3

MONEY AND FINANCE

Financial sector reforms constitute an important component of the programme of policy reform. In the current financial year monetary policy and financial sector reforms continued with reductions in both cash reserve ratio (CRR) and statutory liquidity ratio (SLR), freeing scheduled commercial banks to lend more of their resources at commercial rates. SLR was brought down by three percentage points for total and five percentage points for incremental net demand and time liabilities of the scheduled commercial banks. CRR was also reduced by one percentage point. The number of classified lending rate slabs was reduced to three. Limits on consortium lending were raised and several other restrictions on bank advances have been liberalised to enhance the flexibility of bank operations. The minimum lending rate was cut by three percentage points to bring down the cost of bank credit. Government released Rs.5700 crore to the public sector banks to help them attain capital adequacy norms after the signing of performance agreements between them and Reserve Bank of India. They are also being enabled by the Government to go to the capital market to raise debt and equity, and State Bank of India (SBI) has already raised additional capital through a public issue. Legislation has also been passed to facilitate the recovery of loan arrears of banks and financial institutions through the setting up of special recovery tribunals. Over time, these measures along with the entry of new private banks, will increase competitive pressure for improving profitability and quality of service to depositers, borrowers and other clients. A separate Department of Supervision (DOS) has since been set up in RBI for strengthening the supervisory arrangement for banks to ensure adherence to prudential norms and to detect irregularities.

2 The Securities and Exchange Board of India (SEBI) has initiated a number of measures to ensure full disclosure of information to and fair treatment of investors. Prudential and capital adequacy norms for brokers and code of advertisement for public issue were introduced by the SEBI. Merchant banking has been brought under its regulatory framework and a number of private mutual funds have started operations as per its guidelines. More than a hundred Foreign Institutional Investors (FII) were registered and they have also been allowed to engage foreign brokers to operate on their behalf in the Indian capital market. Over-the-Counter Exchange of India (OTCEI) commenced operations with a number of listed shares. In the money market, inter bank call money rates remained much lower in this financial year and commercial paper fared quite well. The auctioned 91 day and 364 day treasury bills began to develop a fairly diversified clientele and their yields began to reflect underlying demand and supply conditions.

3 The reserve money and money supply growth which remained more or less under control in the first half of the year has started accelerating because of a large accretion to net foreign assets of the banking sector and faster expansion in net bank credit to Government. Total bank credit to commercial sector has registered a modest growth even though food credit has increased substantially.

Monetary Trends and Developments

4 Despite the success in controlling inflation through monetary policy and reasonable fiscal control in 1992-93, inflation remained the main focus of monetary targeting. The evidence of set back to industrial growth which was present from December 1992 and continued in 1993 had eventually to be given more weight. The sharp increase in bank credit to Government has also influenced the actual evolution of the monetary scenario and is a cause for great concern.

Monetary Trends in 1992-93

5 Broad Money (M3) growth declined from 19.4 per cent in 1991-92 to 14.2 per cent in 1992-93. The decline in

Narrow Money (M1) growth was even sharper from 23.6 per cent in 1991-92 to 7.3 per cent in 1992-93. Underlying this differential growth was a steep increase in the share of time deposits from 68.5 per cent of aggregate deposits in 1991-92 to 98.9 per cent in 1992-93. The policy of keeping deposit interest rates relatively high, and providing a real return to savers proved very successful in inducing this shift from demand to time deposits.

6 The second factor responsible for the decline in money supply growth was the slowing down of the growth of reserve money. Reserve Money growth declined from 13.4 per cent in 1991-92 to 11.5 per cent in 1992-93. A major factor responsible for this development was a deceleration in the growth of net RBI credit to Government. The growth rate of net RBI Credit to Government was brought down from 5.8 per cent in 1991-92 to 4.7 per cent in 1992-93. The decline in the build up of net foreign exchange assets of RBI also played a role in moderating reserve money growth in 1992-93.

7 The high interest rates on advances, which allowed higher rates on the bank deposits, and a reduction in reserve money growth were successful in controlling inflation. The inflation rate as measured by the point to point growth in the wholesale price index declined from 13.6 per cent in March 1992 to 7 per cent in March 1993. There was also an improvement in the growth rate of GDP from manufacturing from (-) 3.2 per cent in 1991-92 to 2 per cent in 1992-93. Real lending rates and M1 growth also have a bearing on industrial production. The slow growth of M1 at 7.3 per cent which was the lowest growth rate in over a decade, therefore, required close monitoring to ensure that credit expansion was adequate to sustain recovery.

Monetary Policy in 1993-94

Objectives

8 Inflation control remained the primary objective of monetary policy in 1993-94. Money is, however, both a channel for the transmission of inflationary impulses into the economy and a lubricant for the growth of production. With the decline in inflation, higher weight had to be given to the second objective viz; growth of production. With the objective of sustaining the improvement on the balance of payment front, exports continued to receive special attention.

Instruments and Targets

9 Monetary policy and monetary expansion in the past have been largely determined by the government's borrowing requirement and as such the distinction between objectives and instruments has been blurred. Historically, SLR and CRR have been the main instruments of monetary policy. Rising fiscal deficits over the eighties made the monetised deficit a major factor driving money supply growth. The aim should be to gradually delink budget and fiscal deficits from net RBI credit to Government so that the latter becomes an independent instrument for monetary policy.

10 In the light of these objectives and constraints, monetary expansion in 1993-94 was originally targeted by RBI at about 12 per cent . But it was subsequently revised to 14 per cent in October 1993.

Reform of Monetary Mechanisms

11 Monetary reforms continued the process of modernising the instruments of monetary control to make them more suitable for the conduct of monetary policy in a market economy. Though administered interest rates continued to play a role, they were made more flexible. There were also changes in other instruments such as the CRR and SLR, repurchase auctions (repos), treasury bills and dated securities. These changes had the dual objectives of reducing the implicit tax on the banking system, resulting from forced lending to Government and of replacing physical control of monetary variables by instruments based on market incentives.

Interest Rate Policy

12 The floor commercial bank lending rate was also reduced in line with falling inflation. The interest rate on advances of scheduled commercial banks to borrowers with credit limits over Rs. 2 lakh, was lowered from 18 per cent to 17 per cent from March 1, 1993. It was further reduced to 16 per cent from June 24 and then to 15 per cent from September 2, 1993. The real lending rate which had exceeded 10 per cent in January-May 1993, declined gradually since July 1993 and was of the order of 7 per cent in January 1994. There has also been an accompanying adjustment of the rates charged by financial institutions.

Cash Reserve Ratio (CRR)

13 CRR was reduced in two phases - from 15 per cent to 14.5 per cent effective April 17, 1993 and further to 14 per cent effective May 15, 1993. To rationalise the incentive for banks to raise funds from different sources, CRR liability was reimposed on Certificates of Deposit (CD). This is applicable beyond their pre May 2, 1992 limits, (equivalent to 5 per cent of the fortnightly average outstanding aggregate deposits in 1989-90). The reduction in CRR was estimated to add about Rs.2360 crore to lendable resources of banks after adjusting for CRR liability of Rs.520 crore on CDs.

Statuatory Liquidity Ratio (SLR)

14 The phased reduction of the SLR is designed to bring down the level of pre-emption of resources by the Gov-

ernment at below market rates. This is accompanied by an effort to make Government securities an attractive instrument for banks and financial institutions to hold voluntarily. As part of this policy, SLR was reduced from 37.75 per cent at the beginning of 1993-94 to 37.5 per cent on August 21, and to 37.25 per cent on September 18, 1993. The net demand and time liabilities (DTL) base to which this ratio was to be applied was shifted to September 17, 1993 from April 3, 1992 with effect from October 16, 1993 and SLR was further reduced to 34.75 per cent. The incremental SLR on any increase in net DTL above the September 17, 1993 level was fixed at 25 per cent. Over time, this is expected to bring down the average SLR on net DTL of the banks to 25 per cent.

Auction of Dated Securities

15 Associated with the changes in SLR has been a switch over in the Central Government borrowing through dated securities from fixed coupon rates to market related interest rates. This includes both new borrowing and the recycling of old below-market rate securities which mature during the year. Dated securities of varying maturities have been auctioned. This is an important step in the move towards making such securities a usable instrument for open market operations as envisaged by the Chakravarty Committee. A similar process will have to be initiated with respect to State Government securities by closing the gap between their coupon rate and the market rates, and by establishing marketing/auctioning procedures.

Repurchase Auctions

16 Repurchase (Repos) auctions in respect of Central Government dated securities were introduced in December 1992, inter alia, to even out short term fluctuations in liquidity of the system. They have become a regular feature of the RBI's market operations. The term of the repo transactions which was initially limited to one or two days, may now extend upto 14-days. Between December 1992 and November 1993, 48 repo auctions were conducted and the cut-off rates fell to 6.25 per cent in the auctions held in December 1993-January 1994, from 13.5 per cent in March 1993. With the introduction of repo auctions, the earlier switch quota system for swapping government securities of different maturities and rates became redundant and RBI has discontinued this system. Repos are developing into an instrument, useful for evening out sharp fluctuations in the very short end of the money market.

Treasury Bills

17 Treasury bills have also become increasingly market based. The 364-day treasury bill auctions which were started on April 28, 1992 have become a regular fortnightly feature. The sale of these bills was a success. Outstandings on the date of issue rose to Rs 9381.74 crore in about a year. On April 16, 1993, bills for an aggregate face value of Rs 7122.8 crore maturing in 1993-94 were converted into 12.75 per cent Government stock ,1996. Outstandings, therefore, fell to Rs 6368.50 crore in July 1993, but have gradually risen to Rs 14378.21 crore by January 7, 1994. Interest rates on these bills have, however, remained within a very narrow range between 10.96 per cent and 11.36 per cent, despite changes in other interest rates and inflation.

18 The 91-day treasury bill auction was started in January, 1993, and has become a weekly feature. The total amount of outstanding treasury bills sold by auction have steadily increased to reach Rs 3700 crore by January 8, 1994. The reduction in RBI's holdings from a peak of Rs 1174 crore to Rs 60 crore, and the fluctuations in interest rates (between 7.78 per cent and 11.10 per cent) suggest that these are now more market based. As market experience and knowledge accumulates over time, they will gradually become a sensitive indicator of short-term market conditions. There is, however, a considerable way to go before treasury bills can be used as an effective instrument of open market operations.

Bank Rate

19 Over the years, the bank rate had fallen out of use as an instrument of monetary policy. Instead refinance by RBI for banks and the commercial sector, came to be increasingly determined by other policy considerations. As the financial system becomes more market oriented, the importance of physical controls and limits on lending and reserve money control through allocation of direct lending by RBI, should decline. The role of the discount rate and of rediscount rates for selected categories should increase.

Monetary Trends in 1993-94

20 Reserve money growth and net RBI credit to Government have seen a sharp increase in 1993-94 (Table 3.1 and 3.2). During financial year 1993-94, till January 7,1994 reserve money has grown by 16.9 per cent, compared to 8.5 per cent during the corresponding period of last year. This growth has been fuelled by additon to foreign assets of the banking sector and RBI credit to the Central Government. Though net RBI credit to Government (NRCG) grew by 8.8 per cent, only marginally higher than that registered in the corresponding period of last year, the 10.5 per cent increase in net Central Government borrowing from Reserve Bank has been a major source of monetary expansion. Of the total increase in reserve money, 46 per cent is contributed by net RBI credit to Government, and 60 per cent by net increase in the foreign exchange assets of RBI. The decline in RBI credit to other banks by 32 per cent served to offset about a quarter

TABLE 3.1
Sources of Change in Money Stock

	Variations during $					
	1992-93 Mar.31 to Mar.31	1992-93 Mar.31 to Jan.8	1993-94 Mar.31 to Jan.7	1992-93 Mar.31 to Mar.31	1992-93 Mar.31 to Jan.8	1993-94 Mar.31 to Jan.7
1	2	3	4	5	6	7
		(Rs. crore)			(Per cent)	
I. M1 (Money supply with the public)	8440	3619	17923	7.3	3.2	14.5
II. M3 (Aggregate monetary resources)	45184	39370	51279	14.2	12.4	14.1
i) Currency with the public	7414	5031	10999	12.1	8.2	16.1
ii) Demand deposits with banks	408	-2889	6749	0.8	-5.5	12.7
iii) Time deposits with banks	36744	35751	33356	18.1	17.6	13.9
iv) Other deposits with RBI	618	1477	175			
III. Sources of change in M3 (1+2+3+4-5)						
1. Net bank credit to Government (a+b)	17826	16532	28448	11.3	10.4	16.2
a) RBI's net credit to Government (i+ii)@	4433	7491	8686			
i) Central Government	4257	8724+	10167			
ii) State Governments	176	-1233	-1481			
b) Other banks' credit to Government	13393	9041	19762			
2. Bank credit to commercial sector (a+b)	28380	24439	13089	15.1	13.0	6.0
a) RBI's credit to commercial sector *	-1040	-1239	75			
b) Other banks' credit to commercial sector	29420	25678	13014			
3. Net foreign exchange assets of the banking sector#	3809	-3261	11270	17.4	-15.4	45.1
3a. Excluding revaluation of gold	2369	-3110	9450	11	-14.7	37.8
4. Government's currency liabilities to the public	94	89	81	5.5	5.2	4.5
5. Banking sector's net non-monetary liabilities other than time deposits (a+b)	4925	-1571	1609	9.4	-3.0	2.8
a) Net non-monetary liabilities of RBI	641	-2836	-1763			
b) Net non-monetary liabilities of other banks (residual)	4284	1265	3372			

$ ..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.

* Excludes, since the establishment of NABARD ,its refinance to banks.

@ Includes special securities

\# 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.

\+ 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.

TABLE 3.2
Sources of Change in Reserve Money

	Outstanding as on March 31, 1992	Variations+					
		1992-93 Mar.31 to Mar.31	1992-93 Mar.31 to Jan.8	1993-94 Mar.31 to Jan.7	1992-93 Mar.31 to Mar.31	1992-93 Mar.31 to Jan.8	1993-94 Mar.31 to Jan.7
1	2	3	4	5	6	7	8
		(Rs.crore)				(per cent)	
1. Net RBI credit to Government $	94016	4433	7491	8686	4.7	8.0	8.8
2. RBI credit to banks@	5103	4783	2565	-3144	93.7	50.8	-31.8
3. RBI credit to commercial sector*	7260	-1040	-1239	75	-14.3	-17.1	1.2
4. Net foreign exchange assets of RBI#	18838	3809	-3261	11270	20.2	-17.3	49.8
4a. Excluding revaluation of gold		2369	-3110	9450	12.6	-16.5	41.7
5. Government's currency liabilities to the public	1787	94	89	81	5.5	5.2	4.5
6. Net non-monetary liabilities of RBI	127415	641	-2836	-1763	2.3	-10.3	-6.3
7. Reserve Money (1+2+3+4+5-6)	99505	11438	8481	18731	11.5	8.5	16.9

\+ Variations are worked out on the basis of March 31 data after closure of Government accounts. All figures are provisional.

@ Includes claims on NABARD

* Excludes, since the establishment of NABARD, its refinance to banks.

$ Includes special securities.

\# 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.

of the rise in net foreign exchange assets of RBI, and has thus served to partly moderate the impact of the latter on reserve money growth.

21 As a result of the faster growth of reserve money, M1 has grown at 14.5 per cent in 1993-94 up to January 7 1994 and the rate appears to be rising. This rate is much higher than the 3.2 per cent growth over the corresponding period of 1992-93. The growth of M3 at 14.1 per cent has been faster than the 12.4 per cent growth during the corresponding period of last year. The growth in M3 has been lower than in reserve money because of a decline in money multiplier resulting from an increase in currency with public (CWP) and bankers' deposits with RBI. Currency with public has grown by 16.1 per cent during 1993-94 compared to 8.2 per cent during 1992-93, while bankers' deposits with RBI have grown by 19.7 per cent during 1993-94 compared to 5.8 per cent during 1992-93.

22 Other banks' credit to Government has grown by 25.4 per cent in 1993-94 up to January 7 1994, nearly twice the growth of 14.1 per cent in the corresponding period of 1992-93. In contrast, other banks' credit to the commercial sector has grown by only 6.2 per cent this year as against 14.2 per cent last year. From April 1, 1992 to January 8 1993, net bank credit to Government (NBCG) grew at a lower rate (10.4 per cent) compared to 13.0 per cent growth rate recorded by bank credit to commercial sector. In complete contrast, the former has grown by 16.2 per cent and the latter by only 6.0 per cent during the corresponding period of 1993-94.

Non-Food Credit

23 Total credit of the scheduled commercial banks grew by 5.7 per cent during 1993-94. Non-food credit growth was negligible (2.9 per cent). The major component of growth in bank credit was food credit, which grew by 64 per cent in 1993-94 (Table 3.3 and 3.4). Expansion in food credit is consistent with the rising ratio of currency with public(CWP) to demand deposits from 1.3 to 1.4, and of CWP to aggregate deposits from 22.3 per cent to 23.9 per cent.

24 There are several possible reasons for the slow growth of non-food credit in 1993-94 relative to its growth in 1992-93 :- (a) the growth in 1992-93 included demand which had been supressed by various credit control measures adopted in 1991-92 and relaxation of these controls in

TABLE 3.3
Scheduled Commercial Banks — Selected Indicators

Items	Variations during			
	1991-92 March 22 1991 to March 20 1992	1992-93 March 20 1992 to March 19 1993	1992-93 March 20 to Jan.8*	1993-94 March 19 to Jan.7*
1	2	3	4	5
		(Rs.crore)		
1. Aggregate deposits (a+b)	38216	37814	31549	35410
a) Demand deposits	11895	1373	-1827	6079
b) Time deposits	26321	36441	33376	29331
2. Borrowings from R.B.I.	-2891	1042	2536	948
3. Cash in hand	204	285	85	-14
4. Balances with R.B.I.	10318	-5644	1856	15820
5. Net balances with R.B.I. (4-2)	13209	-4602	-680	14872
6. Money at call and short notice	904	1293	2367	-1040
7. Bank Credit (a+b)	9291	26390	21085	8592
a) Public food procurement credit	164	2073	824	4336
b) Non-food bank credit	9127	24317	20261	4256
of which to Priority Sector #	2510	4333	1304+	-210++
8. Investments in approved securities	15131	15460	10999	19640
a) Government securities	12729	13218	8764	18796
b) Other approved securities	2402	2242	2235	844
9. Balances with other banks in current account	621	-192	385	-290
		(per cent)		
10. Credit-Deposit Ratio	54.4	56.6	55.9	52.8
11. Investment-Deposit Ratio	39.1	39.3	38.6	41.2

* Provisional
\+ Up to August 28, 1992
++ Up to August 27, 1993
\# Data relate to 48 banks accounting for more than 90 per cent of bank credit.

TABLE 3.4
Sectoral Deployment of Gross Bank Credit

On the last reporting Friday	1991-92	1992-93	April-August 1992-93	April-August 1993-94	1991-92	1992-93	April-August 1992-93	April-August 1993-94
	Variations during*							
1	2	3	4	5	6	7	8	9
	(Rs.crore)				(Per cent)			
I Gross bank credit	7986	21066	7159	-1249	6.8	16.7	5.7	-0.8
1. Public food procurement	164	2073	-710	2309	3.6	44.4	-15.2	34.2
2. Gross non-food credit (a+b+c+d)	7822	18993	7869	-3558	6.9	15.7	6.5	-2.5
a) Priority sector (i+ii+iii)	2510	4333	1304	-210	5.8	9.5	2.9	-0.4
i) Agriculture	1407	1727	656	132	8.4	9.5	3.6	0.7
ii) Small scale industry	969	1877	327	-40	5.6	10.3	1.8	-0.2
iii) Other priority sectors	134	729	321	-302	1.5	8.0	3.5	-3.1
b) Medium and large industries	2582	11537	5202	-1921	5.8	24.5	11.0	-3.3
c) Wholesale trade (excluding food procurement)	244	755	413	-551	4.1	12.3	6.7	-8.0
d) Other sectors	2486	2368	950	-876	12.3	10.4	4.2	-3.5
II. Export credit +	1108	5054	1369	539	12.1	49.1	13.3	3.5
Priority sector advances as proportion of net bank credit.@					38.7	35.0	37.1	34.4

* All figures after 1991-92 are provisional.
@ In the last month of each period. Advances include inter bank participation.
\+ Also included in non food credit.
Note: Data relate to 50 scheduled commercial banks which account for about 95 per cent of the credit of all scheduled commercial banks. Gross bank credit data exclude bills rediscounted with RBI, IDBI, Exim Bank and other approved financial institutions.

1992-93 released the pent-up demand for bank credit which may have, therefore, grown at a higher pace than its normal growth; (b) the provisioning and capital adequacy norms introduced for prudential reasons have made banks more careful in the matter of borrower selection and credit expansion, to avoid growth in non-performing assets; (c) yields on Government securities are now close to the minimum lending rate on bank advances of over Rs.2 lakh. As Government securities have been assigned zero risk weight under the new norms, banks have bought more Government securities in 1993-94 (Rs.13549 crore) than in the corresponding period of 1992-93 (Rs.11955 crore); (d) the corporate sector has raised more funds from capital markets, foreign suppliers' credit and commercial paper, indicating increased financial disintermediation; and (e) more efficient inventory management and reduced inventory holdings may have reduced working capital requirements, leading to early repayment of some loans taken at higher interest rates.

25 An important underlying reason for the limited increase in credit to the non-food commercial sector, is the large borrowing requirement (fiscal deficit) of the Government. A high fiscal deficit has led to high interest rates on bank advances to commercial sector, which has made some investments unviable, and also pushed the private sector into looking for other sources of finance. Containment of fiscal deficit is, therefore, an important policy tool for freeing bank resources for injection into the agriculture, industry and commerce.

Banking Policy and Trends

26 The size and the reach of the banking system, have increased tremendously over the last two and a half decades. Aggregate deposits have risen from about 15 per cent of GDP to 38 per cent, and the total number of bank branches, from around 8500 to over 60000. Of these, 58 per cent are now rural/semi-urban as against less than 25 per cent in 1969. This tremendous expansion has, however, carried the seeds of problem within it.

27 Quality of customer service has not kept pace and the time taken for processing and completing banking transactions is too long. The failure to keep up with revolutionary changes in banking and communication technology, has affected the speed and the accuracy of service, internal controls and interbank reconciliation of accounts. Both productivity and profitability have suffered as a consequence. As our exporters have found, reliable, efficient and low-cost financial services are an essential part of overall competitiveness.

28 This year saw major developments both in the identification of the inherent weaknesses in the banking sys-

BOX NO 3.1

BANKING AND FINANCIAL REFORMS: 1991-92 to 1993-94

- Statutory Liquidity Ratio (SLR) on incremental net demand and time liabilities (DTL) reduced from 38.5 per cent to 25 per cent.SLR and on net total DTL reduced from 38.5 per cent to 34.75 per cent. Expected to fall to 33 per cent by March.
- Incremental Cash Reserve Ratio (ICRR) of 10 per cent removed. One-third of the impounded cash balances under incremental CRR was released, implying a reduction in CRR by 0.6 per cent. CRR on net total DTL reduced from 15 per cent to 14 per cent.
- Number of interest rate slabs on bank advances reduced from about 20 in 1989-90 to 3 in the current financial year. Controlled floor interest rate on bank advances and ceiling interest rate on term deposits reduced by 4 percentage points and 3 percentage points, respectively.
- Prudential norms for income recognition classification of assets and provisioning for bad debts introduced. Banks to complete provisioning for doubtful and substandard assets by end March, 1994.
- Introduction of capital adequacy norms requiring 4 per cent to be attained by all banks by March 31, 1993 and 8 per cent by March 31, 1996. Foreign banks operating in India and Indian banks with branches abroad must attain 8 per cent by March 31, 1993 and March 31, 1994, respectively.
- Budgetary support of Rs.5700 crore for capitalisation of banks released after the nationalised banks entered into performance agreements with RBI for strengthening bank management and ensuring efficiency improvement.
- State Bank of India (SBI) 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.1400 crores as equity (including premium) and Rs. 1000 crores as bonds through a public issue. The RBI shareholding is now 67 per cent as against 99 per cent earlier.
- Bill to enable nationalised banks to access the capital market for debt and equity, introduced in Parliament.
- 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.
- 'In principle' approval given to seven 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.
- A new Board of Financial Supervision being set up within RBI to strengthen the supervisory system of banks and financial institutions. A new department viz. Department of Supervision, established in RBI as an independent unit effective December 22, 1993 for supervision of commercial banks.
- 'Recovery of debts due to banks and financial institutions Act, 1993' passed to set up Special Recovery Tribunals to facilitate quicker recoveries of loan arrears.
- Bank lending norms liberalised and banks given freedom to decide levels of holding of individual items of inventories and receivables.
- Ordinance promulgated amending Banking Regulation Act,1949 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 penalties for contravention of the act.
- Union agreement in October 1993 paves way for faster computerisation in banks.
- Scope of mandatory consortium arrangements 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.
- Financial institutions' access to SLR funds reduced and they are encouraged to approach capital market for funds.
- 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.
- Ceiling on interest rate on debentures and bonds removed except for that on tax-free PSU bonds.
- Auction of 91 day treasury bills and Government securities commenced from January 8, 1993 and June 3, 1992, respectively. Auction of 364 day treasury bills started from April 28, 1992 and replaced auction of 182 day treasury bills. Repo auctions in Government securities introduced in December 1992. Term can now be up to 14 days.

tem and in the initiation of system response. The task of decontrol and introduction of competition initiated earlier also went forward (Box 3.1). New trends, such as the voluntary holding of Government securities by banks in excess of statuatory requirements, emerged as a result.

Systemic Problems

29 The rise in fiscal deficits over the eighties has been paralleled by an increase in CRR and SLR, both of which peaked in 1991-92. Government borrowing from RBI put pressure on monetary growth, which was countered by raising CRR. The pressure to borrow from non-RBI sources led to increases in SLR and a pre-emption of bank resources which could have been lent to the commercial sector for productive purposes. At its peak, the total pre-emption reached 63.5 per cent of incremental bank deposits. Banks' profits were reduced, and they responded by raising interest rates (above the floor) on commercial advances, raising them to very high levels. It also led them to look for other sources of income such as the portfolio management scheme(PMS) which proved to be the source of many irregularities surfacing in early 1992.

30 The new income recognition and provisioning norms, and accounting procedures and format, which were among the measures announced in April, 1992, took effect from the year 1992-93. They have revealed the true extent of the deterioration in the profitability of the banks (Table 3.5). Apart from State Bank of India and its subsidiaries, only seven other public sector banks declared profits. During the current financial year, provisioning requirements of the banks will be much higher than in 1992-93 and, therefore, a larger number of banks are expected to report net loss at the end of this year.

TABLE 3.5
Provisions and Profits in 1992-93

(Rs. crore)

Banks	Gross Profit	Provision	Net Profit
1	2	3	4
a) S B I Group	2164	1984	280
b) Other Public sector banks	805	4453	(-)3648
c) All Public sector banks	2969	6437	(-)3368

31 Profits as a percentage of working funds also declined for private sector banks, foreign banks and all public sector banks excepting the SBI Group. For the SBI Group, it remained constant at a low level of 0.2 per cent. Except for SBI group, expenses as a percentage of working funds have increased for all categories of banks (Table 3.6).

32 It is well known that the banks have been required to lend at below market rates of interest to designated priority sectors (initially 33-1/3 per cent, later raised to 40 per

TABLE 3.6
Working Results of Scheduled Commercial Banks for 1991-92 and 1992-93

Item	SBI group		Other public sector banks		Private sector banks		Foreign banks		All banks	
	1991-92	1992-93	1991-92	1992-93	1991-92	1992-93	1991-92	1992-93	1991-92	1992-93
1	2	3	4	5	6	7	8	9	10	11
A. Rupees crore										
A. Income	13428	13963	21018	22126	1298	1595	3674	4009	39418	41693
i) Interest	11775	12166	18975	19945	1160	1410	2829	3700	34739	37221
ii) Other incomes	1653	1797	2043	2181	138	185	845	309	4679	4472
B. Expenditure	13184	13683	20459	25774	1221	1520	3354	4851	38218	45828
i) Interest	7392	8416	13630	15696	708	987	1845	2570	23575	27669
ii) Other operating expenses	2864	3283	5020	5625	375	417	570	858	8829	10183
iii)Provisions and contingencies	2928	1984	1809	4453	138	116	939	1423	5814	7976
C. Profit	244	280	559	-3648	77	75	320	-842	1200	-4135
D. Working Funds	115081	124567	186636	211614	11917	15111	25103	31678	338737	382970
B. Per Cent of Working Funds										
A. Income	11.7	11.2	11.3	10.5	10.9	10.6	14.6	12.7	11.6	10.9
i) Interest	10.2	9.8	10.2	9.4	9.7	9.3	11.3	11.7	10.3	9.7
ii) Other incomes	1.4	1.4	1.1	1.0	1.2	1.2	3.4	1.0	1.4	1.2
B. Expenditure	11.5	11.0	11.0	12.2	10.2	10.1	13.4	15.3	11.3	12.0
i) Interest	6.4	6.8	7.3	7.4	5.9	6.5	7.3	8.1	7.0	7.2
ii) Other operating expenses	2.5	2.6	2.7	2.7	3.1	2.8	2.3	2.7	2.6	2.7
iii) Provisions and contingencies	2.5	1.6	1.0	2.1	1.2	0.8	3.7	4.5	1.7	2.1
C. Profit	0.2	0.2	0.3	-1.7	0.6	0.5	1.3	-2.7	0.4	-1.1

cent of total net credit). Besides low interest rates some of this lending also had higher administrative costs and poorer recoveries, thus increasing banks' losses. Other problems have included an excessive focus on quantity as against quality of lending, external pressures and loan waivers, dilatory court proceedures and the Urban Land Ceiling Act.

System Reform

33 Prudential norms require banks to make 100 per cent provision for all loss assets in 1992-93. As funding required for provisioning is estimated to be about Rs.14000 crore, it is being phased over two years. Banks had to make at least 30 per cent provisions against doubtful and substandard assets in 1992-93 and the remaining 70 per cent in 1993-94.

34 Reserve Bank of India prescribed new capital adequacy norms in April 1992, in line with Basle Committee norms to be complied with by banks over a three year period. Banks were expected to reach a 4 per cent capital to risk weighted asset ratio(CRAR) by March 1993. This is to rise to 8 per cent by March 1996, for all banks. Foreign banks operating in India and Indian banks with international presence were, however, required to attain 8 per cent by March 1993 and 1994, respectively.

35 The 1993-94 Central Budget contained a provision of Rs 5700 crore for recapitalisation of public sector banks. This is not sufficient for full achivement of norms by all banks. As Government resources are limited, banks will have to mobilise debt and equity resources from the public. State Bank of India has already taken this step, and other stronger banks are also preparing to do so. To facilitate access to the market, the amendment of SBI Act has (i) simplified registration procedures for SBI shareholders, (ii) reduced the minimum value of SBI shares from Rupees one hundred to Rupees ten, (iii) relaxed the limit on individual share holding and (iv) permitted individual shareholders to exercise voting rights up to 10 per cent of total shares.

36 The supervisory system of RBI is being strengthened with the establishment of a new Board for Financial Supervision under the chairmanship of a Deputy Governor of the RBI. The board will ensure implementation of regulations in the areas of credit management, asset classification, income recognition, provisioning, capital adequacy and treasury operations.

37 A new department viz. Deprtment of Supervision (DOS) has been carved out of the Department of Banking Operations and Development (DBOD) in RBI as a separate unit. Set up on December 22, 1993 DOS will take over the work relating to the supervision of the scheduled commercial banks from DBOD and later the supervisory functions of other departments. Over time, the jurisdiction of DOS will extend to the supervision of the financial institutions as well as the non-banking financial companies. It will undertake on-site inspection and off-site surveillance. It will also take up special investigations including those connected with frauds. The work relating to the appointment of statutory auditors will also be its responsibility. Eventually, it will be assisting the Board of Financial Supervision as and when it is set up.

38 Several measures have been initiated in the current financial year to improve the functioning of the banks. Agreements between public sector banks and RBI has been drawn up to improve their management and quality of performance. This includes management information systems and the internal audit and control mechanisms. Such improvements are linked to the provision of capital by the Government and are essential if the capital is not to be frittered away in losses. Computerisation in banking operations is in progress and the public sector banks hope to fully computerise 400 branches during the next 2-3 years. Inter-ministerial discussions are also being held to consider major issues relating to rural credit, including a viable interest rate structure.

39 Large debt arrears are like a mill stone around the neck of Indian banks and financial institutions, which not only affect their capacity for further lending but also eat into their financial health by reducing profits. The "Recovery of debts due to banks and financial institutions Act, 1993" has recently been passed, under which Special Recovery Tribunals will be set up to facilitate quicker recoveries of loan arrears. Several of these tribunals are in the process of being set up.

Decontrol and Competition

40 A number of steps have been taken during the year to reduce controls and distortions in the banking system and to promote competition. These include interest rate reforms, permission for entry of private banks, relaxations in lending restrictions and credit control. The objectives of these changes are: (a) to replace restrictions based on control and coercion of banks to the use of market based incentives, so that bank management and staff are free to use their intelligence and commercial initiatives; (b) to have the necessary prudential regulations needed to protect the depositors and the banking system; and (c) to create an environment in which the banks compete with each other to provide the best service to depositors, borrowers and other clients (Box 3.2).

Interest Rate Policy

41 The degree of cross-subsidy in the banking system is being gradually reduced, by unifying the interest rate structure. From April 8, 1993 the prescribed lending rates were

reduced from four to three (Table 3.7). Currently, there is a rate of 12 per cent for advances below Rs 25000, and a rate of 15 per cent (fixed) for advances above Rs.25000 but less than Rs 2 lakh, and a floor rate of 15 per cent for advances above Rs 2 lakh.

TABLE 3.7
Changes in Interest Rates on Lending by Scheduled Commercial Banks

(Per cent)

Size of credit limit	Old Rates	New Rates as on 1993		
		April 8	June 24	Sept 2
1	2	3	4	5
1. Upto and inclusive of Rs.7500/-	11.5			
2. Over Rs.7500/- and upto Rs.25000/-	13.5	12.0	12.0	12.0
3. Over Rs.25000/- and upto Rs.2 lakh	16.5	16.5	16.0	15.0
4. Over Rs.2 lakh (minimum rates)	17.0	17.0	16.0	15.0

42 The interest rates on Rupee export credit provided by the scheduled commercial banks were also reduced across-the-board by one percentage point with effect from March 1, 1993. This brought down the basic lending on Rupee export credit to 13 per cent from March 1, 1993.

Private Banks

43 Existing private sector banks have been assured that they will be allowed to expand without fear of nationalisation. New private sector banks are also being allowed as per RBI guidelines. The policy on NRI holdings in Banks has been brought on par with that for industial companies. NRIs' can now hold upto 40 per cent of the equity in new banks. Foreign companies can also hold upto 20 per cent of the equity. RBI has already given 'in principle' approval to several proposals for setting up new banks in the private sector. Entry of new banks with modern customer service systems will, over time, spur the existing banks, their management and staff, to improve the quality of service provided. On January 31,1994 an Ordinance was promulgated to amend the Banking Regulation Act, 1949 with a view to (a) enabling a banking company to have a non-executive chairman and up to three directors from among the directors of promoting institutions, (b) raising the ceiling on the exercise of voting rights by a shareholder from one per cent to ten per cent of total voting rights of all shareholders (similar to the position now obtaining in State Bank of India after the amendment of SBI Act), and (c) raising the ceiling on maximum penalties and introducing a simplified procedure for adjudging penalty to be levied on a banking company for contravention of the Act.

Consortium Arrangements

44 To spur competition and slow down disinter-mediation, lending restrictions are also being reduced. Large borrowers above a specified credit limit are required to borrow through a consortium of scheduled commercial banks headed by a lead bank. The threshold limit for such consortium arrangement has been raised from Rs.5 crore to Rs.50 crore in October 1993. This will reduce the number of borrower accounts subject to this procedure from 934 to 76. The consortium lending procedure for remaining borrowers was also liberalised by allowing borrowers to induct new banks into the consortium. To ensure financial discipline, banks would be required to dispose of loan proposals in a consortium within a prescribed time frame.

45 Banks will also have the discretion to leave the consortium after a minimum period of two years from the date of their joining it. As an alternative to consortium arrangement over the new threshold limit of Rs.50 crore, banks will have the option to organise syndication of credit limits. In the case of multiple lending below the new limit, timely and meaningful exchange of information among banks would be necessary to overcome the risk of excess financing.

Maximum Permissible Bank Finance (MPBF)

46 The guidelines for determining the maximum permissible bank finance have been made more flexible. Banks will now have greater freedom in determining the working capital needs of borrowers and responding to local conditions and requirements in a timely manner. Subject to the observance of prescribed prudential norms and quarterly reporting requirements, banks would be free to develop and apply their own norms for individual items of inventory and receivables to be permitted to their borrowers, and the quantum and period of *ad-hoc* credit limits not subject to additional interest. The working capital norms for village, tiny and other SSI units which limit loans to 20 per cent of the projected turnover were hitherto applicable to working capital limit up to Rs.50 lakh. The working capital limit for application of this simplified norm has now been raised to Rupee One crore.

47 Though the requirement of maintaining a minimum current ratio (assets to liabilities) of 1:1.33 would continue, the definition of liability was modified. From, April, 1993 only one-third of the term loan instalments falling due in the next 12 months were to be included as current liability for determining the minimum current ratio and working out the maximum permissible bank finance. In October 1993, the entire term loan instalments falling due in next 12 months were excluded from current liability,

BOX NO. 3.2

Credit Policy Measures in 1993-94

- Floor interest rate on bank advances of over Rs.2 lakh brought down in stages from 17 to 15 per cent and the number of interest rates on bank advances reduced from four to three.
- Interest rates on Rupee export credit reduced across the board by one percentage point.
- The ceiling interest rate on domestic term deposits of commercial banks reduced in stages from 12 per cent to 10 per cent and the interest rate on domestic saving deposits reduced from 6 per cent to 5 per cent
- Ceiling interest rate on term deposits under NRER accounts reduced from 13 per cent to 11 per cent. Interest rate on saving deposits under these accounts reduced to 5 per cent.
- Minimum maturity period of FCNR deposits raised to two years and above but less than three years.
- A new FCNR (Banks) Scheme exempt from CRR and SLR with exchange rate gurantee by banks introduced.
- Authorised dealers allowed to rediscount export bills at rates linked to international interest rates and scope of preshipment export finance in dollar extended. Refinance limits for Export Credit (Rupee) refinance and post-shipment export credit denominated in U.S. dollar reduced.
- 32 per cent of net bank credit stipulated as priority sector credit target for foreign banks with sub-targets of 10 per cent each for credit to SSI sector and to export sector, to be reached by end March 1994.
- Direct and indirect advances for agriculture clubbed within 18 per cent target for agricultural advance for domestic banks.
- Definition of small scale industries for priority sector advance revised to include units with investment in plants and machinery upto Rs.60 lakh.
- 40 per cent of the total credit to SSI by each bank to flow to cottage, khadi and village and tiny industries.
- Package of measures to boost flow of bank credit to SSI units introduced including annual credit budget at branch level in consultation with SSI Units; minimum of 20 per cent of annual turnover as working capital finance for units requiring fund- based credit upto Rs 50 lakh institutional framework for redressal of grivances and Working capital finance for their marketing companies.
- Selective credit controls removed from bank advances against wheat, cotton/kapas and relaxed on bank advances against paddy and rice.
- Concession given to Certificates of Deposit (CD) in the form of exemption from CRR withdrawn.
- Companies allowed to issue commercial papers for maturities between 3 months and less than one year(in place of 6 months earlier) from the date of issue,and both the minimum net worth and minimum working capital (fund based) limit for eligibility of a company for issuing CP reduced from Rs.5 crore to Rs.4 crore.
- Stipulation regarding minimum rate of interest of 14 per cent per annum on inter-bank participations(IBP) on risk-sharing basis withdrawn.
- Select All India financial institutions permitted to borrow from the term money market for three to six months.
- General Line of Credit from RBI to NABARD raised to Rs. 3700 crore from Rs. 3100 crore.
- Banks allowed to finance hire purchase and equipment leasing companies upto four times the net owned funds.
- Minimum margin on bank advances against shares and debenture/bonds reduced from 75 per cent to 50 per cent.
- Ceiling for investment by banks in public sector bonds/deposits raised from 1.5 per cent to 5 per cent of the incremental aggregate deposits of the previous year.

for determining the MPBF. This would raise the finance that the banks can provide for working capital by Rs.1500 -Rs.2000 crore

Shares and debentures as collateral

48 The minimum margin stipulated on loans to individuals against shares and debentures which was 75 per cent since April 1992, was reduced to 50 per cent from April 8, 1993. This will be sufficient to protect against fairly large fluctuations in share prices. The stipulation that total outstanding credit against shares and debentures/bonds should not increase, was also withdrawn. These measures will make it easier for ordinary investors to borrow from banks against the pledge of their shares and debentures.

Investment Norms

49 The ceiling for banks' investment in, and underwriting of, bonds issued by the public sector units was raised in October 1993 from 1.5 per cent to 5 per cent of the increase in aggregate deposits in the previous year. This would also give greater flexibility to banks in deploying their funds, and have a stimulative effect on the market for PSU bonds which has been inactive since the beginning of 1993-94.

Export Credit

50 Banks were given greater freedom in deploying their foreign exchange resources. Based on the recommendations of the RBI Committee on Structure of Export Credit, authorised dealers were allowed to rediscount export bills at international rates. Pre-shipment credit in foreign currencies earlier available only for import of inputs for export production, was extended to financing of domestic inputs. It would be available at LIBOR related interest rates on the basis of confirmed/firm export orders and/or confirmed letters of credit. Such credit would not, however, be eligible for refinance from RBI. These measures will help improve the liquidity of exporters and the competitiveness of exports.

51 Adjustments were also made in refinancing of export credit by RBI. It refinances Rupee export credit at 11

TABLE 3.8
Selected Interest Rates of Scheduled Commercial Banks

Category	(Per cent per annum) Rates @ as on March 1, 1993	September 2, 1993
1	2	3
A Bank deposits		
(a) Domestic term deposits	Not exceeding 11.00	Not exceeding 10.00
(b) Non-Resident (External) Rupee Accounts	Not exceeding 13.00	Not exceeding 12.0$+
(c) Savings deposits	6.0	5.0$
B Bank credit (other than export credit)		
i) Up to and including Rs. 7500	11.50	12.00
ii) Over Rs.7500 and up to Rs.15000	13.50	12.00
iii) Over Rs. 15000 and up to Rs.25000	13.50	12.00
iv) Over Rs. 25000 and up to Rs.50000	16.50:	15.00
v) Over Rs. 50000 and up to Rs. 2 lakh	16.50:	15.00
vi) Over Rs. 2 lakh (minimum)	17.00	15.00
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	13.00	13.00
v) Pre-shipment credit (181 - 270 days)*	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	20.00
vii) All other export credit not listed (minimum)	17.00	15.00
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
C DRI advances	4.00	4.00
D Term loans (to agriculture, SSI and transport operators owning up to two vehicles)#		
i) Over Rs. 25000 and up to Rs. 2 lakh	15.00	15.00
ii) Over Rs. 2 lakh (minimum)	15.00	15.00

@ The rates are exclusive of interest tax, effective October 1,1991.
Export credit is exempted from interest tax from April 1,1993.
$ With effect from July 1,1993
* With prior approval of RBI
+ Effective October 12,1993 maximum interest rate payable on NRE term deposits was reduced to 11 per cent.
# With effect from September 2,1993 structure of lending rates for both working capital and term loan is the same for all categories of borrowers.

TABLE 3.9
Selective Credit Controls on Bank Advances
(Effective October 12, 1993)

Commodities	Minimum Margin			(Per cent)
	Mills/ processors	Others	Ware-house receipts	Credit ceiling*
1	2	3	4	5
1 Paddy and rice	30	45	30	100
2 Pulses	45	60	45	100
3 Other foodgrains	45	60	45	100
4 Oilseeds (viz groundnut, rapeseed/mustard, cottonseed, linseed, castorseed and all imported oilseeds)	45	60	45	100
5 Vegetable oils (viz. groundnut oil, rapeseed/mustard oil, cottonseed oil, linseed oil, castor oil, vanaspati and all imported oils)	45@	60	45	100
6 Sugar				
a) Buffer	0	-	-	-
b) Unreleased stock	20	-	-	-
c) Released	75	75	60	-
7 Gur and khandsari	45	75	60	-

@ Applicable to registered oil mills
- Not applicable * Percentage of peak level of credit given to a party in any of three years ending 1991-92 (November-October)

per cent and US dollar denominated post-shipment export credit (PSCFC) at 5.5 per cent interest rate. RBI refinance of export credit almost doubled in absolute value during 1992-93 and constituted over 69 per cent of outstanding export credit on March 19, 1993. In 1993-94 the refinancing of rupee export credit was reduced to 60 per cent of the increase in export credit between 1988-89 (measured by the monthly average level (MAL) of outstanding credit) and up to April 1993. The reduction in export refinance was necessary for controlling the increase in reserve money. The refinance limit for post shipment credit denominated in US dollar was also reduced from 120 per cent to 100 per cent in April 1993 and subsequently to 90 per cent in October 1993.

52 Adequate export credit would, however, continue to be provided as the loanable funds of the scheduled commercial banks have increased with reduction in CRR. With the SLR reduced, banks should have no difficulty in meeting the export target of 10 per cent (of net bank credit) in 1993-94. The overall impact on bank income will also be positive as the interest rate on export refinance is higher than that on CRR cash balances with RBI.

Interest Rate on Deposits

53 In financial year 1992-93 banks were freed to set interest rates on their term deposits subject to a cap (of 13 per cent, later reduced to 12 per cent). Banks were free to evolve a term structure consistent with the preferences of depositors and the term pattern of loan demand. Bank deposit rates were brought down as inflation subsided in 1993-94. The ceiling interest rate on term deposits was reduced to 11 per cent from March 1, 1993 in line with the one percentage point reduction in the interest rate on bank advances of over Rs.2 lakh. The ceiling on banks' term deposit rates was further reduced by one per cent from September 2, 1993. Interest rates on savings deposits were reduced from 6 per cent to 5 per cent June 24, 1993 (Table 3.8). Rates of interest on postal (time, recurring) deposits, and six year monthly income scheme were brought down by 1 to 1.5 percentage points on September 2 ,1993. The interest rate ceiling on deposits raised by non- bank financial companies was lowered from 15 per cent to 14 per cent

54 The ceiling interest rate on term deposits (of 46 days to 3 years and above) under the Non-Resident (External) Rupee Accounts (NRER) scheme was reduced by one percentage point to 12 per cent on April 8,1993 and further to 11 per cent on October 12, 1993. The interest rate on NRER savings deposits was reduced to 5 per cent from October 12, 1993, so as to bring it on par with the domestic savings deposits.

Foreign Currency Deposits

55 In accordance with the policy of reducing exchange risk guarantees by RBI on private foreign currency deposits, a new Foreign Currency (Non-Resident) Accounts (Banks) scheme was launched in April 1993. As in the FCNR scheme, depositors have full freedom to repatriate funds, but the implicit exchange rate guarantee is to be provided by the authorised dealer banks (and not by RBI). Banks have the incentive to provide such guarantees, as these deposits will not be subject to SLR, CRR and lending rate restrictions.

56 As part of the strategy of reducing publicly guaranteed short term debt, the FCNR term deposits of term "less than two years" were discontinued. The existing FCNR deposits of these maturities would, of course, continue till maturity. These maturities would, however, be available in the newly introduced FCNR (Banks) scheme.

Selective Credit Controls

57 Several changes were effected with regard to selective credit controls, in view of the price - output trends over the preceeding year. In April 1993, minimum margins against bank advances, and bank credit ceilings against the stock of price sensitive commodities, were reduced. The three year reference period for fixing credit ceiling was shifted by a year to 1989-90 through 1991-92 (November - October). As the price-output situation for paddy/ rice, wheat, pulses, other foodgrains, oilseeds and oils had improved, the credit ceiling was raised by 15 percentage points and the minimum margin requirements reduced by 15 percentage points. Effective June 24, 1993 the mini-

TABLE 3.10

Assistance by All India Financial Institutions

(Rs. crore)

Institutions	1991-92	1992-93	April-Sept. 1992	April-Sept. 1993	April-Dec. 1992	April-Dec. 1993
1	2	3	4	5	6	7
A. Sanctions						
a) All India Development Banks	17169	21659 (26.2)	9602	11103 (15.6)	14636	19687 (34.5)
b) Specialised Financial Institutions	133	169	34	54	89	129
c) Investment Institutions	5844	9750	5656	3502	8528	7924
B. Disbursements						
a) All India Dev. Banks	11619	14393 (23.9)	6311	7093 (12.4)	9856	10726 (8.8)
b) Specialised Financial Institutions	74	93	28	31	52	67
c) Investment Institutions	3896	7575	3254	1938	5485	3962

a) All India Development Banks-IDBI,IFCI,ICICI,SIDBI, IRBI and SCICI.
b) Specialised Financial Institutions-RCTC,TDICI and TFCI.
c) Investment Institutions - LIC,GIC and UTI.
Note:- (i) Data for 1992 and 1993 are provisional. (ii) Figures in brackets indicate percentage changes.
Source: Industrial Development Bank of India.

mum margins on loans against wheat stocks were further reduced by 15 percentage points. The ceiling against cotton and kapas was raised from 100 per cent to 115 per cent, in view of the improved supply position of these commodities.

58 Effective October 1993, RBI lifted selective credit controls against both wheat and cotton/kapas and relaxed them against paddy and rice by reducing the minimum margins by 15 percentage points. But oilseeds and vegetable oils were placed under tighter control by raising minimum margins on bank advances against them across-the-board by 15 percentage points with effect from the same date. The existing minimum margins and credit ceilings for commodities covered under selective credit control have been brought out in the Table 3.9.

Priority Sector Credit

59 The credit policy for the second half of 1993-94, made some changes in the composition of priority sector targets, within its overall 40 per cent target. Banks have been allowed to club "direct" and "indirect" advances to agriculture within the 18 per cent target. In order to maintain the focus of banks on direct loans to agriculture their indirect lending for agriculture has been limited to one fourth of the total agricultural lending. The eligibility criterion for small scale industries and ancillaries in terms of investment in plant and machinery have been revised as per the new definitions adopted by the Government. The SSI ceiling has, therefore, been raised from Rs.35 lakh to Rs. 60 lakh and the ancillary ceiling from Rs.45 lakh to Rs.75 lakh. Within the SSI credit proportions, 40 per cent of SSI credit is to be earmarked for khadi, village, cottage and tiny units.

60 A 15 per cent priority sector lending obligation on foreign banks was introduced in August, 1988 to be achieved by March 1992. As the actual attainment was only 7.86 per cent, the time period was extended to June, 1993. It was also stipulated by RBI that any shortfall in the attainment of the target would have to be deposited, at 10 per cent interest, with the Small Industries Development Bank of India (SIDBI). From July 1, 1993 the priority sector credit target for foreign banks was raised to 32 per cent to be attained by March end, 1994. This was done to level the field between foreign and Indian banks in the matter of priority sector advance. Given their specialisation in foreign banking transactions and the need to promote exports, they were allowed to include export credit as a component of priority sector credit. Within the overall stipulation, sub-targets of 10 per cent for loans to export sector and SSI units were also specified.

Rural Credit

61 Limits under General Line of Credit I (GLCI) provided by the RBI to National Bank for Agriculture and Rural Development (NABARD) for short-term seasonal agricultural operations which had been increased from Rs.

2700 crore to Rs.3100 crores in January, 1993 was again raised to Rs.3300 crores from April 8, 1993. RBI further enhanced limits under GLCI to NABARD to Rs.3700 crore to support Rabi agricultural operations. Thus, additional resources of Rs.1000 crore were provided to NABARD for agricultural activities over nine months.

Credit for Small Scale Industries

62 Based on the recommendations of the Nayak Committee, a special package of measures to boost credit flow to SSI units was announced in April 1993. It included (a) drawing up of annual credit plan by banks at branch level in consultation with SSI units, (b) working capital finance to be made available to SSI units to a minimum of 20 per cent of the annual turnover. This would apply to units needing financial assistance up to Rs.50 lakh (revised to Rs.1 crore in October 1993), (c) setting up of grievance redressal mechanism in banks for SSI units, (d) full financial support to companies marketing SSI products, and (e) modification of the definition of sick SSI units for speedy rehabilitation of potentially viable units.

Development Finance Institutions

63 Measures of financial liberalisation extended to all the segments of the financial system and aimed at making the financial intermediation process more efficient. Financial institutions had to adjust to the changed environment, following policy reforms. Their operations during the last two years reflected the changing economic structure and trends.

Trends in lending

64 In 1992-93, sanctions by all India development finance institutions (IDBI, IFCI, ICICI, SIDBI, IRBI and SCICI) increased by 26.2 per cent from Rs.17169 crore in 1991-92 to Rs.21659 crore (Table 3.10). Disbursement similarly increased by 23.9 per cent, from Rs 11619 crore in 1991-92 to Rs.14393 crore.

65 During April-December 1993 financial assistance sanctioned by the development finance institutions (DFIs) registered 34.5 per cent growth (from Rs.14636 crore to Rs. 19687 crore). Disbursements have also gone up by 8.8 per cent. According to DFIs, the demand for funds from the set of known high quality borrowers appears to have declined, because of more efficient utilization of existing capacities under the pressure of competition and globalisation. Potential borrowers also appear to be more careful in starting large capital intensive industry which may not remain competitive if import tariffs decline as per Tax Reform Committee recommendations. The DFIs are, therefore, exploring new sets of borrowers and new directions for lending.

66 Among the major sectors receiving assistance from the DFIs are chemicals and chemical products, textiles, power, iron and steel, machinery, electrical and electronic equipment and services. New projects involving creation of fresh capacity through expansion or diversification accounted for more than half of the aggregate assistance sanctioned by them during the last two years. Assistance to export-oriented units formed 11.5 per cent of the direct financial assistance sanctioned by the Industrial Development Bank of India (IDBI) in the last financial year.

67 A significant development in the operations of DFIs during the last two years was the increasing emphasis on non-project assistance. During 1992-93, sanctions for schemes such as asset credit, equipment leasing, bridge loans and other short-term loans by IDBI, ICICI and IFCI totalled Rs.4679.5 crore. This was 65 per cent higher than the sanction for these schemes in 1992-93 (Rs.2837.6 crore) and constituted one-third of total direct sanctions (as against 30 per cent in 1991-92).

Policy reform

68 Steps have been taken to free DFIs to mobilise funds from the capital market and reduce the need for SLR and other concessional funds. IFCI has been converted into a company in July, 1993 and made its maiden public issue of Rs.550 crore in December 1993. IDBI has received clearance for accessing the capital market and a proposal for its capital restructuring is under active consideration. Increased resources are being raised from the capital market and money market through innovative products at market related interest rates. Securitisation of the loan assets can increase the liquidity of loan portfolio. In response to the changing environment, other DFIs like the Industrial Reconstruction Bank of India (IRBI) are also drawing up their corporate plans. The Shipping Credit and Investment Corporation of India (SCICI) and IRBI have expanded their field of operation to all sectors of industry. Over the last two years, development finance institutions have recognised the importance of prudential norms as a means to maintain financial health and have also been following norms for credit concentration, asset classification, income recognition, provisioning and balance sheet disclosure.

69 SIDBI set up in 1992-93 a venture capital fund for SSI units which do not qualify for assistance under conventional modes. It also became a member of the Over the Counter Exchange of India (OTCEI) which would help many SSI units access capital market. SIDBI has decided to establish a line of credit for select finance companies and merchant banks which lend to and service SSI units. It will also enter into Memorandum of Understanding (MOU) with the banks and financial institutions.

70 In tune with the growing environment of competition, the previous formalised system of consortium finance is getting replaced by informal loan syndication. Interest regime has become more liberalised during the last one year. The floor rate of interest was lowered three times and at present it stands at 15.5 per cent (inclusive of interest tax). DFIs have also amended their norms regarding promoters' contribution and debt-equity ratio to increase promoters' stake in projects. In a move toward universal banking, financial institutions are setting up commercial banks and planning to enter into the fields of mutual funds, investor services, etc.

Money Market Developments and Trends

71 Money markets are not merely a channel for transferring short term funds from savers to investors, but also provide information on the underlying conditions of supply and demand. More importantly, they are essential for moving from quantity based to market based instruments of monetary management. There is, therefore, an urgent need for deepening and broad-basing the market for debt instruments and Government dated securities. Institutional support should be provided wherever needed.

Inter Bank Call Money Market

72 During 1992-93 call money market rates were high and tended to rise on days when banks were required to meet their CRR obligations. In contrast, in 1993-94 rates have been much lower and have fallen more than would be justified by the fall in inflation and in general interest rates. Further, the low rates have been inter-spersed with spells of close to zero rates. The current financial year started with rates as high as 20 per cent. As the year progressed, there has been a steep fall, and the rate even touched 0.5 per cent on October 10, 1993. This is indicative of the high liquidity in the banking system. Average call money rates remained much below the cut-off rates on auctioned 91 day treasury bills. This suggests a lack of integration between different segments of the money market and indicates an urgent need for institutional and market development (Figure 3.1).

Certificates of Deposit (CD)

73 Issue of CDs by banks has declined because of their comfortable liquidity position. As banks' demand and supply of CDs has declined, the volume of CDs has also come down. The interest rates on CDs have fallen with the overall decline in interest rates. The bank-wise limits for issue of CDs has been withdrawn with effect from October 16, 1993. The overall limit for the banking system had earlier been raised, effective April 17, 1993 to 10 per cent of the average outstanding aggregate deposits in 1991-92. This will provide greater flexibility to banks in mobilising deposits at competitive rates, enabling them to issue CDs as per their requirements.

Commercial Paper (CP)

74 Another important trend has been a large increase in the issue of CP, particularly by the better rated companies. Outstanding issues of CPs have registered significant rise to over Rs. 2600 crore at mid-October 1993 compared to only Rs. 577 crore at March end, 1993. The incentive for highly rated companies to issue commercial papers may have increased temporarily in early 1993-94, as banks' nominal rates were lowered more slowly than the fall in inflation. As these are the highest quality borrowers, banks are reportedly subscribing to CPs in a large way. This phenomenon may be part of the explanation for the low expansion in bank credit to commercial sector. In view of easy conditions in the money market CP rates too have declined below 12 per cent and fallen even below the CD rates, which is rather unusual. One possible (and preferable) response of banks is to increase the quality of the service they provide to such borrowers so as to attract them back to direct borrowing. Another is to co-ordinate through the Indian Banks Association to set minimum rates below which they will not subscribe to CPs.

75 The maximum maturity period for the issue of CP by companies has been raised from 6 months to one year from October 1993. CPs can now be issued by companies for maturities varying from 3 months to less than one year from the date of issue. The eligibility norm for companies issuing CPs has been liberalised from a minimum net worth of Rs. 5 crore to Rs. 4 crore, and from a minimum working capital (fund-based) limit of Rs. 5 crore to Rs. 4 crore. The issue limits for CP remain at 75 per cent of working capital (fund based) limits.

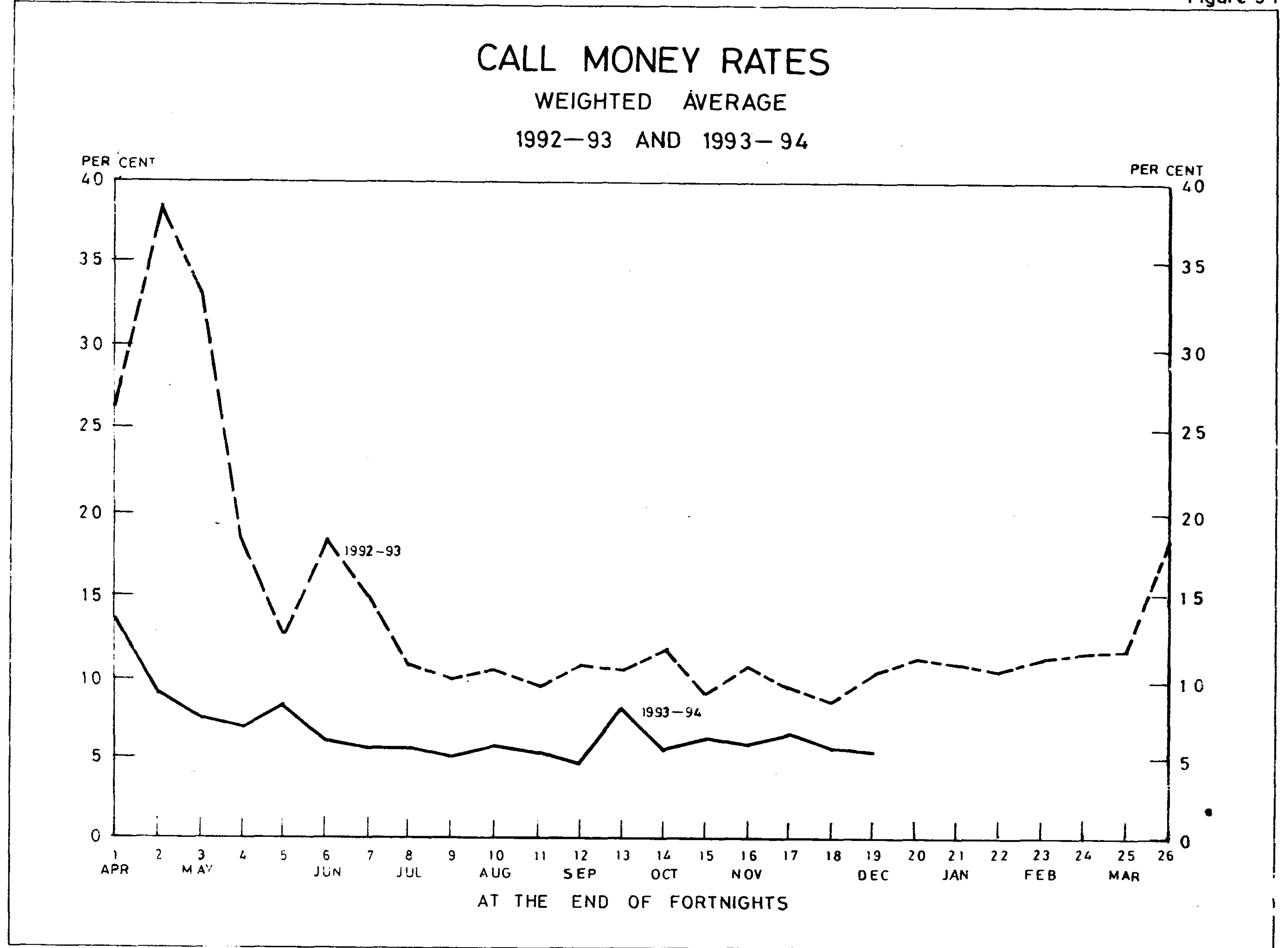
Commercial Bills

76 Business turnover in commercial bills shrank in 1992-93 consequent upon the steps taken by RBI to ensure that recourse to commercial bill finance takes place only for genuine commercial bills and within the need based credit limits of borrowers. In the curent financial year also this trend continued. Banks too are reportedly holding these bills to maturity because of their comfortable liquidity position.

Decontrol

77 Select financial institutions (IDBI, IFCI, ICICI, SIDBI, IRBI, EXIM BANK and NABARD) which could hitherto only lend in the money market have now been allowed to borrow on these markets within limits stipulated for each institution. Permitted terms range from 3 months to 6 months. This measure would provide flexibility to these institutions in managing their funds and help develop term money market.

Figure 3·1



Treasury Bills

78 Both the 91 day treasury bills and 364 day treasury bills are becoming preferred instruments in the money market. In spite of some conversion of treasury bills into dated securities, the volume of treasury bill traded rose rapidly. Up to October, 1993 the outstanding 91 day and 364 day treasury bills totalled Rs. 2455 crore and Rs. 10073 crore, respectively. Banks, in particular, have shown a strong preference for holding these bills. Though there has been a fall in the cut-off yields in their auctions, the fall is much less than for other money market instruments. There has also not been much correspondence in the relative movements in the 91 day and 364 day rates.

Discount and Finance House of India

79 The Discount and Finance House of India (DFHI) is the principal agency for developing a secondary market for money market instruments and Government of India Treasury bills. During the years 1992-93 and 1993-94 the volume of secondary transactions (particularly treasury and commercial bills) was low. In 1993-94, this was partly due to the shadow of the securities scam and the easy conditions in the call money market. Details of turnover of DFHI in various instruments are indicated in the Table 3.11.

TABLE 3-11

Buisness of Discount and Finance House of India

(Rs. Crore)

Item	1992-93 (up to Dec.25, 1992)	1993-94 (up to Dec.24, 1993)
1	2	3
I. Lendings		
i) Call Money Market	343441	386946
(daily Average)	(1249)	(1407)
ii) Notice Money (2-14 days)	1332	3852
iii) Term Money (15-90 days)	3673	1514
II. Turnover		
i) Treasury Bills	13094	13665
ii) Commercial Bills	565	16
iii) Certificates of Deposits (CD)	28	179
iv) Commercial Paper (CP)	-	123
v) Government Securities	6233	14104

Government Securities Market

80 The coupon rate on 15 year Central Government securities were raised in two phases from 11.25 per cent

BOX 3.3

Capital Market Reforms in 1992-93 and 1993-94

- Capital Issues (Control) Act, 1947 repealed and the office of the Controller of Capital Issues (CCI) 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 (SEBI) armed with necessary authority and powers for regulation and reform of capital market.
- Indian companies permitted to access international capital markets through Euro-equity shares.
- Companies required to disclose all material facts and specific risk factors associated with their projects while making public issues.
- Merchant banking statutorily brought under the regulatory framework of SEBI and merchant bankers required to abide by a code of conduct.
- Private mutual funds permitted and a few already set up. All mutual funds allowed to apply for firm allotment in public issues.
- Investment norms for NRIs liberalised allowing companies to accept capital contribution and issue shares or debentures to NRIs or overseas corporate bodies without prior permission of RBI.
- Foreign Institutional Investors (FII) permitted to invest in Indian capital market on registration with SEBI. Common application forms simplified for them and foreign brokers permitted to assist them.
- Over the Counter Exchange of India (OTCEI) commenced operations and a number of shares already listed with it.
- SEBI notified several regulations for intermediaries in the secondary market bringing these intermediaries within regulatory framework for the first time.
- SEBI introduced new reforms in the primary market for improving the disclosure standards, introducing prudential norms and simplifying issue procedures.
- The procedures for lodgement of securities for transfer was considerably eased for domestic and foreign institutional ivestors through the introduction of a 'jumbo' transfer deeds and consolidated payment of stamp duty.
- SEBI inroduced a code of advertisement for public issues for ensuring fair and truthful disclosures.
- SEBI introduced a number of measures for streamlining the functioning of the secondary market, such as reconsitution of the governing boards of the stock exchanges, capital adequacy norms for brokers, and for providing transparency in client/broker relationships.
- National Stock Exchange of India with nationwide stock trading facilities, electronic display, clearing and settlement facilities being set up by financial institutions and banks.

in 1990-91 to 12.50 per cent and that on 20 year maturity was also raised from 11.50 per cent to 12 per cent in 1991-92 (Table 3.12). In 1992-93 the maximum interest rate on dated securities was raised to 12.75 per cent (10 year bonds). In 1993-94, coupon rates based on auctions ranged from 12 per cent on 2 year securities to 13.40 per cent on 9 year securities. Judged in the context of a much lower annual inflation rate in 1992-93 and in 1993-94 so far, these changes mean substantial improvement in the yield on investment in Government debt.

81 For the first time in the current financial year, the Union Government introduced zero coupon bonds in the market for sale by auction. These bonds have no coupon rate and are only sold at a discount. They are redeemable after five years but unlike dated securities they do not require interest payments. While notified amount of these bonds for sale was Rs.3000 crore, 324 bids for an aggregate amount of Rs.6995.34 crore (nominal) were received on January 17, 1994. RBI, therefore, sold bonds worth Rs.3000 crore by partial allotment to bidders who bid for a cut-off price of Rs.53.90 and above. This implies a yield of 12.75 per cent per annum.

TABLE 3.12

Coupon Rates on the Dated Securities issued by the Central Government

(per cent)

Maturity	1990-91	1991-92	1992-93@	1993-94@
1	2	3	4	5
2 year				12.00*
3 Year				12.75*
5 Year	10.50	10.50	12.00	13.00
	10.75			
6 Year			12.30	13.12
7 Year			12,60	13.25
8 Year			12.70	13.31
9 Year				13.40
10 Year	10.75	10.75	12.75	
		11.00		
15 Year	11.25	11.25	11.50	
		12.50		
20 Year	11.50	11.50	12.00	

@ Coupon rates based on auctions, except * Pre-announced.

Institutional Development

82 Since there are no established institutions like DFHI exclusively or mainly engaged in the development of a secondary market for Government securities and PSU bonds, it has been decided to set up Securities Trading Corporation of India to foster the development of a secondary market for these debt instruments. It will have an initial authorised (and paid up) capital of Rs.500 crore and its ownership could be broad-based to include RBI, commercial banks, co-operative banks, financial institutions, mutual funds and public sector units. The Corporation can also hold short term money market assets like treasury bills as part of its liquidity management.

83 Initiatives taken by the RBI for the development of secondary market for Government debt instruments, include a new refinance facility and Repo auctions. The "Government Security Refinance Facility" will allow banks to borrow from RBI against the collateral of Govternment securities. This facility will be limited to their excess holding of Government securities over SLR requirements. Short duration repurchase obligation auction (Repos) for sale of Govt. dated securities from RBI's portfolio was introduced in December 1992.

Credit Rating Agencies

84 Credit rating has assumed great importance for individual investors, brokers and financial advisers with the expansion of money, Government security and equity markets. Credit Rating and Information Services of India Limited (CRISIL) has rated over 750 debt instruments issued by 557 companies. It has started rating the debt instruments of banks, and has already rated four public sector banks and one private sector bank, and of IDBI, Exim Bank, SIDBI and SFCs. This is being extended to rating of debentures, fixed deposits and commercial paper. Investment Information and Credit Rating Agency of India Limited (ICRA) also rates long term (e.g. debentures, bonds and preference shares), medium term (e.g. fixed deposit) and short term (e.g. commercial paper) instruments. Cumulatively till end December 1993, ICRA has rated 236 debt instruments of manufacturing and finance companies involving Rs.11049 crore.

85 A new credit rating agency for individual credit viz., ONIDA Individual Credit Rating Agency of India Limited (ONICRA), was launched in November 1993. It will assess the creditworthiness of individuals seeking finance for purchase of consumer durables or trade credits. IDBI has also recently set up in collaboration with some banks and financial service companies, a credit rating organisation viz. Credit Analysis and Research Limited.

Developments in the Capital Market

86 The reform measures initiated in the capital market over the past two years, starting with the conferring of statutory status on the Securities and Exchange Board of India (SEBI), repeal of Capital Issues Control Act and the abolition of the office of the Controller of Capital Issues, have brought about significant improvement in the functional and regulatory efficiency of the market. Steps taken by SEBI for establishing a fair, transparent and a strong regulatory structure for the efficient functioning of the capital market and protecting the interests of the investors have helped in developing the capital market on healthy lines and will, in due course, bring the functioning of the domestic capital market up to international standards.

Market Regulations

87 Rules/regulations have been notified by SEBI under the SEBI Act, for regulating intermediaries in the securities market, namely, merchant bankers, brokers and sub-brokers, portfolio managers, underwriters, registrars and share transfer agents. These intermediaries have been brought into the regulatory purview for the first time and would now have to adhere to specific capital adequacy norms, meet certain eligibility criteria and abide by a code of conduct which specify a high degree of responsibility toward investors. The regulations also lay down the responsibilities and obligations of these intermediaries and provide for action by SEBI in case of default.

Primary Market Reforms

88 SEBI has initiated further reforms in the primary market. The objective is to strengthen the standards of disclosure, introduce certain prudential norms for the issuers and intermediaries, and remove the inadequacies and systemic deficiencies in the issue procedures. Among the steps taken are the following: (a) The minimum percentage of securities to be issued to the public, for the purpose of listing of securities, was reduced from 60 per cent to 25 per cent through an ammendment of the Securities Contract (Regulation) Rules, 1957; (b) An advertisement code was laid down to ensure that the advertisements are fair and do not contain statements to mislead the investors; (c) Allotment procedures were revised to introduce the requirement that shares be alloted on a pro-rata basis, raise the minimum amount of application money for public and rights issues to Rs.5000 and on par issues from 100 to 500 shares, allow mutual funds and Foreign Insitutional Investors (FIIs) to apply for firm allotment in public issues and reduce the number of collection centres to a minimum of 30; (d) A system of appointing SEBI representatives to supervise the allotment process was introduced to minimise malpractices in allotment of oversubscribed public issues; (e) prudential norms were introduced for rights issues; and (f) Public sector bonds were brought under the regulatory authority of SEBI (Box 3.3).

Mutual Funds

89 SEBI has notified the regulations for mutual funds. For the first time mutual funds are governed by a uniform set of regulations which require them to be formed as trusts and managed by a separate asset management company (AMC) and supervised by a board of trustees or trustee company. SEBI (Mutual Fund) regulations provide for arms length relationship between the various constituents of the mutual fund and thus bring about a structural change which will ensure qualitative improvement in the functioning of the mutual funds. The regulations lay down certain eligibility criteria for the sponsors of mutual funds and require that the AMCs have a minimum net worth of Rs.6 crores of which the sponsors must contribute at least 40 per cent. The SEBI (Mutual Fund) Regulations also provide for an approval of the offer documents of schemes by SEBI. The Regulations prescribe minimum amount to be raised by each scheme. A close ended scheme with a fixed size of mutual fund must raise a minumum of Rs.20 crore and open ended scheme of Rs.50 crore . The entire subscription amount must be refunded within six weeks of the closure of the scheme in case the amount collected by the scheme falls short of the prescribed amount. There will also be certain investment restrictions for AMCs. The advertisement code prescribes norms for fair and truthful disclosure by the mutual funds in advertisements and publicity materials. The Regulations are intended to ensure that the mutual funds grow on healthy lines and investors' interests are protected.

90 Twenty private sector sponsors have been given approval by SEBI to set up mutual funds. In accordance with the regulations, these sponsors are now in the process of setting up separate asset management companies, trustee companies, and appointing independent custodians. Some of them have completed these formalities and set up the mutual funds and also launched schemes after approval of the offer documents by SEBI. The existing mutual funds have also restructured the funds in accordance with the regulations. Since the notification of the Regulations by SEBI, there has ben visible improvement in the disclosure standards of the mutual funds.

Secondary Markets and Intermediaries

91 To bring about greater transparency in transactions, SEBI has made it mandatory for brokers to maintain separate accounts for their clients and for themselves. They must disclose the transaction price and brokerage separately in the contract notes issued to their clients. They must also have their books audited and audit reports filed with SEBI.

92 SEBI has issued directives to the stock exchanges to ensure that contract notes are issued by brokers to clients within 24 hours of the execution of the contract. Exchanges are to see that time limits for payment of sale proceeds and deliveries by brokers and payment of margins by clients to brokers are complied with. For ensuring the fulfilment of deals (safety of the trades) in the market and protecting investors SEBI has introduced capital adequacy norms for brokers. This will ensure that member firms are adequately capitalised in relation to their outstanding position. The norms prescribe a base minimum capital plus additional capial related to volume of business. The exchanges are amending their bye-laws to incorporate the capital adequacy norms.

93 Through an order under the Securities Contracts (Regulation) Act, 1956, SEBI has directed the stock exchanges to broad-base their governing boards and change the composition of their arbitration, default and disciplinary committees. The broad basing of the governing boards of the stock exchanges would help them function with greater degree of autonomy and independence so that they become truly self regulatory organisations. Elected stock broker directors must be equally balanced by Government or SEBI nominees on the board. Similarly, representation of stock broker directors has to be limited to 40 per cent on the disciplinary committee. Inspection of stock exchanges, commenced by SEBI in July, 1992-93 continued during 1993-94. 14 stock exchanges including those of Bombay and Calcutta have been inspected. Besides enquiries were ordered into the affairs of the governing boards of two of the stock exchanges by SEBI in exercise of its powers vested under the Securities (Contract) Regulations Act, 1956.

94 Apart from the above measures taken by SEBI for improvement in the regulatory standards of the securities market, it is also contemplating other steps for market development which include reducing the settlement cycles, encouraging the setting up of depositories institutions and developing the market infrastructure.

Market and Institutional Development

95 As part of its effort at institutional and market development, RBI has issued guidelines to banks for providing financial support to market makers (who make a commitment to quote buying and selling prices and to purchase and sell at these prices) for scrips in various stock exchanges. Market makers are approved by SEBI based on the recommendations of the stock exchanges. The introduction of market makers will improve liquidity of scrips and benefit investors.

96 Recognition has been accorded by Government to the National Stock Exchange of India Ltd (NSEI), being set up by financial institutions and banks (with IDBI as the nodal agency). As a model exchange, it is expected to move rapidly towards a nation-wide electronic screen based "scripless" and "floorless" trading system in securities which will be both efficient and transparent and offer equal and nation-wide access to investors. It will operate in two different segments, viz., Wholesale Debt Market (WDM) and capital market (CM), the first to be concerned with trading in instruments like Government Securities, PSU bonds, Units 64 of UTI, CDs and CPs by corporate entities (like banks, institutions, brokerage houses) and the second with equity and corporate debt instruments by both corporate entities and individuals. It will encourage high net worth corporate trading members with dealer network and short settlement cycles. The WDM segment to be launched first is in advanced stage of installation of the operational systems. The trading systems for the capital market of the NSEI is proposed to be launched in the second stage.

97 The Over the Counter Exchange of India (OTCEI), Bombay started its operations in September, 1992 and sixteen companies have already been listed with it. Regional windows have been opened at Delhi and Madras, besides representative offices have been opened in 18 major cities throughout the country.

Foreign Institutional Investors (FIIs)

98 With a view to facilitating the entry of Foreign Institutional Investors (FIIs) into the country SEBI has simplified the common application forms. The entry of FIIs is also to be facilitated by increasing the role of foreign brokers in the transactions of FIIs. Foreign brokers will be allowed to assist FIIs and operate on their behalf by transmitting orders to buy or sell securities to members of the Indian stock exchanges. These foreign brokers have been permitted to open bank and custodial accounts for this purpose. Government have also allowed some foreign firms to set up joint ventures in the financial sector.

99 There has been a continuous increase in the number of FIIs registered with SEBI and in the volume of investments effected by them in India. Till the middle of January 1994, SEBI had registered 134 FIIs who have 175 broad based institutional funds under them which have also been approved for investment in the market. About US $ 1 billion have already beeen invested by these FIIs. The size of the inflow of investment funds and the increase in the number of FIIs registered in India are indicative of the growing confidence of the international investing community in Indian markets and their regulatory mechanism. The short term capital gains of FIIs will be taxed at the rate of 30 per cent while long term capital gains are taxed at 10 per cent. This will guard against volatility in fund flows. Dividend payments will be subject to a tax rate of 20 per cent.

Globalising Indian Equity

100 Another important trend in the market has been the increase in the number of Indian companies accessing the international capital markets. Upto the end of December 1993, twelve companies accessed the international capital market and have raised about US $ 900 million as against US $ 240 million raised during 1992-93 as a whole. They have issued both foreign currency convertibile bonds and ordinary shares through the global depository receipt (GDR) mechanism. Total approvals given for these instruments up to the middle of February 1994 is about US$2.3 billion

New Issues

101 The primary market remained fairly buoyant in 1992-93 despite some setback to investors' confidence consequent upon the exposure of the irregularities in securities transactions and the associated steep fall in share prices. The repeal of the Capital Issues (Control) Act, 1947, the shift to market based pricing of securities, and the quick steps taken by both Government and RBI based on the reports of the Janakiraman Committee, kept the primary market active. During 1992-93, Rs.18690.64 crore were raised through 1016 issues compared to Rs. 5562.53 crore raised through 512 issues during 1991-92. The total number of offer documents vetted by SEBI during 1992-93 was 1236 for raising a total capital of Rs.27194.74 crore. Of these 680 documents were prospectus for public issues aggregating Rs. 11449.86 crore and the balance 556 documents were letters of offer for rights issues aggregating Rs. 15744.18 crore. The momentum in the primary market has been kept up in 1993-94. During the period April-December, 1993, total funds mobilised through equity and debt issues aggregated Rs. 16848 crore, compared to Rs. 13400 crore in the corresponding period of 1992-93.

102 A growing number of companies have been accessing the capital market rather than relying exclusively on loans by banks and DFIs. During the first nine months of 1993-94 the private sector companies mobilised Rs. 7068 crore of debt (convertible and non-convertible debentures). This compares with Rs. 7652 crore of debt raised in the corresponding period of 1992-93. There has, however, been a relative shift from non-convertible to convertible debentures. The debenture market is likely to expand further, with the development of new innovative instruments like floating rate notes, deep discount bonds and hybrid bonds.

103 During the year several major public sector institutions in the banking, infrastructure and power sectors were allowed to go to the market to raise capital through equity and debt instruments. They were also required to follow appropriate disclosure norms in their offer documents.

Behaviour of stock prices

104 The BSE Sensitive Index of ordinary share prices (SENSEX 1978-79=100) which stood at 4285 at the end of March, 1992 came down steeply and touched 2280 by the end of March 1993. The stock markets remained subdued and stock prices ruled low during most part of the year 1992-93, excepting for temporary revival in September, 1992 and February 1993. The subdued trend continued during the first four months of the current financial year. Several factors were responsible for keeping the stock market subdued. These were the resistance of stock brokers to SEBI's call for a wide range of reforms in stock trading and management, the fallout of the irregularities in the trading in securities detected in 1992, social disturbances and their effect on industrial output.

TABLE 3.13

Trends in Selected Stock Market Indicators

Indicators	1992 April	1992 December	1993@ April	1993@ December
1	2	3	4	5
a) Index				
i) SENSEX	4131.01	2535.64	2205.37	3301.55
ii) National Index	1850.94	1162.92	993.63	1589.55
b) Price/Earning Ratio (P/E)				
i) SENSEX*	52.60	31.35	27.36	39.64
ii) National Index#	49.13	29.37	25.14	39.52
c) Average daily turnover (Rs. crore)	672	187	173	438
d) Market Capitalisation (Rs. crore)	278000	205000	176000	305000

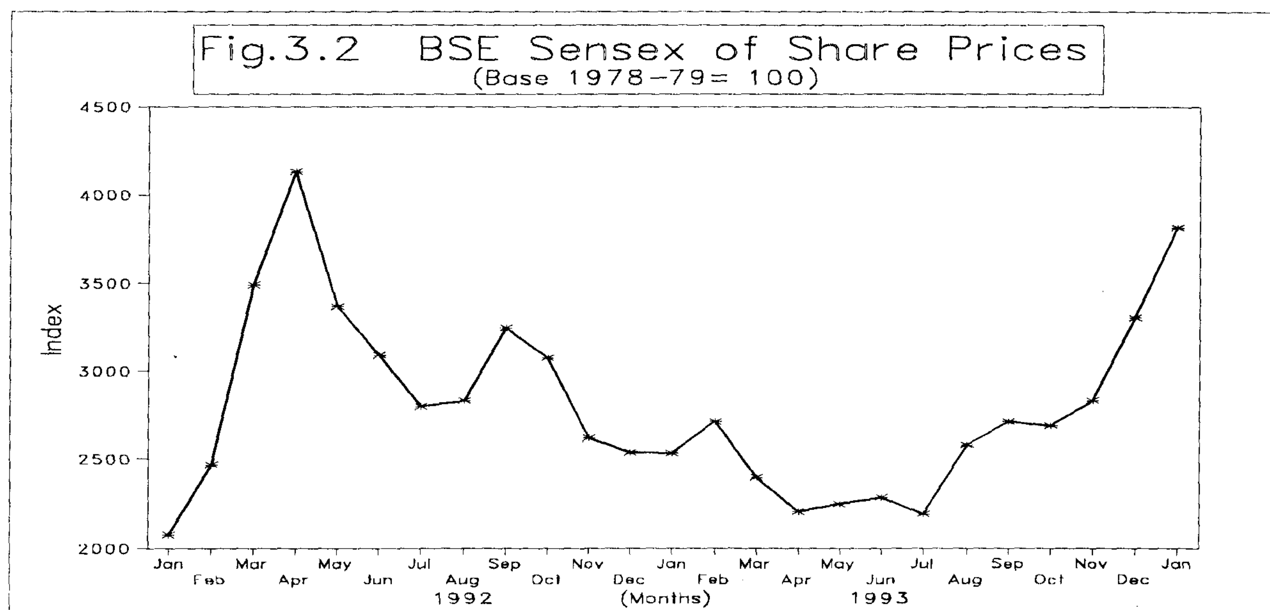
* Monthly average relating to 30 scrips of BSE Sensex

\# Monthly average relating to 100 scrips of BSE National Index.

@ Provisional,as at the end of the month;

105 The downtrend in stock market prices was reversed in August and the index rose steadily thereafter (Fig. 3.2). By the middle of January 1994 the BSE Sensitive Index had climbed to 4020. Price Earnings ratios for the 30 scrips of the BSE Sensitive Index which had declined from 52.60 as at the end of April 1992 to 27.36 by April 1993 had climbed up to 39.64 at the end of December 1993 (table 3.13). The average daily turnover which had come down steeply from Rs. 672 crores in April, 1992 to Rs. 173 crore in April 1993 rose again to Rs. 438 crore by the end of December 1993.

106 The upward trend in share prices triggered concern about possible speculative activity, distorting market behaviour. In this connection, it was felt that the system of trading in 'specified shares' prevalent in the major stock exchanges at Bombay, Ahmedabad, Delhi and Calcutta under which carry-forward of transactions are permitted from one settlement period to another on payment of 'badla' charges may be contributing to overheating. In order to check speculative pressure arising from this mechanism, SEBI issued a directive to these exchanges on December 13, 1993 that henceforth all transactions in securities shall be settled at the end of each settlement by delivery and payment and that the existing carried-over business positions shall be liquidated in a time-bound manner. This decision was taken by SEBI to protect the interests of investors and to enable the determination of the stock prices by buying and selling of securities for delivery and payment. As a result of this intervention, there



was a progressive reduction in the outstanding positions over a period of time and a distinct increase in the proportion of transactions for ready delivery.

107 Despite the reduction in outstanding positions and the increase in transactions for ready delivery the BSE Sensitive Index continued to rise upto mid-January when it reached 4020 after which it has fluctuated around this level. It is difficult to ascribe particular reasons for short term movements in stock market prices since these are affected by several factors including underlying perceptions about the economy, expectations about the future and also speculation. There were, however, some identifiable reasons for the pressure on prices. Investment demand from Foreign Institutional Investors was clearly one factor, adding to buoyancy in the markets. This was particularly evident after October, 1993 when there was an increase in the flow of FII funds. There was also perhaps a shortage of scrips compared to demand because many leading Indian companies opted for GDR issues abroad which would otherwise have added to scrips available in the domestic capital markets. The entry of public sector equity in the market on account of disinvestment was also delayed and this may also have contributed to the shortage of scrips. Developments in the capital market are kept under close review by SEBI to ensure that existing rules are being fully observed.

Report of the Joint Parliamentary Committee

108 Joint Parliamentary Committee (JPC) which was set up in August 1992 to enquire into all aspects of the Securities scam (i.e., irregularities in securities and banking transactions) and to make suggestions about future reforms of the system, submitted its report to Parliament on December 21, 1993. The report presents an assessment of the factors which led to the securities irregularities detected in early 1992 and makes a number of important recommendations. The report was discussed in both Houses of Parliament on December 29 and 30, 1993. The report is under examination and the response of the Government and the action taken or proposed to be taken on various recommendations made by the Committee will be reported to Parliament.

Insurance Reforms

109 A committee was appointed in April 1993 by the Ministry of Finance under the Chairmanship of Shri R.N. Malhotra, former Governor of Reserve Bank of India to study the working of Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC) and its four subsidiaries and the insurance business as a whole and to make recommendations for reforms in the insurance sector in line with ongoing reforms in other parts of the financial sector viz. banking and capital market. The Committee has submitted its report on January 7, 1994. Some important recommendations made by the Committee in this report are presented in Box No. 3.4

Outlook

110 Significant steps have been taken in the field of financial sector reforms. These seek to develop a strong, competitive and vibrant financial sector operating on sound commercial principles and within a good, transparent regulatory framework. The reforms must continue in full swing. Banks have to be cleared of bad debts and their financial strength and profitability improved through better management, efficient customer services and prudent investment policies. Similarly, reliance of the Government on captive financial institutions for mobilisation of

BOX 3.4

RECOMMENDATIONS OF THE COMMITTEE ON THE REFORMS IN THE INSURANCE SECTOR

- Private sector be permitted to enter insurance industry with a minimum paid up capital of Rs.100 crore.
- Foreign insurance companies be allowed to enter by floating an Indian company perferably a joint venture with Indian partners.
- State level cooperatives be enabled to set up cooperative societies not more than one in a State for transacting life insurance business subject to regulation by the insurance regulatory authority. Their capital base should be appropriately lower.
- Postal life insurance be permitted to transact life insurance business in rural areas among the general public. It should be suitably strengthened.
- The Office of Controller of Insurance be restored its full functions under the Insurance Act and set up as a separate office.
- States be initiated to set up a strong and effective insurance regulatory authority in the form of a statutory autonomous board on the lines of SEBI.
- Life Insurance Corporation of India (LIC) be converted into a company and its capital should be raised to Rs.200 crore, 50 per cent to be owned by Government and the rest by public at large with suitable reservation for its employees.
- Capital of General Insurance Corporation of India (GIC) be also raised to Rs.200 crore, 50 per cent to be owned by Government and the rest by public at large with suitable reservation for its employees.
- LIC be fully restructured. Its central office should be a compact and highly professionalised establishment concentrating on policy formulation, investment, product development, actuarial valuation, personnel policy and accounts of the Corporation.
- Zonal Offices of LIC be converted into its Head Offices for insurance business and related matters in their jurisdictions and zonal managers be made members of LIC board.
- GIC to function exclusively as a reinsurance company and as Indian reinsurer under the Insurance Act.
- Four subsidiaries be fully delinked from GIC by acquistion of entire stock in each of them by the Government.
- Capital of each subsidiary be thereafter raised to Rs.100 crore, with 50 per cent equity held by Government and rest by public at large with suitable reservation for concerned employees.
- Tariff Advisory Committee (TAC) be delinked from GIC to functiön as a separate statutory body under necessary supervision by the insurance regulatory authority.
- Landless Agricultural Labourers Group Insurance (LALGI) and Integrated Rural Development Programme (IRDP) beneficiaries schemes, Personal Accident and Social Security (PASS) and Hut Insurance schemes of genral insurance which are relief oriented welfare schemes be transferred to the concerned Government authorities.
- All insurance companies be treated on equal footing and governed by the provisions of the Insurance Act. No special dispensation to be given to LIC, GIC and its four subsidiaries.

resources has to come down progressively. It must give way to a regime in which both Government and the commercial sector enter the market and raise resources at competitive rates.

111 The fiscal developments in 1993-94 and their impact on the monetary sector have again brought home the importance of reduced fiscal and monetised deficits in making larger resources available for productive purposes, at reasonable interest rates. Further cuts in fiscal deficit through both containment of expenditure and more efficient mobilisation of resources are essential for this purpose. A reduction of fiscal deficits will also facilitate financial reform, by eliminating any residual risk of a high interest-fiscal deficit spiral. It is not, however, a pre-requisite for institutional development of primary and secondary markets for Government securities and a range of debt instruments. A smooth transition from a plethora of detailed controls to a regime in which financial agents build strong internal control mechanisms and are subject to sound prudential regulations, and the authorities use market based instruments for monetary control and credit management is desirable.

112 An important new challenge the monetary policy may face for the first time in recent history is to manage the monetary effects of large external capital inflows. In 1991-92 foreign exchange inflows added about Rs. 11000 crore to reserve money and in 1993-94 this increase may be of the order of Rs. 16000 crore. The contribution is likely to increase next year, and we must be prepared to meet this challenge.