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Theme 210
RBI ANNUAL POLICY STATEMENT 2009-2010

A monthly publication from South Indian Bank

18th Year of Publication

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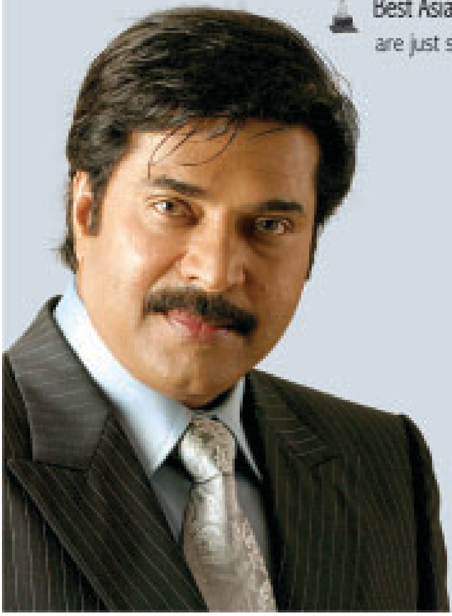

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MAY 2009

Theme No. 210 : RBI ANNUAL POLICY STATEMENT 2009-10

The annual policy statement for 2009-10 is announced by the RBI on April 21, 2009, in the context of exceptionally challenging situation in the global economy. The financial crisis has snowballed into the deepest and the widest economic crisis of the last many years. Global GDP is projected to contract to between 0.50 and 1.0 percent (IMF), and global trade will contract by 9.0 per cent (WTO).

Both the Government and the RBI have responded to minimize the impact of the crisis. The RBI shifted from monetary tightening to monetary easing and the commercial banks have responded by reducing their deposit and lending rates. The Government launched three fiscal stimulus packages during 2008-09 besides implementing safety net programmes for the rural poor and farm loan waiver packages.

The RBI has allayed the concerns that the economy was slipping into a deflationary phase with inflation inching to sub-zero levels. The RBI expects inflation, as measured by annual variation in wholesale price index (WPI) to touch 4 per cent by end of FY10 and the economy to grow by 6 per cent this fiscal. To achieve this growth, the RBI has projected money supply would grow by 17 per cent. Consistent with this, deposit growth is placed at 18 per cent and credit is expected to grow by 20 per cent.

What is the general policy framework for the year 2009-10?

The stance of the monetary policy in 2009-10 is broadly as follows:

- Credit expansion at viable rates while preserving credit quality so as to support the return of the economy to a high growth path.
- Minimizing the impact of adverse global and domestic developments and reinforcing the impact of positive developments.
- Price stability and financial stability taking into account the emerging lessons of the global financial crisis.

What are the changes proposed in the policy rates and the reserve rates of the RBI?

The Bank rate has been retained unchanged at 6.0 per cent. The Repo rate under the Liquidity Adjustment Facility (LAF) has been reduced by 25 basis points from 5.0 per cent to 4.75 per cent with immediate effect. The reverse repo rate under the LAF has been reduced by 25 basis points from 3.50 per cent to 3.25 per cent. Repo is the rate at which the RBI lends to banks while reverse repo is the rate banks park their surplus money with the RBI. A lower return under reverse repo will desist banks from parking money with the RBI.

The Cash Reserve Ratio (CRR) has been retained unchanged at 5.0 per cent of net demand and time liabilities. The SLR (Statutory Liquidity Ratio) will remain unchanged at 24 per cent.

What are the policy implications on the lending rates of the commercial banks?

It has been observed that the large and quick changes effected in the policy rates by the RBI have not fully transmitted to banks' lending rates. Also, the system of BPLR has lost relevance as a meaningful reference rate as bulk of loans is advanced below BPLR. This makes loan pricing system non-transparent. A Working Group will be constituted to review the present BPLR system and suggest changes to make credit pricing more transparent.

Both repo and reverse repo rates were cut aggressively during the last six months. There were pressures from the industry to further reduce rates. There are many factors creating distortions in the movement of interest rates – administered interest rates on small savings, depositor preference for fixed rate term deposits, legacy effects of deposits contracted at higher rates earlier, cross-subsidization of concessional lending rates, and large government borrowing programme. There is also the emergent problem of rising credit risk in a scenario where growth is slowing and uncertainties abound.

What are the major prudential and institutional measures announced in the policy?

At present the commercial banks are required to have a medium term plan in respect of branch expansion. The request for opening off-site ATMs was part of such plans. The present policy allows the scheduled commercial banks to set up offsite ATMs without prior approval. Also branch expansion policy will be guided by greater flexibility, enhanced penetration and competitive efficiency consistent with financial stability.

Presently banks are permitted to use services of NGOs/MFIs to set up as societies, trusts, Section 25 companies, post offices, co-operative societies and more recently retired bank employees, ex-servicemen and retired government employees as banking correspondents (BCs) for delivery of various banking services. Now it is proposed to scale up the BC model of financial inclusion and a Working Group will be constituted.

Also, it has been proposed to make payment of interest on savings bank accounts on daily product basis with effect form April 1, 2010.

The stress testing guidelines were already indicated by the RBI in the earlier mid-term review. Now banks are required to carry out periodic stress testing. The stress testing guidelines will be upgraded. Also, a settlement mechanism for corporate bonds will be introduced to minimize counterparty risk.

It was earlier indicated that the CRAR for NBFCs would be raised from 10 per cent to 12 percent by March, 2009 and further to 15 per cent by March 2010.In view of the difficulties in raising equity capital in the current economic environment, the implementation has been deferred by one year. Currently, loans up to Rs.20 lakhs are allowed against FCNR and NRE rupee deposits of NRIs. This is now proposed to be enhanced to Rs.1 crore. The scope of the Banking Ombudsman Scheme, 2006 was widened to include deficiencies arising out of internet banking.

How does the policy deal with the issue of presence of more foreign banks in India?

In February 2005, the government and the RBI released the 'Roadmap for Presence of Foreign Banks in India'. This aimed at increasing the efficiency and stability of the banking sector in India and set two targets - Consolidation of the domestic banking system, both in private and public sectors, and Gradual enhancement of the presence of foreign banks in a synchronized manner. In view of the uncertainties across the world, there will not be any change in the present system and further liberalization is not envisaged at present.

What are the indications in the policy as regards Credit Rating Agencies?

In India, all credit rating agencies are registered with the SEBI. The RBI has accorded accreditation to four SEBI registered credit rating agencies for the limited purpose of using the ratings for assigning risk weights within the framework of the Basel II Accord. Now there is a need to review the performance of the credit rating agencies for continuation of the accreditation. The RBI will liaise with SEBI and performance of rating agencies will be reviewed. The RBI along with SEBI will now look at the methodologies and models that rating agencies follow.

What are the new proposals on securitization in the backdrop of sub-prime crisis?

It is well known that the liberal loan securitization practice in the US was one of the key factors behind sub-prime crisis. To immunize the domestic economy, the RBI has now prescribed minimum lock-in-period and minimum retention criteria for securitizing loans originated and purchased by banks. Thus banks are now barred from selling the assets immediately after the creation or acquisition of assets. Some banks were also dividing the total loan for one project into different tranches and securitizing a few tranches even before the total disbursement is complete, thus passing on the project implementation risk to the investors. This can be corrected by prescribing minimum lock-in-period.

Conclusion

The policy statement appears to be a mix of lower interest rate signals coupled with moral suasion on banks to bring down lending rates. The monetary transmission, which was already weak in India, has become weaker because of the global crisis. However the RBI wants banks to lower their BPLRs so that interest on the loans, old and new, softens. Under the current environment, the challenge for banks is to keep credit flowing, while at the same time maintaining portfolio quality.

Highlights of the RBI Annual Policy Statement 2009-2010

Monetary Policy Action

- Reduce the repo rate under LAF by 25 basis points from 5.0% to 4.75%
- Reduce the reverse repo rate under LAF by 25 basis points from 3.5% to 3.25%
- Keep the CRR unchanged at 5.0% of net demand and time liabilities (NDTL)

Measures relating to financial markets

- Further liberalisation of the FCCBs buyback policy
- Extension of the relaxation on the all-in-cost ceilings for ECBs up to December 31, 2009
- Extension of the special refinance facility and term repo facility and increased limit for export credit refinance for banks up to March 31, 2010
- Introduction of STRIPS to aid the development of a sovereign zero-coupon yield curve
- Revise the issuance structure of floating rate bonds

Measures relating to credit delivery mechanism and banking services

- Issuing guidelines to banks on rehabilitation of sick SMEs
- Phased introduction of capital to risk-weighted asset ratio (CRAR) for regional rural banks (RRBs)
- A non-disruptive roadmap to ensure that only banks with license operate in the co-operative space by 2012
- Setting up banking facilities at commercially unviable centres in the North-Eastern region

Measures relating to institutional developments

- Permit eligible SCBs to issue all categories of pre-paid payment instruments
- Permit eligible non-bank entities, including NBFCs, to issue semi-closed instruments
- Permit extension of area of operation of Tier II urban co-operative banks (UCBs) in Grade I to the entire State of registration
- Guidelines to UCBs on internal controls, risk management systems, ALM and disclosure norms
- Apply capital charge for market risks in respect of large UCBs
- Defer the implementation of CRAR for NBFCs-ND-SI by one year

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Your comments and feedback on this publication may be sent to Staff Training College, The South Indian Bank Ltd., Thrissur 680 001 or by E.mail: ho2099@sib.co.in

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