3

Monetary and Banking Developments

After a growth of 7.5 per cent and inflation of 5 per cent in the previous year, 2005-06 started with signs of a growth rebound accompanied by some inflationary pressures stemming from hardening petroleum and primary product prices in the international markets. Recognising the emerging trend, the Reserve Bank of India (RBI), in April 2005, in its Annual Policy Statement for the year 2005-06, identified the need for assuring appropriate liquidity in the system and at the same time for pursuing polices for macroeconomic stability to facilitate growth. Furthermore, in the liberalised financial sector, banks and other financial institutions are now designing new products at competitive prices, which have transformed the operating framework. Recognising the greater systemic risks, RBI has initiated a series of regulatory and supervisory measures in tune with the best international practices to strengthen and safeguard the monetary framework.

3.2 In 2004-05, the higher demand for bank credit induced by a robust performance of the industrial and the services sectors resulted in a 13.3 per cent increase in net domestic credit from the banking system from Rs. 17,59,053 crore at end-March 2004 to Rs.19, 93,371 crore at end-March 2005. The Annual Policy Statement of the RBI in April 2005 projected GDP growth at 7.0 per cent and the rate of inflation in the range of 5.0-5.5 per cent for 2005-06. Consistent with this, broad money (M_3) was projected to grow at 14.5 per cent during 2005-06. Monetary developments during 2005-06 so far have been characterised by (i) rapid increase in credit, (ii) reduction in SLR investments by banks to meet rising non-food credit demand, (iii) slow down in accretion of foreign exchange reserves and hence net foreign assets of the banking system, and (iv) higher international commodity and crude oil prices influencing expectations about the impact on domestic inflation. Accordingly, the monetary policy stance calibrated the extent of operations of Market Stabilisation Scheme (MSS), as well as the Liquidity Adjustment Facility (LAF) through reverse repo/repo operations and introduction of second LAF to modulate liquidity in the system. With prudent monetary management, the redemption of India Millennium Deposits (IMDs) by the State Bank of India in end-December 2005 could go through smoothly. Owing to the timely and apposite initiatives, the liquidity and interest rates in the system have continued to catalyse growth.

3.3 The upbeat growth trend of 8.1 per cent in the first half of 2005-06 has been reflected in a steady increase of 17.5 per cent in net domestic credit from the banking system from Rs.19,84,330 crore on January 21, 2005 to Rs. 23,32,326 crore on January 20, 2006. The growth in net domestic credit during the current financial year up to January 20, 2006 was 14.4 per cent. The steady expansion in net domestic credit contributed as much as 15.9 percentage points to the overall increase in M_3 (year–on-year) on January 20, 2006. The year-on-year growth of M_3 at 16.4 per cent was higher than the growth not only of 13.9 per cent last year but also of the RBI-projected 14.5 per cent for the full year in April, 2005. Nevertheless, headline (point to point) inflation declined sharply to 3.3 per cent in the week ended August 27, 2005 from 5.7 per cent for the week ended April 2, 2005. The inflation rate in the week ended January 28, 2006 was 4.3 per cent. Price stability despite a rapid increase in money supply during the current year testified the investment-driven nature of the credit growth and stability of inflation expectations based on confidence in the appropriate stance of monetary and fiscal policies.

Monetary trends and developments

Broad money (M_3)

3.4 Growth in M_3 of 12.2 per cent at end-March 2005 was lower than both the 14.0 per cent projected by the RBI in its Annual Policy Statement for 2004-05 and 16.7 per cent at end-March 2004. Growth in all the three components of M_3 – currency with the public, demand deposits and time deposits with banks – was lower at end-March 2005 (13.0 per cent, 9.8 per cent and 12.4 per cent, respectively) than at end-March 2004 (16.0 per cent, 30.1 per cent and 14.7 per cent, respectively). However, relative to the previous year, growth in sources of M_3 displayed some diversity with net domestic credit growing faster (13.3 per cent compared to 11.7 per cent during 2003-04) and net foreign exchange assets (NFA) of the banking sector growing slower (23.3 per cent compared to 33.7 per cent during 2003-04). Much of the net domestic credit expansion in 2004-05 was from growth in bank credit to the commercial sector (22.8 per cent) while net bank credit to government increased by only 0.4 per cent. (Table 3.1)

3.5 The deceleration in money supply growth observed in 2004-05 appears to have been reversed in the current year. M_3 in 2005-06 up to January 20, 2006 grew at a much higher 13.2 per cent as compared to 9.2 per cent observed in the corresponding period of the previous year. The year-on-year growth of M_3 at 16.4 per cent on January 20, 2006 was not only higher than the projected growth of 14.5 per cent in RBI's Annual Policy Statement for 2005-06, but also higher than the rate observed a year ago. In the current financial year up to January 20, 2006, the three main components of M_3 – currency with the public, demand deposits and time deposits with banks – grew by 13.5 per cent, 17.7 per cent and 12.5 per cent, respectively, which were significantly higher than the growth observed during the same period of the previous year. Strong industrial performance and overall higher business confidence index have led to higher demand for the bank credit during the current financial year. During 2005-06, bank credit to commercial sector has continued to remain the main source of growth of M_3; from a high base of Rs. 12,80,539 crore (inclusive of conversion of IDBI into bank) at end-March 2005, it grew 21.2 per cent to Rs.15, 52,471 crore on January 20, 2006. On the other hand, outstanding net bank credit to government increased to Rs 7,79,855 crore on January 20, 2006 from Rs. 7,57,905 crore (inclusive of conversion of IDBI into bank) at end-March 2005. The other main source of M_3 – NFA of the banking sector – grew at a much slower rate of 0.4 per cent during the current financial year so far up to January 20, 2006 compared to 13.9 per cent observed during the corresponding period of the previous year owing to the widening of the current account balance and slow down in capital inflows. (Table 3.1)

3.6 In terms of annual average growth, the historic trend of M_3 growing at a marginally higher rate than GDP at current prices appears to have continued in the recent past. The velocity of money came down from 1.48 in 2003-04 to 1.47 in 2004-05, and is likely to have gone down further.

Reserve money (M_0)

3.7 Growth in reserve money (M_0) decelerated from 18.3 per cent during 2003-04 to 12.1 per cent during 2004-05 reflecting a deceleration in the growth of the main source of M_0, namely NFA of the RBI, from 35.2 per cent at end-March 2004 to 26.5 per cent at end-March 2005. Nevertheless, NFA flow at Rs. 1,28,377 crore was significantly high. The accretion to NFA of the RBI during 2004-05 also led to a further rise in the NFA to M_0 ratio from 111.0 per cent at end-March 2004 to 125.3 per cent at end-March, 2005. The year 2004-05 was also characterised by extensive use of MSS and LAF operations by the RBI, with the outstanding balances under the two

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

Items	Outstanding balances as on March 31, 2005 (net)	Outstanding balances as on Jan. 20, 2006	Variations during Mar. 31 2004 to Mar. 31 2005	Mar. 31 2004 to Jan. 21 2005	Mar. 31 2005 to Jan. 20 2006	Jan. 23 2004 to Jan. 21 2005	Jan. 21 2005 to Jan. 20 2006	Mar. 31 2004 to Mar. 31 2005	Mar. 31 2004 to Jan. 21 2005	Mar. 31 2005 to Jan. 20 2006	Jan. 23 2004 to Jan. 21 2005	Jan. 21 2005 to Jan. 20 2006
1	2	3	4	5	6	7	8	9	10	11	12	13
			Rs. crore					*Percent*				
I. M_1 (Narrow Money)	646263	742752	67547	37516	96489	87511	126520	11.7	6.5	14.9	16.6	20.5
II. M_3 (Broad Money) (1+2+3+4)	2250425	2551911	244749	184012	297973	266992	358710	12.2	9.2	13.2	13.9	16.4
1. Currency with the public	355768	403925	40797	32030	48157	40974	56924	13.0	10.2	13.5	13.4	16.4
2. Demand deposits with banks	284017	334180	25391	5095	50163	44491	70459	9.8	2.0	17.7	20.3	26.7
3. Time deposits with banks	1604162	1809159	177202	146496	201484	179481	232190	12.4	10.3	12.5	12.9	14.7
4. "Other" deposits with RBI	6478	4647	1359	391	-1831	2046	-863	26.5	7.6	-28.3	59.1	-15.7
III. Sources of change in money stock (M_3)												
1. Net bank credit to Governemnt (A+B)	745713	779855	2809	7157	21950	25790	17601	0.4	1.0	2.9	3.6	2.3
A. RBI's net credit to Govenent	-17975	27323	-62883	-30719	45298	-38222	13134	-	-	-	-	-
(i) Central Government	-23258	27364	-60178	-25897	50622	-37277	16341	-	-	-	-	-
(ii) State Governments	5283	-41	-2705	-4822	-5324	-945	-3207	-	-	-	-	-
B. Other banks credit to Government	763688	752532	65692	37876	-23348	64012	4467	9.4	5.4	-3.0	9.5	0.6
2. Bank credit to commercial sector (A+B)	1247658	1552471	231508	173046	271931	220896	330393	22.8	17.0	21.2	22.8	27.0
A. RBI's credit to commercial sector	1390	2339	-671	-172	949	-175	450	-32.6	-8.3	68.3	-8.5	23.8
B. Other banks' credit to commercial sector	1246268	1550132	232179	173218	270982	221071	329943	22.9	17.1	21.2	22.9	27.0
3. Net foreign exchange assets of the banking sector	649255	651754	122669	72966	2499	95765	52202	23.3	13.9	0.4	19.0	8.7
4. Government's currency liabilities to the public	7448	8618	152	140	1170	155	1182	2.1	1.9	15.7	2.1	15.9
5. Banking sector's net non- monetary liabilities other than time deposits	441210	440786	153949	110856	-424	117176	42669	53.6	38.6	-0.1	41.7	10.7
Memorandum Items												
1. Money multiplier (M_3/M_0)	4.61	4.77	-	-	-	-	-	-	-	-	-	-
2. Velocity of money	1.47	-	-	-	-	-	-	-	-	-	-	-
3. Net domestic assets	1601170	1900157	122080	111046	295474	171227	306508	8.3	7.5	18.4	12.1	19.2
4. Net domestic credit	1993371	2332326	234317	180203	293881	246686	347994	13.3	10.2	14.4	14.6	17.5

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

2. Outstanding balances as on March 31, 2005 are net of conversion of IDBI into bank.

Table 3. 2 : Components and sources of reserve money

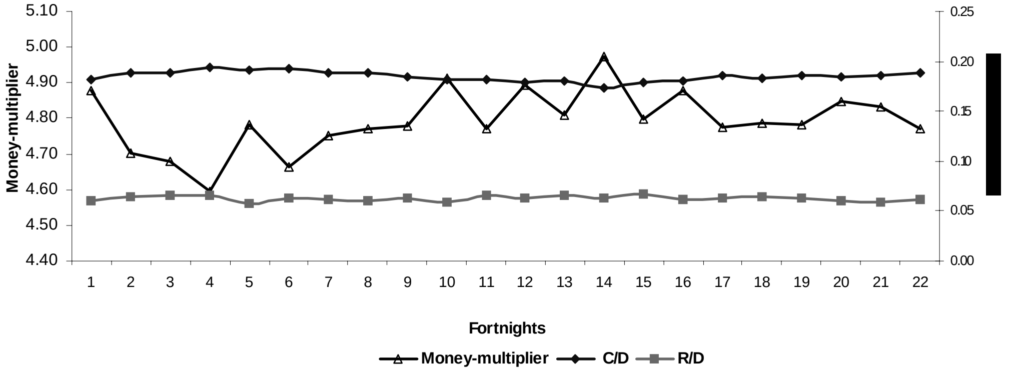
Items	Outstanding balances as on		Variations during					Percentage variations				
	March 31, 2005	Jan. 20, 2006	2004-05	Financial year so far 2004-05	Financial year so far 2005-06	Year-on-year 2004-05	Year-on-year 2005-06	Full Year 2004-05	Financial year so far 2004-05	Financial year so far 2005-06	Year-on-year 2004-05	Year-on-year 2005-06
1	2	3	4	5	6	7	8	9	10	11	12	13
	Rs. Crore							Per cent				
Reserve Money	489135	534963	52623	29219	45828	61628	69232	12.1	6.7	9.4	15.3	14.9
A: Components												
a. Currency in circulation	368661	417189	41633	30966	48528	41612	59195	12.7	9.5	13.2	13.2	16.5
b. Bankers' deposits with RBI	113996	113127	9631	-2138	-869	17970	10900	9.2	-2.0	-0.8	21.3	10.7
c. "Other" deposits with RBI	6478	4647	1359	391	-1831	2046	-863	26.5	7.6	-28.3	59.1	-15.7
B: Sources												
1. Net RBI credit to Government	-17975	27323	-62882	-30720	45298	-38222	13136	-	-	-	-	-
2. RBI credit to banks	5258	6084	-162	814	826	2677	-150	-3.0	15.0	15.7	75.3	-2.4
3. RBI credit to commercial sector	1389	2339	-672	-172	950	-175	450	-32.6	-8.3	68.4	-8.5	23.8
4. Net foreign exchange assets of RBI	612790	614833	128377	75930	2043	87448	54490	26.5	15.7	0.3	18.5	9.7
5. Government's currency liablities to the public	7448	8618	152	140	1170	155	1182	2.1	1.9	15.7	2.1	15.9
6. Net non-monetray liabilities of RBI	119776	124235	12191	16775	4459	-9745	-125	11.3	15.6	3.7	-7.3	-0.1
Memo items:												
1. Net domestic assets of RBI	-123655	-79870	-75754	-46711	43785	-25820	14742	158.1	97.5	-35.4	37.5	-15.6
2. Net domestic credit by RBI	-11328	35746	-63716	-30528	47074	-35720	13886	-121.6	-58.3	-415.6	-62.0	63.5

(LAF net of repo and reverse repo) on March 31, 2005 at Rs. 64,211 crore and Rs. 19,330 crore, respectively. With these operations, absolute increase in the M_0 stock during 2004-05 was lower at Rs. 52,623 crore compared to Rs. 67,451 crore during 2003-04. As a proportion of currency in circulation, NFA of the RBI increased from 148.1 per cent on March 31, 2004 to 166.2 per cent on March 31, 2005.

3.8 In sharp contrast to the deceleration observed in the previous year, in the current financial year 2005-06 up to January 20, 2006, M_0 growth accelerated to 9.4 per cent from 6.7 per cent observed during the corresponding period of the previous year. However, on a year-on-year basis, M_0 growth at 14.9 per cent on January 20, 2006 was lower than 15.3 per cent observed on the corresponding date of 2005. In 2005-06, in spite of the deceleration of the growth of NFA of the RBI – on both financial year and year-on-year basis – it continued to dominate growth of M_0 in terms of its contribution: it contributed 11.7 percentage points to the overall 14.9 per cent growth of M_0. (Table 3.2)

3.9 The money-multiplier (the ratio of M_3 to M_0) rose from 4.59 at end-March 2004 to 4.61 at end-March 2005 and further to 4.77 on January 20, 2006. However, the money-

Fig. 3.1 **Trends in Money Multiplier, Currency-Deposit Ratio and Reserve-Deposit Ratio**



multiplier on January 20, 2006 was still marginally higher than 4.71 observed a year ago. During the current financial year, among the components of money multiplier as on January 20, 2006, the currency-deposit ratio remained stable at 0.188 which was observed a year ago suggesting no change in public preference for deposits or currency on these two dates, while the reserve-deposit ratio was lower at 0.061 than 0.064 observed on the corresponding date of last year and was still higher than the required level under CRR.

Liquidity management

3.10 During the current financial year, a considerable slow down in reserve inflows through the external balance of payments has been observed. The increase in NFA of the banking sector during April1, 2005 -January 20, 2006 at Rs. 2,499 crore was substantially lower than the increase of Rs. 72,966 crore observed during the corresponding period of the previous year. The lower order of increase in NFA largely reflected the redemption of IMDs in December, 2005. Concomitantly, the outstanding balances under MSS, which reflect the RBI's efforts to sterilise excessive and disorderly reserve inflows, after rising from Rs. 64,211 crore at end-March 2005 to Rs. 78,908 crore in September 2005, fell to Rs. 34,852 crore on February 3, 2006.

3.11 The amounts absorbed by the RBI through the LAF operations reflected the liquidity conditions in the system. From a level of Rs. 19,330 crore on March 31, 2005, the outstanding amount under LAF reverse repos increased to Rs. 38,930 crore on April 1, 2005 and further to Rs. 51,390 crore on September 5, 2005. Thereafter, it declined over the period. In the context of the redemption of IMDs, the RBI also injected liquidity during December 2005 and January 2006 through repo operations. In order to assuage the liquidity conditions, auctions of Treasury Bills (TBs) under MSS were cancelled effective November 6, 2005. Moreover, to fine-tune the management of liquidity and in response to suggestions from the market participants, the RBI introduced a Second Liquidity Adjustment Facility (SLAF) effective November 28, 2005. First LAF operations are conducted in the forenoon between 9.30 a.m. and 10.30 a.m. and SLAF are conducted on all working days except Saturday between 3.00 p.m. and 3.45 p.m. On a review of the macroeconomic, monetary and liquidity conditions, including the redemptions of IMDs, the RBI decided on December 30, 2005 to suspend the issue of TBs and dated securities under MSS. However, within the overall MSS ceiling for 2005-06, the RBI would retain the flexibility of conducting auctions under MSS from time to time with sufficient notice to the market, in response to evolving liquidity conditions in the system. As on February 3, 2006 the outstanding reverse-repo amount was Rs. 2,505 crore while that under repo was Rs. 5,115 crore.

3.12 Absorption of excess liquidity under reverse-repo (LAF) and MSS came down substantially from about Rs. 83,500 crore (3.7 per cent of M_3) on March 31, 2005 to Rs. 40,178 crore (1.6 per cent of M_3) on January 20, 2006. However, from mid-December 2005, signs of liquidity tightening were observed, partly on account of redemption of IMDs of the State Bank of India on December 29, 2005. Total outgo under IMDs redemption was about Rs. 32,000 crore. To address the build up of the tightening of liquidity, the RBI responded by injecting liquidity through repo operations (daily average) injection of Rs. 25,131 crore during December 26, 2005 - January 2, 2006 and again Rs. 19,939 crore during January 9, 2006 to February 2, 2006.

3.13 The emergent liquidity scenario also reflected the rapid increase in the bank credit to the commercial sector during the current financial year. The banking system, despite higher growth rate of deposits, also took recourse to augmenting liquidity through other means like borrowings to fund the increased demand for credit.

Monetary and credit policy

3.14 In its Annual Policy Statement for 2005-06, the RBI delineated the objectives of its monetary and credit policy stance as (i) provision of appropriate liquidity to meet credit growth and support investment and export demand in the economy while placing equal emphasis on price stability; (ii) consistent with the above, pursuit of an interest rate environment conducive to macroeconomic and price stability, and maintaining the momentum of growth; and (iii) consideration of measures in a calibrated manner, in response to evolving circumstances with a view to stabilising inflationary expectations. After the announcement of the Annual Policy Statement for 2005-06 on April 28, 2005, the fixed reverse-repo rate was raised by 25 basis points to 5.0 per cent with effect from April 29, 2005. The Annual Policy Statement 2005-06 also stated that effective and vibrant communication with the economic agents would be improved through quarterly reviews of the annual statement. The first quarterly review was released in July 2005. On review of the macroeconomic outlook, the RBI had kept the projections regarding real GDP and rate of inflation unchanged.

3.15 In its Mid-Term Review of the Annual Policy Statement of 2005-06, coinciding with the second quarter review, the RBI on October 25, 2005 reiterated the policy thrust enunciated in April, underscored the need for ensuring an interest rate environment that is conducive to meet genuine credit needs and also support export and investment demand in the economy for maintaining the growth momentum; and the need for maintaining vigil on the price level owing to the rising trend of international crude oil prices. With effect from October 26, 2005, both fixed repo and fixed reverse repo rates under LAF were raised by 25 basis points to 6.25 per cent and 5.25 per cent, respectively. However, the Bank Rate was kept unchanged at 6.0 per cent. RBI also announced several measures for improving the credit delivery mechanism; and strengthening the prudential norms, and structural and regulatory framework for enhancing the robustness of the financial system etc. (Box 3.1)

3.16 On the basis of review of macroeconomic and monetary developments for the purpose of monetary managment, the RBI in the third quarterly review of the Annual Policy Statement 2005-06 (January 24, 2006), had projected real GDP growth for 2005-06 higher in the range of 7.5-8.0 per cent based on the current assessment of a pick up in agricultural output and the momentum in industrial and services sectors, and kept inflation estimate unchanged in the range of 5.0-5.5 per cent. The advance estimates of the real GDP for 2005-06, released by the Central Statistical Organisation (CSO) on February 7, 2006, had placed the growth at 8.1 per cent. M_3 expansion is expected higher than 14.5 per cent as projected in April 2005. Based on growth and inflation expectations, barring the emergence of unexpected sectoral developments in the economy, the overall monetary stance has been articulated in the third quarter review of the Annual Policy Statement 2005-06 as: (a) to maintain the emphasis on price stability with a view to anchoring inflationary expectations; (b) to continue to support export and investment demand in the economy for maintaining the growth momentum by ensuring a conducive interest rate environment by macroeconomic, price and financial stability; and (c) to provide appropriate liquidity to meet genuine credit needs of the economy with due emphasis on quality. Bank Rate has been kept unchanged at 6.0 per cent. Fixed reverse-repo rate was revised upward by 25 basis points to 5.50 per cent with effect from January 24, 2006 and the spread between fixed repo rate and fixed reverse-repo rate was kept at 100 basis points. Accordingly fixed repo rate was placed at 6.50 per cent.

Interest rates

3.17 With the steady increase in credit to the commercial sector in recent times, most of liquidity injection by the RBI at short end of the market is through the fixed repo transactions under LAF. The importance of the Bank Rate, reintroduced in April 1997 to signal monetary policy stance, may have declined. Bank Rate has been kept unchanged at 6.0 per cent since April 2003, while the fixed repo and fixed reverse-repo rates under LAF have undergone several changes.

3.18 Money markets during 2005-06 have been largely marked by comfortable liquidity conditions, with average daily call money rates generally anchored to the reverse repo rate till October 2005. The average weighted call

Box 3.1: Annual Policy Statement for the Year 2005-06

A: Annual Policy Statement for the Year 200 5-06

- Bank rate kept unchanged at 6.0 per cent.
- Fixed Repo Rate under LAF kept unchanged at 6.0 per cent.
- Reverse Repo Rate increased by 25 basis points to 5.00 per cent, from 4.75 per cent.
- Cash Reserve Ratio (CRR) kept unchanged at the present level of 5.00 per cent.
- With effect from the fortnight beginning June 11, 2005, non-bank participants, except PDs, would be allowed to lend, on average in a reporting fortnight, up to 10 per cent of their average daily lending in call/notice money market during 2000-01.
- With effect from August 6, 2005, non-bank participants, except PDs, would be completely phased out from the call/notice money market.
- With effect from the fortnight beginning April 30, 2005, the benchmark for fixing prudential limits on exposures to call/notice money market in the case of scheduled commercial banks would be linked to their capital funds (sum of Tier I and Tier II capital).
- From April 30, 2005, all NDS members are required to report their term money deals on NDS platform.
- The minimum maturity period of certificates of deposit (CDs) reduced from 15 days to 7 days with immediate effect.
- In order to facilitate further deepening of the government securities market, it is proposed to permit sale of government securities allotted in primary issues with and between Constituent's Subsidiary General Ledger CSGL account holders also on the same day.
- It is proposed to raise the ceiling of overseas investment by Indian entities in overseas joint ventures and/ or wholly owned subsidiaries from 100 per cent to 200 per cent of their net worth under the automatic route.
- It is proposed to accord general permission to authorised dealers (ADs) to open foreign currency accounts of the project offices set up in India by foreign companies and operate the accounts flexibly.
- A Working Group was constituted by RBI to evolve guidelines for voluntary merger of banking companies.

B: Mid-term Review of Annual Policy Statement for the year 2005-06

- Bank Rate kept unchanged at 6.0 per cent.
- Reverse Repo Rate increased by 25 basis points to 5.25 per cent, effective October 26, 2005. The spread between reverse repo rate and the repo rate under LAF maintained at 100 basis points.
- The cash reserve ratio (CRR) kept unchanged at 5.0 per cent.
- Screen-based negotiated quote-driven system for call/notice and term money markets and electronic trading platform for market repo operations in government securities are being developed by Clearing Corporation of India Ltd. (CCIL).
- Banks advised to fix their own targets for financing the SME sector.
- A debt restructuring mechanism for units in the SME sector, in line with the corporate debt restructuring (CDR) mechanism prevailing in the banking sector, has been formulated by the Reserve Bank.
- The Micro Finance Development Fund (MFDF) set up in the NABARD re-designated as the Microfinance Development and Equity Fund (MFDEF) and its corpus increased from Rs.100 crore to Rs.200 crore.
- Bank's aggregate capital market exposure restricted to 40 per cent of the net worth of the bank on a solo and consolidated basis; consolidated direct capital market exposure modified to 20 per cent of the bank's consolidated net worth.
- By end-March 2006, 15,000 branches are proposed to be covered by Real Time Gross Settlement System (RTGS) connectivity.
- The National Electronic Funds Transfer (NEFT) system would be implemented in phases for all networked branches of banks all over the country.
- The IBA advised its member banks to announce a benchmark prime lending rate (BPLR), with the approval of their boards.
- An Internal Working Group (Chairman: Shri C. S. Murthy) was set up by the Reserve Bank to review the existing policy on priority sector lending including the segments constituting the priority sector, targets and sub-targets and recommend changes as necessary.
- The Micro Finance Development Fund (MFDF),redesignated as the Micro Finance Development and Equity Fund (MFDEF), increased its corpus from Rs.100 crore to Rs.200 crore.
- In line with international standards, banks were advised to adopt the Standardised Approach for credit risk with effect from March 31, 2007. Banks are required to migrate to the New Capital Adequacy Framework with effect from March 31, 2007.

Table 3.3 : Trends in interest rates

(Per cent per annum)

Interest rate	March 25, 2005		January 21, 2005	January 20, 2006	
Bank rate	6.00		6.00	6.00	
CRR	5.00		5.00	5.00	
IDBI[1]	10.25		10.25	10.25	
BPLR[2]	10.25-10.75		10.25-10.75	10.25-10.75	
Deposits rate[3] (> one year)	5.25-6.25		5.25-6.25	5.25-6.25	
Call money (borrowings)(low/high)	3.85/5.60		2.25/5.25	4.50/7.95	
CDs by SCBs	4.21-6.34	$	3.91-6.26&&	4.40-7.75	&
CPs by companies (at face value)	5.20-7.25	#	5.10-6.30@@	6.65-8.50	@
Fixed repo rates	6.00	#	6.00	6.50	##
Fixed reverse-repo rate	4.75	#	4.75	5.50	##
91 days T-bills	5.37		5.32	6.69	$$
364 days T-bills	5.61		5.77$##	6.30	$#

$ Relates to March 18, 2005. **& Relates to January 6, 2006.**
 # Relates to March 31, 2005, **## Relates to January 27, 2006.**
$$ Relates to January 25, 2006. **@ Relates to January 31, 2006.**
@@ Relates to January 31, 2005. **$# Relates to January 18, 2006.**
&& Relates to January 7, 2005. **$## Relates to January 19, 2006.**

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

money rate was 5.01 per cent during April-October 2005. During the current financial year so far reverse repo rate has been revised upward by 25 basis points on three occasions in April 2005, October 2005 and further in January 2006. The call money rate also edged up accordingly by similar magnitudes. More recently as surplus liquidity was getting unwound, the call money rate has shown a tendency to firm up and traded above the repo rate on a few occasions. During November and December 2005 the average weighted call money rates were 5.79 per cent and 6.0 per cent, respectively, mainly due to advance tax outflows and IMDs redemption pressures.

3.19 Tightened liquidity position resulted in some hardening of yields on short- and medium-term money market instruments. The yield on 10-year benchmark G-sec, on market concerns about the continuous rise in international crude oil prices, rose sharply to 7.31 per cent on April 30, 2005 from 6.65 per cent on March 31, 2005. But with a decline in headline inflation, the yield on 10-year G-sec also started softening to decline to 6.94 per cent on June 1, 2005. However, with inflationary concerns and emerging tightening of liquidity in the system, yield started to rise again and was 7.30 per cent on February 3, 2006.

Banking policy and trends

3.20 Continuing the process of financial reforms for induction of best practices and technological changes, the RBI emphasised transparency, diversification of ownership and strong corporate governance practices to mitigate the prospects of systemic risks in the banking sector. The overall improvement in the efficiency parameters of the scheduled commercial banks (SCBs) reflects the positive response to the policy initiatives and changing business environment.

3.21 In February 2005, the RBI had released a roadmap for entry of foreign banks consistent with WTO commitments. Broadly, the roadmap requires that: (i) ultimate ownership and control should be well diversified; (ii) important shareholders should be 'fit and proper' (as per the guidelines of

February 3, 2004 on acknowledgment for allotment and transfer of shares); (iii) directors and CEO should be 'fit and proper' and should observe sound corporate governance principles (as contained in the June 25, 2004 circular of the RBI); (iv) private sector banks should maintain a minimum capital (initially Rs. 200 crore, with a commitment to increase it to Rs. 300 crore within three years) / net worth (Rs. 300 crore at all times) for optimal operations and for systemic stability; and (v) policy and process should be transparent and fair.

3.22 The guidelines also envisaged that aggregate foreign investment in private banks from all sources cannot exceed 74 per cent of paid-up capital of a bank. If foreign direct investment (FDI), other than by foregin banks or foreign bank groups, in private banks exceeds 5 per cent, then the entity acquiring such stake would have to meet the 'fit and proper' criteria as indicated in the share transfer guidelines and has to obtain the RBI's approval for transfer of the shares. The aggregate limit for all foreign institutional investors' (FIIs) investments are restricted to 24 per cent, which can be raised to 49 per cent with the approval of the board/ shareholders. The current aggregate limit for all non-resident Indians (NRIs) investments is 24 per cent, with the individual NRI limit being 5 per cent, subject to the approval of board/shareholders.

3.23 RBI has also continued to monitor the progress of implementation of the Basel II framework, which is to be operationalised by banks and other financial institutions by March 2007. To enable banks operating in India to acquire Basel II, the Reserve Bank of India on January 25, 2006 issued detailed guidelines, for raising capital funds to meet market as well as credit risks. The Basel II accord 1998 had specified a three-tier capital structure for banks. Tier 1 covers: permanent shareholders' equity; perpetual non-cumulative preference shares; disclosed reserves; and innovative capital instruments. Tier 2 includes: undisclosed reserves; revaluation reserves; general provisions/general loan-loss reserves; hybrid debt capital instruments (a range of instruments which combine characteristics of equity capital and debt); and subordinated term debt. Tier 3 consists of short-term subordinated debt for the sole purpose of meeting a proportion of capital requirements for market risks. The earlier guidelines on capital adequacy norms did not permit banks to raise Tier 3 capital funds and in respect of Tier 1 and Tier 2 capital funds following instruments were also debarred: (a) preference shares-both cumulative and non-cumulative; (b) innovative capital instruments for Tier 1 capital funds; and (c) hybrid debt instruments for Tier 2 capital funds. The present guidelines, subject to the extant legal framework, allow banks to augment their capital funds through the following instruments: 1) innovative perpetual debt instruments eligible for inclusion as Tier 1 capital; 2) debt capital instruments eligible for inclusion as Upper Tier 2 capital; 3) perpetual non-cumulative preference shares eligible for inclusion as Tier 1 capital; and 4) redeemable cumulative preference shares eligible for inclusion as Tier 2 capital. The RBI had also issued detailed guidelines governing the instruments at (1) and (2) above. Guidelines for Items listed at (3) and (4) would be issued shortly.

3.24 The principle governing the dividend payments was further liberalised. For the accounting year ending March 31, 2005, banks were granted general permission to declare dividend subject to the following conditions: (i) their capital to risk weighted assets ratio (CRAR) should have been at least 9 per cent for the preceding two completed years and the accounting year for which it proposes to declare dividend; and (ii) net non-performing assets (NPA) should be less than 7 per cent. If any bank did not fulfil the above CRAR norm but had a CRAR of at least 9 per cent for the accounting year for which it proposed to declare a dividend, it could do so provided its net NPA is less than 5 per cent. The bank is also required to comply with the extant provisions of the Banking Regulation Act 1949 and current regulations/guidelines issued by the RBI. The proposed dividend should be payable out of the current year's profit and the RBI should not have placed any explicit restrictions on the bank for declaration of dividend.

3.25 The RBI issued detailed guidelines for the merger/amalgamation in respect of the private sector banks on May 11, 2005. These guidelines are applicable to merger proposals between two banking entities or between a banking company and non-banking financial company (NBFC); the same governing principles would be applicable, as appropriate, to public sector banks (PSBs) also. The merger of an NBFC with a banking entity would be subject to satisfaction of the Board of the banking entity on certain safeguards such as (a) whether the NBFC has violated/ is likely to violate any of the RBI/ Securities and Exchange Board of India (SEBI) norms and if so, ensure that these norms are complied with before the scheme of amalgamation is approved; (b) the NBFC has complied with the Know Your Customer (KYC) norms for the accounts, which will become accounts of the banking entity after amalgamation; and (iii) if the NBFC has availed of credit facilities from bankers/financial institutions (FIs), then the consent of the banks/FIs concerned for the proposed merger/amalgamation would be needed.

3.26 On a recent review of the flow of bank credit to the housing sector, particularly to land developers and builders, the RBI found that the majority of banks were not complying with the prescribed control mechanism for managing the risks involved in such transactions. Hence, the RBI, on June 29, 2005, issued a set of instructions for the banks stipulating, among other things, the adoption of Board-mandated policy in respect of their real estate exposure. As per the policy, it is expected that due attention would be paid to exposure limits, collaterals to be considered, margins to be kept, sanctioning authority/level, and sector to be financed depending upon the individual bank's portfolio size, risk appetite and risk containing abilities. Banks were advised to disclose their gross exposure to the real estate sector as well as the details of the direct and indirect exposure to the real estate sector in their annual reports.

3.27 In line with the apparent risk perception in individual housing credit by banks, which are fully secured by mortgage of residential properties and investments in mortgage-backed securities (MBS) of housing finance companies (HFCs) recognised by the National Housing Bank, the RBI increased the risk weight for capital adequacy purposes from 50 per cent to 75 per cent. In the case of MBS of HFCS to be eligible for 75 per cent risk weight, only assets qualifying for 75 per cent risk weight were to back securities issued by the special purpose vehicle (SPV). With effect from July 26, 2005 the risk weight on banks' exposure to the commercial real estate was raised from 100 per cent to 125 per cent. Risk weight on consumer credit, including loans and credit cards receivables, was also increased from 100 per cent to 125 per cent.

3.28 In July 2005, the RBI issued detailed draft guidelines on the sale/purchase of non-performing assets where securitisation companies and reconstruction companies are not involved. The draft guidelines cover: (a) procedure for purchase/sale of non-performing financial assets by banks, including valuation and pricing aspects; (b) prudential norms relating to asset classification, provisioning, accounting of recoveries, capital adequacy and exposure norms and disclosure requirements. The guidelines, among other things, provide that a NPA in the books of a bank shall be eligible for sale to other banks, only if it has remained as NPA for at least two years in the books of the selling bank and such selling should be only on cash basis; a NPA should be held by the purchasing bank in its books at least for a period of 15 months before it is sold to other banks; banks should ensure that subsequent to the sale of a NPA to other banks, they should not have any involvement with reference to the assets sold and do not assume operational, legal or any other type of risks relating to the financial assets sold.

Financial performance

3.29 On the back of strong economic growth and sustained industrial recovery, bank credit off-take posted steady growth. During 2004-05, with deceleration in demand and savings deposits, deposits of SCBs grew at a lower rate of 15.4 per cent (excluding the impact of conversion of Industrial Development Bank of India into a banking entity) compared to 16.4 per cent in the previous year. However, there was a significant increase in non-deposit resources (net owned funds) and borrowings to meet the higher credit demand. Through equity issues, several banks had tapped both the international and domestic markets to augment their capital base. Capital raised through Global Depository Receipts (GDRs) in the international market during 2004-05 and domestic equity market was Rs. 1,473 crore and Rs. 7,444 crore, respectively. Borrowings increased by Rs. 22,749 crore, of which, Rs. 11,941 crore (52.5 per cent) was in foreign currency.

3.30 SCBs' total income during 2004-05 grew at a lower rate of 1.5 per cent (net of conversion) as compared to 6.7 per cent in 2003-04. Expenditure had increased by 2.7 per cent (net of conversion) compared to 4.1 per cent in the previous year. Operating expenses in 2004-05, as per cent of net income, rose to 49.1 per cent from 45.4 per cent in 2003-04 and, as a proportion of total assets, declined marginally to 2.16 per cent from 2.21 per cent in the previous year. (Table 3.4)

Interest spread

3.31 With rising interest rates, interest income of SCBs during 2004-05 increased to Rs. 1,53,128 crore from Rs. 1,44,347 crore in the previous year. But higher interest rates had an adverse effect on bond prices, which reduced the treasury profits (classified as 'other income') of SCBs. Net interest income (spread), defined as the difference between interest income and interest expenses, represents an important efficiency indicator of banks. The spread of SCBs in 2004-05 increased marginally to 2.92 per cent from 2.88 per cent in 2003-04 and continued to be high by international standards. While net interest income as per cent of total assets of the SBI group and of the new and old private sector banks increased, that of nationalised and foreign banks declined.

Table 3.4 : Working results of scheduled commercial banks

Items	Public sector banks		Foreign banks		Old pvt. sector banks		New pvt. sector banks		SCBs	
	2003-04	2004-05	2003-04	2004-05	2003-04	2004-05	2003-04	2004-05	2003-04	2004-05
					Rs. Crore					
A. Income	137587	141061	13008	13034	11555	10509	21721	22099	183872	186703
I)Interest Income	109547	117691	9137	9171	9121	9275	16542	16990	144347	153128
II) Other income	28040	23370	3871	3864	2434	1234	5180	5109.1	39525	33576
B. Expenditure	121041	125890	10765	11032	10109	10073	19686	19002	161601	165997
I) Interest expended	65765	66288	4269	4040	5982	5673	11548	10600	87563	86601
II) Intermediation cost	32533	36081	3754	4397	2381	2597	5041	6064	43709	49140
III) Provisions and contingenies	22744	23521	2742	2595	1745	1803	3098	2337	30329	30256
C. Operating profit (A-Bi-Bii)	39290	38691	4986	4597	3192	2239	5133	5435	52600	50962
D. Net profit (A-B)	16546	15170	2244	2002	1446	436	2035	3098	22271	20706
E. Net interest income (Spread)	43783	51402	4869	5131	3139	3602	4994	6390	56784	66526
F. Total assets	1471077	1692579	135640	154128	102724	133494	246576	294421	1974017	2274622
					As per cent of total assets					
A. Income	9.4	8.3	9.6	8.5	11.2	7.9	8.8	7.5	9.3	8.2
I)Interest Income	7.4	7.0	6.7	6.0	8.9	6.9	6.7	5.8	7.3	6.7
II) Other income	1.9	1.4	2.9	2.5	2.4	0.9	2.1	1.7	2.0	1.5
B. Expenditure	8.2	7.4	7.9	7.2	9.8	7.5	8.0	6.5	8.2	7.3
I) Interest expended	4.5	3.9	3.1	2.6	5.8	4.2	4.7	3.6	4.4	3.8
II) Intermediation cost	2.2	2.1	2.8	2.9	2.3	1.9	2.0	2.1	2.21	2.16
III) Provisions and contingenies	1.5	1.4	2.0	1.7	1.7	1.4	1.3	0.8	1.5	1.3
C. Operating profit	2.7	2.3	3.7	3.0	3.1	1.7	2.1	1.8	2.7	2.2
D. Net profit (A-B)	1.1	0.9	1.7	1.3	1.4	0.3	0.8	1.1	1.1	0.9
E. Net interest income (Spread)	2.98	3.04	3.59	3.33	3.06	2.70	2.03	2.17	2.88	2.92
F. Total assets	1.1	0.9	1.7	1.3	1.4	0.3	0.8	1.1	1.1	0.9
Memo item										
1. Operating expenses as per cent of net income	45.3	48.3	43.0	48.9	42.7	53.7	49.5	52.7	45.4	49.1

Table 3.5 : Non-performing assets of scheduled commercial banks

Items	Gross NPAs (Rs. Crore)			Percentage to gross advances			Percentage to total assets		
	2002-03	2003-04	2004-05	2002-03	2003-04	2004-05	2002-03	2003-04	2004-05
Bank group									
1. Public Sector	54090	51538	47325	9.4	7.8	5.7	4.2	3.5	2.8
2. Private Sector	11782	10354	8782	8.1	5.8	4.4	4.0	2.8	2.1
3. Foreign	2845	2894	2192	5.3	4.6	2.8	2.4	2.1	1.4
SCBs(1+2+3)	68717	64786	58299	8.8	7.2	5.2	4.0	3.3	2.6
Items	**Net NPAs (Rs. Crore)**			**Percentage to net advances**			**Percentage to total assets**		
1. Public Sector	24867	18860	16642	4.5	3.0	2.1	1.9	1.3	1.0
2. Private Sector	6882	4857	4151	5.0	2.8	2.2	2.3	1.3	1.0
3. Foreign	921	898	648	1.8	1.5	0.9	0.8	0.7	0.4
SCBs(1+2+3)	32670	24615	21441	4.4	2.9	2.0	1.9	1.2	0.9

3.32 Declining non-interest income adversely impacted operating profits of SCBs in 2004-05, when such profits declined by 3.1 per cent compared to an increase of 29.3 per cent in 2003-04. Among bank groups, operating profits of nationalised banks, old private sector banks and foreign banks declined, while those of SBI group and new private sector banks increased.

Non-performing assets of the banking sector

3.33 Asset quality of banks registered significant improvements simultaneously with the rapid increase in the quantum of credit to the commercial sector. The robust industrial performance and wider options available to SCBs for recovery of their dues showed up in a significant reduction in the level of NPAs. A significant improvement in recovery of NPAs combined with a sharp increase in gross loans and advances by SCBs led to a sharp decline in gross NPAs to gross advances ratio to 5.2 per cent at end-March 2005 from 7.2 per cent at end-March 2004.

3.34 The setting up of the Asset Reconstruction Company (India) Limited (ARCIL) also provided a major boost to banks' efforts to recover dues. During 2004-05, several banks and some FIs sold their NPAs to the ARCIL to the extent of Rs.15,343 crore. Gross NPAs of SCBs (excluding the conversion impact) declined by Rs.6,487 crore between end-March 2004 and end-March 2005.

Capital adequacy ratio

3.35 The sharp increase in credit portfolio coupled with enhanced risk weight for housing and consumer credits led to a significant rise in the risk weighted assets of SCBs by 33.4 per cent at end-March 2005. However, banks had kept augmenting their capital base by tapping domestic as well as international capital markets to keep pace with sharp increase in risk weighted assets. The overall CRAR of SCBs at 12.8 per cent at end-March 2005 was marginally lower than the previous year's level (12.9 per cent). Nevertheless, in spite of higher requirements of capital charge for market risk, not only did the overall CRAR continue above the stipulated minimum level of 9 per cent, but so did the CRAR of all banks, other than two old private sector banks (accounting for only 0.3 per cent of the total assets of the SCBs).

3.36 Among bank groups, the CRAR of new private sector banks improved significantly, bringing them closer to other bank groups. Within the PSBs, the CRAR of nationalised banks registered a marginal improvement during 2004-05. The CRAR of the State Bank group, old private sector banks and foreign banks declined. The CRAR of five largest banks, which accounted for 39.6 per cent of total assets of SCBs, depicted divergent pattern. While CRAR of three largest SCBs witnessed moderate to sharp increase, that of two other banks registered significant decline.

Bank credit

3.37 Robust growth of the industrial sector and the government's conscious decision to increase credit to the agriculture sector led to rapid increases in bank credit. Non-food credit expanded by Rs. 2,21,802 crore (net of conversion) in 2004-05 compared to the increase of Rs. 1,25,088 crore in 2003-04. During the period (ending on January 20, 2006) of 2005-06, non-food credit expanded further by Rs.2,66,857 crore, up 25.2 per cent from Rs. 1,68,188 crore (net of conversion) in the corresponding period of the previous year.

3.38 Credit by SCBs increased significantly by 27.0 per cent (net of conversion) during 2004-05 compared to 15.3 per cent in the previous year. Food credit extended by SCBs had expanded by Rs. 5,159 crore in 2004-05 compared to a decline of Rs. 13, 517 crore in the previous year. There has been a reversal of the trend in food credit, with food credit declining by Rs. 2,778 crore during 2005-06 up to January 20,2006 compared to the increase of Rs. 5,468 crore during the corresponding period of the previous year. Thus, food credit declined by 6.8 per cent on a financial year basis, and on a year-on-year basis, there was a decline of 7.4 per cent.

3.39 The credit-to-GDP ratio grew steadily from about 10 per cent at end-December 1969 to about 40 per cent by end-March 2005 However, despite the steady increase over the years, the credit-to-GDP ratio in India is much lower than that in several advanced and emerging market economies This suggests that financial deepening is still low in India and could improve further with the development of the financial sector.

Investments

3.40 Investments of SCBs — in Government and other approved securities under Statutory liquidity ratio (SLR) plus investments in the commercial sector in the form of bank credit against and investments in shares, debentures, bonds and commercial papers increased by 7.3 per cent (net of conversion) at end-March 2005 as against the increase of 23.8 per cent at end-March 2004. Furthermore, there was a pronounced shift in the composition of such investments. During 2004-05, the growth in investment in Government and other approved securities was much lower at Rs.61,566 crore (9.1 per cent, net of conversion) than Rs.1, 30,042 crore (23.8 per cent) in the previous year. SLR-investments as a proportion of Net Demand and Time Liabilities (NDTL) of SCBs declined to 38.4 per cent at end-March 2005 from 41.3 per cent at end-March 2004, but were still higher than the stipulated minimum of 25 per cent.

3.41 During 2005-06 up to January 20, 2006, SLR investment by SCBs declined by Rs.24,652 crore compared to an increase of Rs. 34,366 crore during the corresponding period of the previous year. This represents a decline of 3.3 per cent on financial year basis. However, on year-on-year basis increase was 0.4 per cent.

Sectoral deployment of bank credit

3.42 Bank credit disbursal during 2004-05 was well-diversified across different sectors of the economy, with flows to housing and retail sector particularly strong and a substantial pick up in flows to agriculture. Strong industrial recovery was accompanied by much higher credit growth of 17.4 per cent to industry (medium and large) in 2004-05 compared to only 5.1 per cent in the previous year. During 2005-06 up to end-October, 2005, the year-on-year growth of credit to industry accelerated further to 45.7 per cent. The share of industry in gross bank credit declined from 32.3 per cent during 2003-04 to 29.8 per cent during 2004-05. The declining trend was reversed during the current year up to October 2005, with the share increasing to 33.2 per cent from 31.7 per cent during the corresponding period of the previous year.

3.43 At end-March 2005, growth of credit to ‘other sectors’ at 36.0 per cent was higher than the growth of overall non-food credit of 27.9 per cent. Flow of credit to the infrastructure sector, in particular, grew sharply by 41.7 per cent at end-March 2005 compared to 36.9 per cent at end-March 2004. In 2005-06 up to end-October, 2005, year-on-year, credit to other sectors grew by 31.4 per cent. (Table 3.6)

Priority sector lending

3.44 After growing by 24.7 per cent in the previous year, lending by SCBs to priority

Table 3.6 : Sectoral deployment of gross bank credit										
	Outstanding balances of the end of				Variations during[1]					
	2003-04	2004-05	October 2004	October 2005	2003-04	2004-05	Oct.05 over Oct.04	2003-2004	2004-05	Oct.05 over Oct.04
over										
	(Rs. crore)							Per cent		
I. Gross bank credit	764383	972587	860187	1197574	94849	208204	337387	14.2	27.2	39.2
1. Public food credit	35961	41121	39711	39805	-13518	5160	94	-27.3	14.3	0.2
2. Gross non-food credit	728422	931466	820476	1157769	108367	203044	337293	17.5	27.9	41.1
(a) Priority sectors (i+ii+iii)[2]	263834	345627	290015	433422	52225	81793	143407	24.7	31.0	49.4
i. Agriculture[3]	90541	122370	101808	141612	17023	31829	39804	23.2	35.2	39.1
ii. Small scale industry	65855	76114	67177	78780	5461	10259	11603	9.0	15.6	17.3
iii. Other priority sector	107438	147143	121030	213030	29741	39705	92000	38.3	37.0	76.0
(b) Medium and large industries	247210	290186	272626	397135	12042	42976	124509	5.1	17.4	45.7
(c) Wholesale trade (excluding food procurement)	24867	33814	32447	31012	2289	8947	-1435	10.1	36.0	-4.4
(d) Other sectors	192511	261839	225388	296200	41811	69328	70812	27.7	36.0	31.4
Of which:										
(1) Housing	51981	75173	68069	153267	15394	23192	85198	42.1	44.6	125.2
(2) Consumer durables	8274	8655	7316	8791	1055	381	1475	14.6	4.6	20.2
(3) Real estate loans	5577	10612	8240	20148	-317	5035	11908	-5.4	90.3	144.5
(4) Loans to individuals[4]	2020	2390	1956	4843	19	370	2887	0.9	18.3	147.6
II. Export credit[5]	57687	65914	59222	71826	8485	8227	12604	17.2	14.3	21.3

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

Note : (a) Figures for 2003-04 are provisional. Data relate to 47 SCBs which account for 90 per cent of the bank credit of all SCBs. Gross credit data include bills rediscounted with RBI, IDBI, Exim Bank and other approved financial institutions.

(b) Outstanding balances at end-October 2005 for housing includes priority sector housing also.

sectors increased sharply by 31.0 per cent in 2004-05. The flow of credit to priority sectors increased by Rs.81,793 crore (accounting for 39.3 per cent of net bank credit) in 2004-05 compared to Rs.52,225 crore (accounting for 54.8 per cent) in 2003-04. Total outstanding credit to priority sectors on March 31, 2005 was Rs.3,45,627 crore. During 2005-06 upto end-October, 2005, SCBs credit to priority sectors expanded by Rs.1,43,407 crore over the level of the corresponding period of the previous year representing an increase of 49.4 per cent.

3.45 Credit flow to priority sectors was driven mainly by agriculture and 'other priority sectors'. Credit to agriculture had more than doubled in the last three years from Rs. 60,761 crore at end-March 2002 to Rs. 1,22,370 crore at end-March 2005; at end-October 2005, the outstanding balances were Rs. 1,41,612 crore. Credit to small-scale industries, after increasing from Rs. 57,199 crore at end-March 2002 to Rs. 76, 114 crore at end-March 2005, further increased to Rs. 78,780 crore at end October 2005. RBI initiated a number of policy measures to augment credit flow to Small and Medium Enterprises (SME) sector.

Lending to sensitive sector

3.46 SCBs' credit to sensitive sectors, which consist of capital market, real estate market and some selected commodities, was driven mainly by the demand of the real estate market (Table 3.7). In view of the very rapid growth of credit to the real estate sector, RBI tightened the prudential norm by enhancing the risk weight on banks' exposure to this sector.

Agricultural credit

3.47 During 2004-05, with an aggregate disbursement of Rs.1,25,309 crore to the agricultural sector, the target of Rs. 1,05,000 crore was exceeded by 19.3 per cent. The Union Budget 2005-06 proposed to increase the flow of credit by commercial banks, regional rural banks (RRBs) and co-operative banks by another 30 per cent in the current financial year 2005-06. Further, PSBs were advised to increase the number of borrowers by another

Table 3.7 : Lending to sensitive sectors						
Banks	**2003-04**	**2004-05**	**2003-04**	**2004-05**	**% share in total**	
	Rs. Crore		**Percent**		**2003-04**	**2004-05**
A. SCBs	**29018**	**39240**	**22.5**	**35.2**	**100.0**	**100.0**
(i) Capital market	3711	3767	49.4	1.5	12.8	9.6
(ii) Real estate	15848	24691	27.1	55.8	54.6	62.9
(iii) Commodities	9459	10783	8.3	14.0	32.6	27.5
B. PSBs	**17176**	**22863**	**13.5**	**33.1**	**59.2**	**58.3**
(i) Capital market	1185	1512	14.8	27.6	4.1	3.9
(ii) Real estate	9937	15125	24.4	52.2	34.2	38.5
(iii) Commodities	6054	6225	-0.9	2.8	20.9	15.9
1. Nationalised	**15192**	**18997**	**14.1**	**25.0**	**52.4**	**48.4**
(i) Capital market	1104	1334	15.1	20.8	3.8	3.4
(ii) Real estate	9083	12438	25.6	36.9	31.3	31.7
(iii) Commodities	5004	5225	-2.3	4.4	17.2	13.3
2. State bank group	**1984**	**3866**	**9.0**	**94.9**	**6.8**	**9.9**
(i) Capital market	81	178	11.1	119.3	0.3	0.5
(ii) Real estate	853	2687	12.8	214.9	2.9	6.8
(iii) Commodities	1049	1000	5.9	-4.6	3.6	2.5
C. New Pvt. banks	**6061**	**8644**	**37.0**	**42.6**	**20.9**	**22.0**
(i) Capital market	1167	1048	76.8	-10.2	4.0	2.7
(ii) Real estate	3301	5211	22.2	57.9	11.4	13.3
(iii) Commodities	1593	2384	50.0	49.7	5.5	6.1
D. Old Pvt. banks	**3001**	**4292**	**15.4**	**43.0**	**10.3**	**10.9**
(i) Capital market	280	342	35.4	22.4	1.0	0.9
(ii) Real estate	1231	2311	15.4	87.8	4.2	5.9
(iii) Commodities	1490	1638	12.3	9.9	5.1	4.2
E. Foreign banks	**2781**	**3442**	**82.1**	**23.8**	**9.6**	**8.8**
(i) Capital market	1079	864	84.6	-20.0	3.7	2.2
(ii) Real estate	1380	2042	94.9	48.0	4.8	5.2
(iii) Commodities	322	536	37.0	66.4	1.1	1.4

50 lakh, and also to make efforts to increase their disbursements to small and marginal farmers to 40 per cent of their direct advances under Special Agricultural Credit Plan (SACP) by March 2007. Banks were allowed to waive margin/security requirements for agricultural loans up to Rs.50,000 and, in the case of agribusiness and agri-clinics, for loans up to Rs. 5 lakh.

3.48 Continuing its endeavour to enhance the flow of credit to agriculture by removing delivery bottlenecks, the RBI, together with NABARD, implemented most of the recommendations of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (Chairman: Prof. V.S.Vyas). Out of 99 recommendations made by the Committee, 33 were accepted and implemented by October 2005. These related to: procedural modifications and rationalisation of systems and procedures; tie-ups with related farm machinery manufacturers by banks; use of a flexible revolving credit limit to small borrowers of production or investment loans for meeting temporary shortfalls in family cash flows; co-opting joint liability group (JLG) and self-help group (SHG) approaches in addressing issues relating to financing oral lessees; addressing delays/refusal in opening savings bank accounts of SHGs; improving staffing in the rural areas to promote retail lending to agriculture, use of individual volunteers, farmers' clubs or NGOs/SHGs as direct selling agents; building synergy between good working primary agricultural credit societies and commercial banks; use of IT in rural branches; working out appropriate incentive structure for prompt repayment; making the rates of interest on small loans reasonable; and improving the efficiency of credit delivery to small borrowers and association with contract farming. Furthermore, some of the recommendations, *viz.*, stepping up credit for marketing and introduction of negotiable warehousing receipt system, support of State Governments for collecting dues, reduction of stamp duty on agricultural loans, legal amendments to Agricultural Produce Marketing Committee (APMC) Act by the State Governments, amendment to NABARD Act for operational autonomy, which were referred to the Government of India for examination, have been accepted.

3.49 As per the 'farm credit package' announced by Government of India on June 18, 2004, the flow of credit for agriculture would be doubled in the ensuing three years. The target for institutional credit for agriculture by all agencies was fixed at Rs.1,05,000 crore for the year 2004-05, ensuring 30 per cent growth over the previous year's achievement. The overall achievement by all agencies during 2004-05 was Rs.1,15,243 crore, equivalent to 44.1 per cent growth over the previous year's achievement (Table 3.8). While the commercial banks and RRBs over performed vis-à-vis their targets of Rs.57,000 crore and Rs.8,500 crore, respectively, there was a shortfall of over Rs. 8,000 crore by cooperative banks vis-à-vis their target of Rs.39,000 crore. Against the target of Rs.1,41,000 crore for flow of institutional credit for agriculture and allied activities in 2005-06, achievement up to December 31, 2005 was Rs.1,17,899 crore, equivalent to 83.6 per cent of the target.

Kisan credit card

3.50 With an overwhelming response from the farmers as well as the bankers to the Kisan Credit Card (KCC) scheme, introduced in August 1998, the number of cards issued up to November 30, 2005 was 555.85 lakh. The growing popularity of the KCC scheme reflects its effectiveness in ensuring hassle-free and timely operations as also availability of credit with minimum transaction cost and documentation.

3.51 In order to safeguard the interests of the KCC holders for coverage under Personal Accident Insurance Scheme (PAIS) on an ongoing basis on competitive terms, NABARD has allowed discretion to the banks to opt for "any insurance company of their choice". This facilitates personal accident insurance coverage on an ongoing basis, at competitive rates/terms. With a view to meet credit needs of the farmers through a single window, NABARD has enlarged the scope of the KCC, beyond the existing facility of providing crop loan limit, to cover term loans for agriculture and allied activities, including a reasonable component of consumption needs.

3.52 With the enlarged coverage of 50 lakh new farmers under KCC scheme by the PSBs during 2005-06, NABARD has advised the co-operative banks and RRBs also to arrive at realistic targets for issue of KCCs to new farmers during the year. Banks have been advised to identify and enlarge the coverage by bringing in the farmers including defaulters, oral lessees, tenant farmers who may be outside the fold of the KCC scheme, as also new farmers. Co-operative banks and RRBs have accordingly set targets of issuing 34 lakh and 16 lakh KCCs, respectively, during the year. Further, banks have been advised to ensure that KCCs continue to be renewed in

Table 3.8 : Flow of institutional credit to Agriculture

Rs. crore

Agencies	2002-03	2003-04	2004-05	2005-06*
1.Cooperative banks	23,716	26,959	31,231	28,947
2.RRBs	6,070	7,581	12,597	11,146
3.Commercial banks	39,774	52,441	81,481	77,806
Total (1+2+3)	69,560	86,981	1,25,309	1,17,899

Source : NABARD. ***Up to December 31, 2005**

a hassle-free manner and to direct their efforts towards ensuring 'quality in operations' of the KCCs and, more importantly, that crop loans are routed only through KCCs.

Micro-finance

3.53 To provide the rural poor accessibility to credit from the banking system and for alleviating poverty, NABARD in 1992 had started a programme of linking SHGs of the rural poor with banks. Over the years, the SHG-Bank linkage programme has emerged as the major micro-finance programme in the country. In all 554 banks (47 commercial banks, 177 RRBs and 330 co-operative banks) are now actively involved in the operation of this programme.

3.54 The 5,39,365 new SHGs credit-linked during 2004-05 represent an increase of 49 per cent over the previous year (Table 3.9). As on 31 March, 2005, the total of 16.18 lakh SHGs credit-linked by banks covered an estimated 242 lakh poor families, with an average loan disbursement per family of Rs. 3,044. Refinance support extended by NABARD amounted to Rs.3,082 crore. A highlight of the programme was that about 90 per cent of the groups linked with banks were exclusively women groups. As against the target of linking 3 lakh SHGs for the whole year 2005-06, until December, 2005, 2.11 lakh new SHGs were added.

Rural infrastructure development fund (RIDF)

3.55 The Government of India in 1995 had announced the scheme for setting up a Rural Infrastructure Development Fund (RIDF), to be sourced from the commercial banks to the extent of their shortfall in their agricultural lending. RIDF has continued from year to year with the corpus being announced annually during the budget. So far, ten tranches have been completed and the eleventh tranche (RIDF-XI) is underway during the current financial year (2005-06).

3.56 As against the cumulative corpus of Rs.50,000 crore, the cumulative sanctions availed by 28 State Governments up to December 31, 2005, under RIDF tranches I to XI, stand at around Rs. 48,896 crore. Disbursements to States on account of investments in rural infrastructure under RIDF amounted to Rs. 28,338 crore.

Non-banking financial companies (NBFCs)

3.57 As per extant guidelines, NBFCs that were granted certificate of registration (COR) in the non-public deposit-taking category should meet the minimum capital requirement of Rs.2 crore for being eligible to apply to the RBI for accepting deposits. By the end of March 2005, the RBI had received 38,096 applications for grant of COR. Of these, the RBI has approved 13,187 applications (net of

Table 3.9: Progress of SHG-Bank linkage programme

Year	SHG financed by banks (No.)		Bank loan (Rs. crore)	
	During the year	Cumulative	During the year	Cumulative
1992-99	32995	32995	57.07	57.07
1999-00	81780	114775	135.91	192.98
2000-01	149050	263825	287.89	480.87
2001-02	197653	461478	545.47	1026.34
2002-03	255882	717360	1022.34	2048.68
2003-04	361731	1079091	1855.53	3904.21
2004-05	539365	1618456	2994.25	6898.46
2005-06#	211391	1829847	1420.67	8319.13

 # Up to December 31, 2005.

cancellation), including 474 applications (net of cancellation) of companies authorised to accept/hold public deposits. By end-June 2005, the total number of NBFCs increased to 13,261 (net of cancellation), of which 507 were public deposit accepting companies.

3.58 The number of reporting NBFCs (registered and unregistered) declined from 875 at end-March 2003 to 777 at end-March 2004 and further to 573 at end-March 2005. The decline was mainly due to the exit of many NBFCs from deposit- taking activity. The number of Residuary Non-banking Companies (RNBCs), which were five at end-March 2003, declined to three at end-March 2004 and remained unchanged at that level at end-March 2005. Assets and public deposits accepted by reporting NBFCs, which declined during the year ended March 2004, increased marginally during the year ended March 2005 even as the number of reporting NBFCs declined sharply. The net owned funds of NBFCs increased in 2004 as well as 2005. Deposits of reporting NBFCs constituted 1.1 per cent of aggregate deposits of scheduled commercial banks at end-March 2005 as against 1.2 per cent at end-March 2004 and 1.5 per cent at end-March 2003.

3.59 Total assets/liabilities of NBFCs (excluding RNBCs), which had declined sharply by 13.1 per cent during 2003-04, increased marginally by 3.3 per cent during 2004-05. Borrowings represented the major source of funds for NBFCs, followed by owned funds (capital and reserves) and public deposits. All these sources of funds declined during 2003-04 as well as 2004-05 except borrowings, which increased marginally during 2004-05 after a sharp decline in 2003-04. The decline in assets continued during 2004-05, except hire-purchase assets, bill business and SLR investments that increased sharply.

3.60 Financial performance of NBFCs improved during 2003-04 and 2004-05 due mainly to containment of expenditure. While both fund-based and fee-based income of NBFCs declined in 2003-04, they improved marginally in 2004-05. The improvement in operating and net profits was due to declines in financial and operating expenditure and also in tax provisions.

3.61 Gross and net NPAs of reporting NBFCs registered a steady decline between end-March 2001 and end-March 2004. However for 2004-05, while the gross NPAs declined to 7.0 per cent of credit exposure at end-March 2005 from 8.2 per cent of credit exposure at end-March, 2004, net NPAs increased significantly to 3.4 per cent of credit exposure at end-March 2005 from 2.4 per cent of credit exposure at end-March 2004.

All India financial institutions (AIFIs)

3.62 Financial assistance sanctioned and disbursed by all-India financial institutions (excluding IDBI which was converted into a bank with effect from October 11, 2004) declined during 2004-05 mainly due to a sharp decline in the sanctions and disbursements by LIC. Consolidation in the banking sector has also encompassed the Development Finance Institutions, which have been the traditional providers of long-term finance. The complexities involved in harmonising the role and operations of these institutions were examined by the RBI which allowed reverse merger with their commercial banking subsidiary. (Table 3.10)

Outlook

3.63 Credit evinced sharp growth during 2004-05, and has continued in the current financial year. This presents both opportunities and challenges to all the stakeholders in the financial sector. Expansion in financial intermediation is generally associated with increased growth and efficiency; at the same time, excessive credit growth without adequate safeguards could lead to some erosion in credit quality. Policy, therefore, has to strike a balance between credit quality and the associated risks, while allowing bank lending to contribute to higher growth and efficiency.

3.64 Tackling the issues of price management while meeting the credit needs of the various sectors are likely to be the continuing challenges of monetary policy. In

Table 3.10: Assistance by AIFIs				
				(Rs. crore)
Institutions\Years	**2001-02**	**2002-03**	**2003-04**	**2004-05**
A. Sanctions				
1. DFIs	28,492	22,747	22,148	32,191
2. Investment institutions	8,372	5,658	23,197	10,294
Total	**36,864**	**28,405**	**45,345**	**42,485**
A. Disbursements				
1. DFIs	21,594	17,716	15,029	16,970
2. Investment institutions	10,398	7,488	16,989	8,972
Total	**31,992**	**25,203**	**32,018**	**25,942**

Notes:

1. Excluding ICICI and UTI
2. Data are provisional and net adjusted for their institutional flows.
3. DFIs include All India Development banks and specialised financial institutions.

this context, the increasing openness of the economy will require a revisit of the instruments for regulating liquidity in the system. A slow-down in foreign reserve inflows relative to earlier years and a growing tempo of credit off-take may exert upward pressure on interest rates and make for a case for considering the unwinding of MSS to release the required liquidity into the system.

3.65 So far banks have been able to finance the credit boom efficiently with a CRAR of 12.8 per cent considerably higher than the 8.0 per cent BASEL norm and 9.0 per cent RBI stipulation. But by end-March 2007, banks are required to conform to BASEL II norms, and this will require additional capitalisation. Recent guidelines issued by the RBI for raising additional capital funds through the issue of innovative perpetual debt instruments, without impinging on the Government equity structure in PSBs, will help banks to acquire BASEL II norms.

3.66 In view of the rapid growth of bank credit, there may be a need for further capitalisation of banks and for developing strict management techniques/methods for the prudent evaluation of investment proposals.