V K Sharma: Supervising in a crisis environment

Address by Mr V K Sharma, Executive Director of the Reserve Bank of India, at the Annual Regulators' Roundtable, organized by the International Credit Union Regulators' Network, Barcelona, 30-31 July 2009.

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I thank International Credit Union Regulators Network for inviting me to this Regulators Roundtable to share our experience of *Supervising in Crisis Environment*. I greatly appreciate the selection of the topic, the relevance of which cannot be over emphasized today. Urban Cooperative Banks (UCBs) in India are akin to Credit Unions as they are member-driven and are essentially community-based. However, unlike credit unions, UCBs are also permitted to accept deposits from non-members and are part of the payments systems.

As the banking, including the urban cooperative banking, sector in India was not affected by the recent global financial crisis, I will share today with this distinguished and august audience the learning curve experienced, not long ago, in dealing with our own kind of crisis. However, I would presently demonstrate how the Reserve Bank, instead of adopting any well-trodden course of action, customized its response, keeping in view the sector-specific problems. I would then review the impact of RBI's approach and strategies for the UCBs and also discuss the ongoing efforts for strengthening the sector. But I must admit that regulating and supervising the UCB sector has been a far more formidable challenge than regulating and supervising the commercial banking sector.

Background

In the year 2004, 38% of the approximately 1926 urban cooperative banks in India were assessed as weak or sick. The deposits of the sector began to show a declining trend and by 2005 the Non Performing Assets rose to 23.2%. In order to address this rather critical situation, several measures were initiated which were both short term as well as long term and far-reaching in nature and which also I propose to discuss today.

Genesis of the crisis

A. Rapid growth of the sector

In the period of 15 years, between 1991 and 2004, the UCB sector had witnessed unprecedented growth. From 1306 urban cooperative banks in 1991, the number of banks increased to 1926 in the year 2004, representing a growth of 47 percent i.e. 620 banks were added in 15 years (not counting for the banks that collapsed in that period). As against this, in the previous 25 years i.e. between 1966 and 1991 only 200 new banks had come up.

This spectacular growth of UCBs since 1991, resulted in increasing their penetration, but ironically, also led to certain weaknesses in the sector that adversely affected public perception and thereby, their competitiveness. The weakening of public confidence in UCB sector began with a crisis in 2001 faced by a large multi-state bank in the prosperous state of Gujarat, when there was a sudden "run" on the bank, following rumours of its large exposure to a leading stock broker who had suffered huge losses in the stock market. The large-scale withdrawal of deposits within a short time resulted in severe liquidity problems for the bank which at that time held about US $ 160 million equivalent of inter-bank deposits from over 200 UCBs in the State and from other States, which obviously posed a systemic risk. The Gujarat episode was followed by another major crisis in the state of Andhra Pradesh in 2002, when one of the largest banks in the state faced a run, following a newspaper report of an inquiry into the affairs of the bank by the State Registrar of Cooperative Societies. The bank was in a weak position, and ultimately, after attempts at its revival failed, its license was cancelled by the Reserve Bank in 2004.The decline in public confidence in the UCB sector deepened in the aftermath of the crisis in Gujarat and Andhra Pradesh and concomitantly, the position of UCBs generally deteriorated which was reflected in the RBI's on-site assessment of the banks.

In this context, I may mention that as part of its on-site inspection, Reserve Bank has a system of categorizing banks into four grades based on parameters of capital adequacy, asset quality, earnings, compliance with CRR/SLR requirements and adherence to RBI guidelines. While Grade I & II banks have no major supervisory concerns, the other two grades indicate presence of supervisory concerns to varying degrees. As on June 30, 2004, 732 out of 1919 UCBs were categorised in Grade III or IV, signifying weakness and sickness. The deteriorating position of UCBs was reflected in the public perception and deposits of the sector declined for the first time since its documented history in 2004-2005 by 4.7%.

In addition to the impact of too rapid a growth, discussed above, there are certain structural aspects of the sector which were a cause of concern for supervisors and as I discuss these, you will notice, that some of these are also, not unique to India.

B. Heterogeneity

There is significant degree of heterogeneity in terms of size, geographical distribution, performance, financial strength as also in the IT and human resources endowment of the UCBs. While on the one hand, there are a number of small neighbourhood unit banks functioning for mutual interest of their members, there are several large UCBs with a wide network of branches, large number of depositors and borrowers on the other, many of whom are medium/large corporates. In the latter, while the cooperative structure exists only as an organizational arrangement, their business model and goals are more like commercial banks. The extent of heterogeneity can be gauged by the fact that 30.7% of the UCBs hold only 2.2% of deposits while at the top end, only 16 banks account for 28.8% of the total deposits of the sector. Incidentally, despite the differences in size, a "one size fits all" approach to regulation and supervision existed with all UCBs being subjected to the same regulatory and supervisory framework as it was for commercial banks.

C. Dual control

Another feature of the UCB sector in India is the duality of control. UCBs are regulated and supervised by both the State Governments, through the Registrars of Co-operative Societies, and by the Reserve Bank of India. While the State Registrars exercise powers with regard to incorporation, registration, management, amalgamation, reconstruction or liquidation, in the case of banks having presence in more than one state, the Central Registrar of Co-operative Societies, on behalf of the Central Government, exercises such powers. The banking related functions such as issue of license to start new banks, or branches, matters relating to interest rates, policies on loans and investments, prudential norms etc. are regulated and supervised by the Reserve Bank of India. It was often our experience that the effectiveness of regulatory and supervisory measures got diluted because of inadequate response from State Government. Reserve Bank's requisition to State Government to supersede the board of a bank, for example, would get acted upon with inordinate delay by the Registrar of Cooperative Societies, in case the State Government did not share RBI's perception about the competence of the board. There was thus no doubt that this was another issue which needed to be addressed as part of the strategy for effectively handling the crisis in the sector.

D. *Business model – corporate governance issues*

Most of the problems faced by the sector arose from lack of good governance in UCBs, as indeed, incidentally, but significantly, was also the case, in the recent global financial crisis, with large global banks. Besides, in India, unlike a company, shareholders/members of a UCB, are generally the debtors of the bank. While this would be an appropriate framework for governance for a cooperative society, which accepts deposits only from members/shareholders, it leads to distortion in the business model when applied to a cooperative bank, which solicits deposits from non-members as well. As majority of the share holders are borrowers in UCBs, the elected management would have an incentive to pursue policies which are more borrower oriented that may not always be in the best interests of depositors. Also, unlike in the case of companies, the shares of which are listed on a stock exchange and can change hands without affecting the capital base, in the case of UCBs, the shareholders can withdraw their contribution to capital and shrink the capital of the bank and thereby limit its ability to increase risk weighted assets and expand business.

Response strategy

Keeping in view the characteristics of the UCB sector, Reserve Bank initiated a series of measures to resolve the structural problems and strengthen the banks. In what follows, I set out the initiatives of the Reserve Bank in dealing with the crisis.

A. *Withholding of new bank and branch licenses*

Licensing norms for UCBs were eased in May 1993 and within 8 years i.e. by June 2004, more than 800 banks mushroomed and close to one third of these newly licensed UCBs became financially weak within a short period of 2-3 years. There was, thus, a need to moderate the pace of growth of this sector and it was, therefore, decided in June 2004 to stop issue of licenses for new banks and branches until a suitable framework for regulation and supervision was in place for the already large number of UCBs.

B. *Vision document for UCBs*

Recognizing the systemic risk concerns, Reserve Bank reviewed the entire gamut of legislative, regulatory and supervisory framework for these banks, and in March 2005, brought out a draft "Vision Document for UCBs". The vision document, discussed the characteristics of the sector, analyzed the problems afflicting the banks and proposed the following regulatory and supervisory strategies for dealing with the problems affecting the sector:

a) Nuanced and granular approach to supervision and regulation

Highlighting the heterogeneity of the sector, the Vision Document observed that the "one size fits all" approach to regulation and supervision of UCBs needed to be abjured and a multi-layered regulatory and supervisory approach be adopted keeping in view the heterogeneity of the sector. Accordingly, it was decided that banks with deposits less than Rs.1 billion (equivalent to US $ 20 million), and whose branches are limited to a small area i.e. Tier-I banks which more closely epitomized the cooperative spirit, be placed under simplified prudential regulation for some time in order to enable them to gradually gain in strength so that over a period of 3 years they could be brought at par with all other banks for the purposes of regulation. Accordingly, the Tier-I banks have been placed under the 180-day delinquency norm while Tier II banks are under the 90-day norm as applicable to commercial banks. The Tier-I banks are, however, required to make adequate provisions in the intervening period to enable them to migrate to the 90-day norm in future. Further, lower provisioning requirements were stipulated for Tier-I compared to Tier-II banks which is also intended to provide a measure of relief to the small UCBs, as lower provisioning would translate into higher profits that could, in turn, be used, during the transition period, to shore up the capital base of the banks.

b) Consultative approach to supervision – TAFCUB

In order to address the problem of Dual Control, Reserve Bank in 2001-2002, suggested that a new Apex Supervisory body be constituted for the UCB sector, comprising representatives of Central / State Governments, RBI and experts from the field. However, since it did not materialize, Reserve Bank proposed the amendment of Banking Regulation Act for providing powers to RBI over the UCBs similar to those that are available in respect of commercial banks. When even the 2nd suggestion did not materialise, the Reserve Bank in *the* Vision document for UCBs proposed the adoption of a coordinated approach to deciding the future set up of weak and sick banks in each state. To this end, Memorandum of Understanding (MoU) was signed between RBI and respective state governments and Central Government, in the case of multi-state urban cooperative banks, to achieve greater convergence of approach of the two agencies tasked with the regulation and supervision of UCBs. As part of the MoU, it was decided to set up of State Level Task Force for Urban Co-operative Banks (TAFCUBs) comprising representatives of RBI, State Government and national and state level federation/association of UCBs. TAFCUB was tasked with the responsibility of identifying the potentially viable and non viable UCBs in the state and providing a revival plan for the former, and a non disruptive exit route for the latter, set of banks. The exit route could include merger/amalgamation with stronger banks, conversion into societies, or ultimately, only as a last resort, through liquidation. Based on recommendations of TAFCUBs, supervisory actions that have been initiated include merger of unviable banks with financially strong UCBs, cancellation of license of unviable banks and rejection of license applications of unlicensed cooperative banks, which were being allowed to conduct banking business pending rejection of license application by RBI, as per the Banking Regulation Act, 1949 (As Applicable to Cooperative Societies (AACS). Significantly, the number of unlicensed banks dramatically dropped from 1066 in 1977 to a mere 58 as of date!

The access to consolidated information from local and national level federations of the banks, as also from the regulators and supervisors, made TAFCUB an effective instrument for consolidating the sector through quick and non-disruptive exit of unviable banks and revival of the viable ones. As recommendations of the TAFCUBs, had the consent of all stakeholders including the Reserve Bank of India, they lent themselves to speedy implementation by all concerned. The first TAFCUB was set up in June 2005 and its success in taking of difficult decisions in a transparent manner and the consequent turning around of banks, has led to its adoption practically in all the states.

c) Information technology

As part of the MoU signed with the states, RBI committed itself to facilitating IT and human resources development initiatives in UCBs. On the technology front, a beginning was made by RBI with the development of software that facilitates compilation and submission of all supervisory and regulatory returns by UCBs to RBI, electronically. The software also allows banks to analyse their own data and it is, therefore, being used as a powerful management information tool by many banks. The data submitted by banks are subjected to analysis by supervisors, inter alia, with the objective of tracking incipient stress faced by banks as also for identifying outlier banks. This off-site surveillance mechanism also acts as a Decision Support System, as data presented in an analysed form facilitates informed decision-making in addition to facilitating a technology-driven system for focussed and continuous supervision of UCBs, which was one of the important objectives set out by the Vision Document. I understand that a presentation on the Off-site surveillance system for UCBs was also made before this group in July 2008 at Hongkong.

Recognising the vast scope for use of IT, the Reserve Bank constituted a Working Group comprising members from State Government, UCB Sector and RBI to examine *"the various* *areas where IT support could be provided to the UCBs by the Reserve Bank."* The report of the Group is being examined for implementation and I hope that the same would give a major fillip to the competitiveness and strength of the UCBs through extensive use of IT.

d) Human resources initiatives

In order to upgrade the skills of officials of UCBs and enhance professionalism, training programs are conducted by RBI in all important areas of banking for Directors, Chief Executive Officers and other officials of UCBs. Training programmes are organized at Regional centres and training imparted in local/regional languages to enable local staff absorb training without any difficulty. These programs for UCBs are conducted free of cost and by now over 2000 officials have so far been trained under this major initiative.

C. Measures for improving corporate governance

While extending necessary support for up-gradation of professional skills of Directors, the Reserve Bank also advised banks to induct at least 2 professional directors on their Boards, with a view to ensuring that Boards have the requisite skill and competence to review and assess management performance. In states that have signed MoU with the Reserve Bank, guidelines for adopting "fit and proper" criteria for appointment of CEOs have also been implemented. These emphasize the track record and integrity of the candidate apart from certain eligibility criteria like minimum qualification and age for being CEO of an urban cooperative bank.

An indicative list of dos and don'ts has also been formulated to serve as a guide to directors to enable them to play their role more effectively. The need for the directors to maintain "arms" length from the day-to-day operations of the bank is also highlighted in the dos and don'ts prescribed by Reserve Bank. Connected lending to directors, their family members and associated business firms, in UCBs has been banned, except for loans against securities like fixed deposits etc. The Reserve Bank has also circulated a list of best practices followed by well-run banks for others to emulate.

Further, banks have also been advised to constitute Audit Committee of the Board and State Governments, as per the MOU signed with RBI, are committed to get statutory audit of larger UCBs conducted by Chartered Accountants. In order to ensure that the financial statements reflect a true and fair picture of banks' financial position, not only is RBI emphasizing on professionalization of audit, but is also providing training to state government auditors.

D. Consolidation in the UCB sector

Consolidation in the sector through the process of merger of weaker entities with stronger ones was set in motion in 2005 by providing transparent and objective guidelines for granting no-objection to merger proposals as a strategy for providing non-disruptive exit for the weaker banks. A four-member external Expert Group has been set up to vet merger proposals, with a view to providing a transparent mechanism and impartial inputs. TAFCUBs have representatives from the sector who also provide local level inputs on banks that are on the lookout for taking over other weak banks as part of their inorganic growth strategy. In all 82 merger proposals have been approved so far, of which 71 mergers have already materialized in the last 4 years.

E. Problem bank resolution: customized solutions

Apart from encouraging voluntary mergers, various other strategies have been adopted for problem bank resolution. Restructuring of liabilities involving conversion of a part of the deposits into equity has been done recently in the case of systemically important banks.

In one case, the depositors of a bank were encouraged to convert entire interest credited to the deposits, from the date of placing the bank under restrictive directions, into equity. As a result, the extent of outside liabilities was reduced and the bank became solvent. As this conversion included amount eligible for insurance cover from Deposit Insurance Corporation, it was also agreed to allow the capital contribution by the small depositors to be added back to their deposits for reckoning insurance cover should a need arise to liquidate the bank before it attained full solvency.

In another case, a part of the deposits were allowed to be converted to equity/ perpetual debt instruments. Also, to ensure that the net worth of the bank turned positive after re-structuring and it had liquid assets adequate to meet the statutory pre-emption, the cash pay outs were suitably adjusted with different levels of sacrifice by the depositors.

Another strategy for problem bank resolution was drawing up schemes for acquisition of a weak UCB by a strong UCB and exploring possibilities of funding the gap between valuation accepted by the acquiring bank and the actual deposit liabilities by the Deposit Insurance and Credit Guarantee Corporation. In certain cases, UCBs have also been able to turn around by taking advantage of the property boom and disposing of surplus land and buildings.

F. Incentives for good banks

While tackling the weak banks was one part of the response strategy, it was felt that encouraging strong banks with incentives by way of newer/additional business opportunities could complement the efforts in building up a strong sector. With this objective in view, the Reserve Bank has been encouraging financially sound and well managed UCBs in the States that have signed MoU, with business development opportunities, such as opening of new branches (including offsite and onsite ATMs), currency chests, opportunities for forex, insurance, mutual fund businesses, extension of area of operations to the entire state, besides providing training in I.T and support for upgrading human resources for all banks in MoU states, including the strong ones.

G. New initiatives for strengthening UCBs

In India, UCBs are working on stand-alone basis at the grassroots level of the financial system. Being comparatively small, it is difficult for such entities to compete with commercial banks and establish market share. Looking at various successful federal models existing internationally, especially in Europe and USA, a need was felt for strong inter-cooperative bonding and co-operation and a centralized apex institution that will be in a position to channelize their resources, aggregate their needs and also lend credibility through mutual support in the financial markets. Besides, the federated model gives options to UCBs to raise capital through subsidiaries etc. The Reserve Bank is examining the prospect of such an arrangement which may further act as a bulwark in crisis situation and strengthen supervision through Self Regulatory Organizations.

Impact of recent initiatives: restoration of public confidence

A quick analysis of the impact of the above measures shows that there is a positive change in public perception about the UCBs. Consequently, not only the larger depositors but also better quality borrowers are getting attracted to these banks. The quality of assets and grade-wise distribution of UCBs over the last few years reflect the improvement in the overall position of the UCB sector:

Changing profile of urban cooperative banking sector

Year (as at end-March)	No of UCBs	Gross NPAs (Rs. billion)	Gross NPA as % of total advances	No. of banks in Grade				% of banks in Grade III & IV
				I	II	III	IV	
2004	1919*	154.06	22.7	880	307	529	203	38
2005	1872	154.86	23.2	807	340	497	228	39
2006	1853	135.06	18.9	716	460	407	270	37
2007	1813	145.41	18.3	652	598	295	268	31
2008	1770	145.83	16.4	748	526	258	238	28

*(*out of 1926 UCBs , ratings of 1919 available) ; NA: data under compilation*

The enhancement of public confidence in the sector is reflected by the growth in the deposit base, which increased from Rs.1140.60 billion as on March 2006 to Rs. 1213.91 billion (US $ 25.1 billion) as on March 31, 2007 and to Rs.1384.96 billion (US $ 28.64 billion) in 2008 i.e. showing a rise of 6.4% and 14.1% respectively, over and above the increase of 8.6% during the year ended March 31,2006, thereby reversing the declining trend of previous years, as shown in the next table:

Year ended March 31,	Number of UCBs	Deposits (Rs.billion)	Growth (in %)	Advances (Rs. billion)	Growth (in %)
1991	1306	101.57	-	80.03	
2001	1618	808.40	-	543.89	
2002	1854	930.69	15.1	620.60	14.1
2003	1941	1015.46	9.1	648.80	4.5
2004	1926	1102.56	8.6	679.30	4.7
2005	1872	1050.21	-4.7	668.74	-1.6
2006	1853	1140.60	8.6	716.41	7.1
2007	1813	1213.91	6.4	797.33	11.3
2008	1770	1384.96	14.1	889.81	11.6

The progress so far in handling the crisis of UCBs is on account of having adopted a flexible approach and being sensitive to the ground realities. We recognized the risk of distancing ourselves from the regulated entities and sought to develop close communication not only with other stakeholders but also with the banks. This gave us an intimate feel of the sector and facilitated formulation of realistic and customized responses. Our next policy goal is to raise the awareness among UCBs of the need for the induction of depositors as regular members, at least, those with deposits above a threshold, which would make for a better balance in the governance of urban cooperative banks and help further boost public confidence. The key to the success of the UCB model would appear to lie in not only adopting a member centric approach, but also taking depositors on board.

Concluding remarks

I have traced the evolution of UCBs over time, their unique structure, strengths and weaknesses. I also discussed the crisis that the sector faced and the multi-pronged response strategy of the Reserve Bank in dealing with the same. Once again, I would like to thank ICURN for inviting me to share the lessons/takeaways from the Indian experience in handling the crisis of the UCB sector. I welcome your views on our response strategy towards strengthening this important sector of the Indian financial system and would take any questions that you may have now or anytime during the course of this conference.

Thank you all so very much.