

Legal and Regulatory Framework for Co-operatives - K.D.Zacharias

1.1 Constitution and governing laws

The incorporation, regulation and winding up of co-operative societies (other than those operating in more than one State) is a State subject¹ and is governed by the State laws on co-operative societies². In the case of co-operatives with objects not confined to one State, their incorporation, regulation and winding up fall in the central domain³ and are governed by the Multi-State Co-operative Societies Act, 2002. As the vast majority of co-operative societies are operating only in one State, the State Government and the Registrar of Co-operative Societies appointed by the State are the main regulatory authorities for the co-operative societies.

1.2 Banking co-operatives

When co-operative societies engage in banking business, in addition to the regulatory laws applicable to co-operative societies, the central laws governing banking⁴ are attracted. Thus, the Banking Regulation Act, 1949 has been made applicable to co-operative banks, but as provided

1. Constitution of India, Schedule VII, List II, Item 32.

2. Enactments like AP Co-operative Societies Act, 1964 and the AP Mutually Aided Co-operative Societies Act, 1995

3. Constitution of India, Schedule VII, List I, Item 44.

4. A central subject under List I, Item 45 of Schedule VII of the Constitution.

5. Section 3 of the Banking Regulation Act, 1949.

6. Section 56(o)(i) ibid.

7. Section 2, ibid.

8. Madhav Rao Committee Report (1999) p.100.

in Section 56 thereof, in a modified manner, limiting thereby the extent of regulation by the Reserve Bank of India. This has resulted in the duality of regulation- under State laws for incorporation, regulation and winding up of cooperative societies and under banking regulation laws for regulation of banking business. However, all co-operative societies engaged in the business of banking are not regulated by the Banking Regulation Act, 1949 as the Act does not apply to Primary Agricultural Credit Societies and Land Development Banks⁵ and the regulatory provisions including that on licencing are not applicable to primary credit societies⁶, thus leaving them under the regulatory purview of the State.

2. Duality of Control -Conflict of laws

In the case of banking companies, which are registered under the Companies Act and are also governed by the provisions of the Banking Regulation Act in respect of their banking business, if the provisions of the Banking Regulation Act are in conflict with the Companies Act, the former prevails⁷. Hence, the Reserve Bank has full regulatory powers over the banking companies.

In the case of co-operative banks, although they are required to obtain a licence under Section 22 of the Banking Regulation Act, they are subject to a lesser extent of regulatory oversight under the modified provisions of BR Act as provided in Section 56. The High Power Committee on Urban Co-operative Banks (Madhav Rao Committee) has made an attempt to list⁸ the banking-related functions and co-operative functions as under :

Banking Related Functions which should be under the domain of Reserve Bank of India		Co-operative Functions which should be under the domain of the Registrar of Co-operative Societies for concerned State	
1.	Issues relating to interest rates, loan policies, investments, prudential exposure norms, forms of financial statements, reserve requirements, appropriation of profits etc.	1.	Registration of co-op. societies.
2.	Branch licensing, area of operation	2.	Approval and amendment to by-laws.
3.	Acquisition of assets incidental to carrying on banking functions	3.	Elections to Managing Committees.
4.	Policy regarding remission of debts.	4.	Protection of members' rights
5.	Audit.	5.	Supersession of Managing Committee for violation on items 1 to 4 above.
6.	Change of Management and appointment of CEO.		
7.	Appointment of Administration.		
8.	Any other banking related function to be notified by RBI from time to time.		

Banking being a Central subject and co-operatives operating within a State being a State subject under the Constitution, providing over-riding effect to the banking laws over the law governing cooperative societies in case of conflict is a contentious issue. Hence, although regulation of the management of banks is also essential for proper regulation of banking business (as is done in the case of banking companies), such powers are not available to the Reserve Bank. However, for the purpose of providing deposit insurance cover under the DICGC Act, as stipulated under that Act⁹, Reserve Bank has been given the powers (by amending the State laws on cooperatives)¹⁰ to issue direction to the Registrar for winding up, reconstruction and supersession of Board of insured banks when necessary.

9. See Section 2(gg) read with Section 13A and 13C of the DICGC Act.

10. For instance, Section 110A of the Maharashtra Cooperative Societies Act, 1964

2.2 Regulation of Banks - Uniform regulations

For the proper regulation of the banking system in the country, it would be essential to have a more or less uniform regulatory regime for all kinds of banks irrespective of their constitution as company, co-operative society or statutory corporation, as these provisions are meant for proper regulation of the business of banking and not in respect of their constitution as such. Any regulation on management, in so far as it is essential for proper management of the business of banking, has to be considered as incidental to the main regulatory provisions on banking and therefore justified even if it touches the subject of regulation of co-operatives which is a State subject. In the case of co-operatives which for any reason do not want to be subject to the discipline of the banking system, they may be given the option to go out of the system and work as thrift and credit societies. Those co-operatives, which continue in the banking system, should be subject to regulation under the Banking Regulation Act on the lines of the provisions applicable to banking companies.

3. Opting Out of Banking - Thrift and Credit

Banking as defined in Section 5(a) of the Banking Regulation Act means accepting for the purpose of lending or investment of deposits of money from the public repayable on demand or otherwise and withdrawable by cheque, draft, order or otherwise. Thus acceptance of deposit from the public is an essential feature of banking and if a society does not accept deposit from the public, it would not be engaged in the business of banking. Hence, societies not accepting public deposit would be outside the purview of the banking regulation Act. If any co-operative society does not want to be subjected to the regulatory regime for banks, such societies may be permitted to go outside the purview of the Banking Regulation Act by not accepting deposits from public and thereby ceasing to do banking business as defined in Section 5 (a) of the BR Act. They may also thereby cease to be part of the clearing, settlement and payment system of banks.

3.2 Deposit and public deposit

A relevant question is whether acceptance of deposits from members has to be treated as public deposits and regulated. Financial Companies which accept public deposits but are not engaged in banking business are regulated by the Reserve Bank under the RBI Act¹¹ and other companies by DCA under the Companies Act¹² and Companies (Acceptance of Deposits) Rules made thereunder.

Deposit or public deposit is not defined in the Banking Regulation Act. In the RBI Act "deposit" is defined in Section 45 I (bb) (for the purpose of regulation of NBFCs and UIBs) to cover all kinds of receipts of money including loans but excluding share capital, security deposit, advance for purchase of goods etc. and loans from banks, financial institutions etc. "Public deposit" is not defined in the RBI Act. However, there is a definition of "public deposit" in the Non-Banking Financial Companies Acceptance of Public Deposits (Reserve Bank) Directions, 1998¹³ which provides that all deposits except certain categories.

11. See Chapter IIIB of the RBI Act.

12. See Sections 58A, 58AA and 58AAA.

13. Para 2(1)(xi).

14. Rule 2(b)(ix).

15. Guidelines for Nidhis have been issued vide Notification-

of deposits specified therein are public deposits. These directions specifically exempt amounts received from a person who at the time of receipt of the amount was a Director of a company or any amount received from its shareholders by a private company from the definition of public deposit. Similar provisions exist in the Companies (Acceptance of Deposits) Rules¹⁴ also. However deposits of members of public companies are not exempted from the definition of public deposits. In any case, mere acceptance of public deposits would not make co-operative society a bank just as companies accepting public deposits without having other features of banking are not banks and are regulated separately as non- banking companies.

3.3 Nidhis and thrift societies

Although, deposit acceptance from a limited number of members may not be problematic as the members themselves will be managing the societies, its impact when the numbers and the amount of deposit increase will have to be considered. If the society ceases to be a bank and has no linkages with other banks, failure of a society may not lead to systemic risk for banks or the banking system. However, when large number of members and large amounts are involved, there would be a wider impact of the failure of such societies and it may lead to hue and cry on the ground of affecting public interest. A case in point is that of Nidhis or Mutual benefit companies which accept deposits only from members, but, hold very huge deposits. These public companies (Nidhis/mutal benefit companies) are not engaged in banking business but accept deposits from the members and lend to their members. They are not subject to

regulation under the RBI Act or the Companies (Acceptance of Deposit) Rules but are registered under section 620A of the Companies Act with DCA. The failure of some of these Nidhis and the consequent uproar has resulted in the Government of India coming out with detailed guidelines¹⁵ for the operation of the Nidhis. In the same manner, it will be for the State Government to regulate the societies which are not engaged in banking and accept deposits only from members and are outside the purview of banking regulation.

3.4 Membership rights

The societies doing business only with their members are considered to be able to manage their own affairs as the society is managed by them and public intervention may not be necessary. However, many societies accept deposits from the public enrolling the depositors as nominal members who may not be eligible to full membership rights and therefore, having no effective control over the management of the society. While allowing societies to go outside the Banking Regulation Act by restricting deposits to member deposits, it may be insisted that such members may have full and equal rights in participation of the affairs of the societies.

3.5 Consequences of opting out

The decision of a co-operative bank to opt out of the banking system may lead to certain consequences. These may relate to (i) use of the term bank, banker or banking in the name¹⁶ (ii) losing the status of bank and the consequent ineligibility¹⁷ for insurance cover under the DICGC Act, (iii) finance/refinance from other credit institutions/banks, (iv) acceptance of deposits withdrawable by cheques¹⁸ and (v) loss of eligibility to participate in payment and settlement systems of banks.

3.5.1 Bank/banker/banking

Section 7 of the Banking Regulation Act prohibits the use of the term "bank, banker or banking" by a co-operative society other than a co-operative bank in its name or in connection with business and no co-operative society shall carry on the business of banking without using any of such words as part of its name. A co-operative bank as defined in sec 5(cci) of B R Act (AACS) is a primary co-operative bank or Central Co-operative bank or a State co-operative bank. However, a

16. Prohibition was Section 7, BR Act read with Section 56.

17. Section 2(gg) of DICGC Act.

18. Section 49A, BR Act.

19. The States of AP, Karnataka, MP, Uttaranchal, Orissa.

20. See the judgement of Supreme Court in Apex Bank Case AIR 2004 SC 141.

primary credit society, a co-operative society formed for the protection of mutual interest of cooperative banks, a co-operative land mortgage bank and co-operative societies formed by employees of banks are exempted. Further, as the B R Act as such does not apply to a primary agricultural credit society, a view can be taken that these provisions do not apply to such societies.

3.5.2 Issuance of cheque

Section 49A of the Banking Regulation Act restricts acceptance of deposits by any person other than a banking company, Reserve Bank, State Bank or any other banking institution, firm or other person notified by the Central Government. However, a primary credit society is exempted from these provisions.

4.1 Mutually Aided Co-operative Societies

The dependence of co-operative societies on Government and the consequent rigors of regulation by Government on co-operative societies has led to the enactment of Mutually Aided Co-operative Societies Act or Self Financing Co-operative Societies Act in several states¹⁹. In the societies under the enactments, Government capital is prohibited and the management of the societies is vested in the Board of Directors and the policies are decided by the General Body subject to limited regulatory powers exercised by the Registrar by way of registration of society, registration of bye laws, etc. These State enactments are in addition to the existing State laws on co-operative societies and provides alternative legal framework for co-operative societies. However, in some States (like Orissa), the State enactments provide for creation of a cooperative as distinguished from a co-operative society. This could lead to the position that the entity in question is not co-operative society and the enactment concerned is not a State law on co-operative societies, and that would render the co-operative ineligible to be licenced as a cooperative bank under section 22 of the BR Act (AACS)²⁰.

4.2.1 Migrating to MACS

The enactments providing for Mutually Aided Co-operative Societies also provide for conversion of existing co-operative societies into MACS by repaying the Government capital, if any, and amending the bye laws prohibiting holding of Government capital. As these co-operatives are organized based on the principles of thrift and credit and self reliance as member- driven entities, existing co-operative societies may be encouraged to move out to the MACS regime. This would help such societies to manage their affairs with a certain level of autonomy. If some of the cooperative banks stop accepting non-member deposits and become thrift and credit societies, it will be possible for such societies also to convert into MACS. As some MACS Acts provide for acceptance of deposits from other than members, this may be restricted to members' deposits except in the case of any banking societies.

4.2.2 MACS and banking

If a MACS wants to engage in the business of banking, such society should be subjected to the provisions of the Banking Regulation Act as applicable to other banks. Currently, those MACS which call themselves as co-operative societies may be eligible, for approaching the Bank for a licence to do banking business as they are cooperative societies registered under a State law on co-operative societies. But, some of these statutes do not provide for conferring powers on the Reserve Bank for directing winding up etc. of insured banks as provided in the DICGC Act and therefore, the societies registered under those statutes would not fall within the definition of eligible co-operative bank²¹ under that Act for the purpose of insurance cover. MACS can, however, be recommended as a prototype for legislation for member driven co-operative societies on thrift and credit basis with some caveats. A MACS may not be permitted to undertake banking business unless they come within the purview of the regulatory discipline as applicable to other cooperative banks.

21. As defined in Section 2(gg) of the DICGC Act.

22. Report of Madhav Rao Committee (1999), pp. 90-109 and 210-217.

4.3 Licencing of Co-operative banks

In the co-operative banking hierarchy of Primary, Central and State co-operative banks, several banks including CCBs are not licenced. Currently, applications of several CCBs are pending with the Bank for licence. The Bank is neither allowing nor rejecting them as they are not currently eligible for licence and if licence is rejected, it may affect the system of co-operative in the State. If, such cooperative banks are not able to improve the financial position over a definite time-frame, it is prudent to reject licence. It would be possible to allow such societies to go outside the purview of the BR Act and work as thrift and credit societies, if they choose so.

5. Legislative reforms and other measures

5.1 Madhav Rao Committee Recommendations

Madhav Rao Committee has made certain recommendations²² for legislative reforms which include -

- Amending Sections 5(ccv) and 22 of BR Act (AACS) to stop automatic conversion of primary credit societies into primary co-operative banks
- Amending Section 5 (ccvi) of BR Act (AACS) to define a primary credit society as a cooperative society whose primary object is to provide financial accommodation to members alone.
- Amending Section 49 A of the Banking Regulation Act (AACS) to prohibit acceptance of deposits withdrawable by cheques by primary credit societies
- Amending section 7 of BR Act (AACS) to provide that only such of the primary cooperative societies which have been specifically licenced to carry on banking business should be allowed the use of the word "bank/banker/ banking".
- Amending section 30 of BR Act (AACS) for appointment of Chartered Accountants approved by the Reserve Bank as auditors of urban co-operative banks.
- Amending Section 36 of BR Act (AACS) to require urban co-operative banks to make changes in management as required by Reserve Bank.
- Amending Part II A and Part II C of BR Act on control over management and acquisition of undertaking respectively to make these applicable to co-operative banks.
- Amending Section 45 of the BR Act (AACS) to further extend its application to co-operative banks
- Amending State Co-operative Societies Acts and Multi State Co-operative Societies Act to confer powers on the Reserve Bank in respect of all issues relating to banking, acquisition of assets incidental to carrying on banking functions, policy regarding remission of debts, audit, change of management and appointment of CEO, appointment of Administrator and other banking related functions to be notified by the Reserve Bank, and not to issue licence or branch licence to any urban co-operative bank unless the Acts are so modified.

The above reforms which require amendments to the Banking Regulation Act and Co-operative Societies Acts may be undertaken in due course. There is an urgent need to enact such legislation broadly on the lines of the Banking Regulation (Amendment) and Miscellaneous Provisions Bill, 2003 (lapsed) which provided for wide- ranging amendments to B R Act to increase the minimum capital requirements of co-op. banks and to extend most of its provisions applicable to companies to co-operative banks.

5.2 Interim measures

As legislative amendments stated above would take their own time, in the meantime, we may look for other measures which may be undertaken at the administrative level. Under Section 58 of the Reserve Bank of India Act, Reserve Bank may make regulations for regulation of Clearing, and Payment and Settlement Systems. The relevant provisions of Section 58 (2) are as under: (p) the regulation of clearing-houses for banks (including post office savings banks); "(pp) the regulation of fund transfer through electronic means between the banks or between the banks and other financial institutions referred to in clause (c) of section 45-I, including the laying down of the conditions subject to which banks and other financial institutions shall participate in such fund transfers, the manner of such fund transfers and the right and obligations of the participants in such fund transfers".

These provisions empower the Reserve Bank to make regulations for regulation of the clearing houses for banks and also to make regulations for regulation of electronic fund transfer for banks and financial institutions. In such regulations, the Bank may lay down the conditions subject to which banks and other financial institutions shall participate in clearing or fund transfers thereby effectively restraining ineligible banks from participating in the system. Primary credit societies (which have not graduated to banks) will not be eligible to participate in the Payment and Settlement Systems of banks, and any cheques, if drawn on them will not be getting currency into the banking system and they will only be like withdrawal slips or payment orders which can be encashed at the respective society counters only. Further, by stipulating suitable conditions for joining the Payment and Settlement Systems, weak banks can be compelled either to improve their systems and be in the banking system or to go outside the banking system, back to the role of credit and thrift societies. The kinds of conditions and restrictions which can be imposed in this regard have to be worked out.

5.3 Recapitalisation scheme

Any scheme for recapitalising the co-operatives may stipulate as terms and conditions of such scheme that certain measures of discipline should be followed for such recapitalisation. These terms and conditions can be adopted by agreement among the parties concerned without waiting for statutory changes.