasury Departments of finance ministries in many countries. In this changed context, only state government debt, which is still issued at below market rates, has a substantive relationship to the SLR. The SLR will become completely redundant when State loans are also raised at market rates. These changes require a reappraisal and reform of the whole system of the Market Borrowing Programme and Central Government debt issue and management.

135. The build-up of foreign exchange reserves with RBI has slackened somewhat in November-December 1994. If this slackening continues, RBI's job of controlling the growth in reserves money will become much easier. If reserve growth reverts to earlier levels, however, open market operations to sterilise the inflow will come into their own and become a prominent feature of monetary policy action.