Urban Cooperative Banks: Problems and Prospects*

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I am indeed proud to have been given the privilege of sharing with you some of my thoughts on the profile of Urban Cooperative Banks (UCBs) at this august gathering. In this brief session, I would like to highlight some of the salient features of the performance of UCBs and some of the emerging issues that are likely to be of significance to us.

I. Introduction:

One of the major areas of the macroeconomy that has received renewed focus in recent times has been the financial sector. One might attribute this to two reasons. Firstly, as Stiglitz (1999)[1] has observed, the financial sector acts as the 'brain' of the economy: it acts as a conduit for channeling resources from final savers to final investors. As a result, the greater the ease of resource intermediation, the lower the cost at which these resources can be available to final investors, enhancing investment and growth. Secondly, the worldwide trend towards de-regulation of the financial sector, ascendancy of free market philosophy and the widespread banking problems that have plagued several economies since the eighties have raised a gamut of questions relating to the linkages between de-regulation, various categories of risks facing the banking sector and banking crises. According to Lindgren *et.al.* (1998)[2] , since 1980, over 130 countries, comprising almost three fourths of the International Monetary Fund's member countries, have experienced significant banking sector problems, with 41 instances of crisis in 36 countries and 108 instances of significant problems. Consequently, the banking sector, or for that matter, the financial sector in general, in most emerging economies are passing through challenging yet exciting times. In the Indian milieu, given the wide diversity within the financial sector itself, I would take this opportunity to throw some light on one particular facet of the financial sector, *viz.,* the Urban Cooperative Banks.

Urban Cooperative Banks were set up with the avowed objective of promoting sustainable banking practices amongst a relatively specific target clientele *viz*., the middle income strata of the urban population. They were brought under the regulatory ambit of the Reserve bank by extending certain provisions of the Banking Regulation Act, 1949, effective from March 1, 1966.

It might be useful to briefly recount the basic structure of the cooperative banking sector and locate Urban Cooperative Banks as a group within that framework. The cooperative banking sector may be viewed as consisting of Rural Cooperative Banks and Primary (Urban) Cooperative Banks. Leaving aside the structure of Rural Cooperative Banks, Primary Cooperative Banks, numbering 1,936, have a network of over 6,300 branches catering to the banking requirements of the lower and middle income groups in urban and semi-urban areas.

II. Recent Performance:

As at the end of March 1999, 1,936 PCBs were functioning in the country with 6,308 offices, including 90 salary earners' banks and 117 *mahila* banks. The total number of licensed PCBs increased to 1,692 as at the end of March 1999. The data available upto end-December 1998 indicates that the growth of both deposits as well as credit of PCBs slackened during the first three quarters of 1998-99. The year-to-year growth in deposits upto March 1999 at 28.9 per cent was lower than that of 32.9 per cent recorded in the previous year. Similarly, the outstanding loans of PCBs at Rs. 30,999 crore at the end of December 1998 registered an annual growth of 22.0 per cent as compared with the growth of 29.0 per cent during 1997-98. Continuing the trend of the previous two years, the growth of deposits of PCBs outpaced the growth of credit in 1998-99. As a result, the credit-deposit (C-D) ratio of PCBs declined to 63.8 per cent as at the end of December 1998 from 68.3 per cent in end-March 1998.

The performance of the cooperative banking sector as a whole has attracted considerable attention in the recent years especially in the context of the ongoing phase of financial sector reforms. Compared to their rural counterparts, the Primary Cooperative Banks (PCBs), which operate in the urban areas, have posted better performance. Not surprisingly however, there is significant heterogeneity in the performance of PCBs which number more than 1,900 at present. While a large number of these banks have shown creditable performance, a fair number of them, on the other hand, have shown discernible signs of weakness. This conference should provide excellent opportunity to discuss this issue more intensively.

It is of interest therefore to analyse the profit and loss accounts of all reporting PCBs. As data reveals, out of the 1,500 PCBs, 1,295 of them registered profits while, the remaining 205 PCBs reported losses during 1997-98. The percentage of gross NPAs to total advances of PCBs remained at around 13.0 per cent during 1995-96 and 1996-97, declined to 11.7 per cent as at the end of March 1998 and further to 10.8 per cent as at end of March 1999. It is, therefore, a healthy sign so far as recovery management of PCBs is concerned. I would take this opportunity to congratulate the urban banking movement for its endeavour in this regard.

In my view, an important contributory factor for this positive feature is the fact that these banks have maintained close proximity with their borrowers. An indiscriminate branch expansion would perhaps erode this vital strength. UCBs would, therefore, do well to keep this in mind while planning their expansion in terms of branches. Secondly, they have developed a certain client profile which has proved to be its strength in the long run. It is important that these banks continue to draw upon this strength and provide much needed financial support to the segment of society which does not have easy access to large commercial banks.

Scheduled Primary Cooperative Banks

Statistics reveal that the outstanding deposits of 29 scheduled PCBs at Rs.16,429 crore as on last Friday of March 1999, posted a lower annual growth of 28.9 per cent as compared to that of 32.9 per cent during the previous year. The outstanding credit of scheduled PCBs at Rs. 10,112 crore recorded a growth of 20.7 per cent in 1998-99, which was lower than that of 33.1 per cent in 1997-98. The Credit-Deposit ratio of scheduled PCBs declined from 65.7 per cent as at the end of March 1998 to 61.5 per cent in end-March 1999.

It needs to be recognised that deposits are the major source of funds for the scheduled PCBs and their share in total liabilities was well over 70 per cent as at the end of March 1999. Capital and reserves constituted about 9 per cent of the total liabilities of the scheduled PCBs. On the asset front, loans and advances constituted the most significant component, followed by investment.

During the year 1998-99, the composition of assets of scheduled PCBs did not show any appreciable change. The share of loans and advances declined from 46.6 per cent to 44.2 per cent, while that of investments increased from 25.3 per cent to 26.4 per cent.

The total income of the scheduled PCBs increased significantly by 24 per cent to Rs. 2,535 crore during 1998-99. The greater share of the total income came from interest income (95 per cent). Total of interest and other operating expenses, however, grew at a higher rate of 28 per cent to Rs. 2,140 crore causing the spread (*i.e.*, net interest income), as a percentage to total assets, to decline from 3.78 per cent in 1997-98 to 3.25 per cent in 1998-99. In absolute terms, the operating profits amounted to Rs. 395 crore and recorded a growth of 5 per cent during 1998-99. As a percentage to total assets, operating profits declined from 2.03 per cent in 1997-98 to 1.67 per cent in 1998-99. The provisioning requirements in 1998-99 declined by 26 per cent from Rs. 290 crore in 1997-98 to Rs. 214 crore in 1998-99. As a result, the scheduled PCBs as a group posted much higher net profits of Rs. 181 crore during 1998-99 as compared with that of Rs. 86 crore in the previous year. As a percentage to total assets, net profits of scheduled PCBs increased from 0.46 per cent in 1997-98 to 0.76 per cent in 1998-99. I must mention here that in view of the increasing competition being currently witnessed in the banking segment, PCBs would need to go in for increased customer orientation and greater product sophistication in order to sustain and increase their market share in the medium to long run.

Lest it be felt that UCBs as a group are totally segregated from the commercial banking sector, let me draw your attention to a number of commonalties in the operating environment between the scheduled PCBs and Scheduled Commercial Banks (SCBs). In essence, an attempt is made to compare the performance of these groups. By virtue of their retail market orientation and identified customer groups, the scheduled PCBs were able to achieve higher growth rates in deposits and credit than the scheduled commercial banks. A comparison of the financial performance of these two groups reveals that in relation to total assets, the spread of scheduled PCBs was higher and the operating expenses were lower than those of SCBs. However, the gap in the operating profit ratios of scheduled PCBs and SCBs narrowed down due to higher share of 'other income' for SCBs. Still the profitability of scheduled PCBs was higher than that of SCBs. While comparing the expenditure pattern of PCBs and SCBs, it was also observed that the interest expenses accounted for a higher share of the total expenses in the case of PCBs but their establishment cost was of relatively lower order.

III. Emerging Challenges:

The second phase of financial sector reforms have brought about vast changes in the structure and operation of the Indian financial sector. However, the reform measures are yet to fully impact the system. Financial and managerial weaknesses of a good number of cooperatives have been a matter of concern for quite some time. State Governments and cooperatives have been demanding capital infusion for wiping out past losses. Unless the inherent weaknesses are adequately addressed, funds infusion alone may not solve the problem. In this respect, the areas that need careful examination include: (i) the pattern of resources of cooperatives (owned funds, deposits, borrowings), (ii) the deployment of resources, (iii) the management and supervision, (iv) the role of cooperative banks in the financial system and (v) the regulatory framework for cooperatives.

The essential spirit of the regulatory and reform measures adopted for the commercial banks need to be extended to the cooperatives as well with necessary adaptations to suit the circumstances in which cooperative banks operate. This would imply that areas such as (i) strengthening of the regulatory and supervisory framework, (ii) enhancing capital adequacy standards (iii) introducing stringent licensing norms for new entrants into the sector (iv) enabling legal amendments and (v) corporate governance measures need to be given very close attention.

As a starting point, it would be useful to look at the Narasimham Committee recommendations. The Committee suggested that the RBI should review the entry norms in respect of UCBs and prescribe revised prudent minimum capital norms for them. To achieve an integrated system of supervision over the financial system, the Committee recommended that UCBs should also be brought within the ambit of the Board of Financial Supervision. In response to these recommendations of the Committee, the Reserve Bank set up a High Powered Committee on Urban Cooperative Banks under the chairmanship of Shri K.Madhava Rao, former Chief secretary to Government of Andhra Pradesh, to review the performance of UCBs and suggest measures to strengthen them.

Licensing Policy: In the new liberalised regime, licensing policy for new UCBs is expected to be not only transparent, but also precise and objective, based on established standards and procedures. Moreover, the procedures governing these licensing norms have to be simple and minimal. Furthermore, in the market driven system, as the role of the regulator moves away from micro management of individual entities towards macro or prudential management, it is desirable that appropriate entry point norms be laid down by the regulator to serve as an effective screening device and the subsequent potential and viability of a bank be left to the promoters' judgement. In connection with the above, the Madhava Rao Committee enunciated a two-fold licensing criteria, depending on the capital base of the bank. This would need to be examined for developing a viable structure of cooperative banks.

Dual Control: One of the problem areas in the supervision of UCBs is the duality in control by the State Government and the Reserve Bank. Since UCBs are primarily credit institutions meant to be run on commercial lines, the responsibility for their supervision devolves on the Reserve Bank. Therefore, while the banking operations pertaining to branch licensing, expansion of areas of operations, interest fixation on deposits and advances, audit and investments are under the jurisdiction of the RBI, the managerial aspects of these banks relating to registration, constitution of management, administration and recruitment, are controlled by the State Governments under the provisions of the respective State Cooperative Societies Act. The Narasimham Committee (1998) recommended that this duality of control be done away with and the responsibility of regulation of UCBs be placed on the Board for Financial Supervision. This will require amendment of the Multi-State Cooperative Societies Act, 1984, State Cooperative Societies Act, and the Banking Regulation Act.

Corporate Governance: Good corporate governance is essential for the effective functioning of any financial entity. It is all the more important in the current liberalised environment when UCBs are expected to function as commercial entities in the face of increasing competition. To this end, the Madhava Rao Committee suggested that at least two directors with suitable professional qualification and experience should be present on the Boards of UCBs and that the promoters should not be defaulters to any financial institutions or banks and should not be associated with chit funds/ NBFCs/coopertaive banks/commercial banks as Director on the Board of Directors. These recommendations would need to be examined intensively before formulating policy actions in this regard.

Capital Adequacy: The Narasimham Committee (1998) had raised the issue of extending capital adequacy prescription for cooperative banks. Accordingly, the Committee recommended that the cooperative banks should reach a minimum 8 per cent CRAR over a period of five years. The findings of the Madhava Rao Committee on UCBs also reiterated that a majority of the UCBs was in favour of extending the CRAR discipline to UCBs. However, the ability of the UCBs to raise additional capital for the purpose has been limited by certain features *viz.*, inability to make public issue of capital and that, they can raise capital only from members, subject to an overall ceiling and restrictions imposed by the various Acts (State Cooperative Societies Act and Multi-State Cooperative Societies Act, 1984) which constrains the number of shares that an individual can hold. In view of the above, it is suggested that scheduled UCBs be brought under the ambit of the CRAR discipline in a phased manner with an immediate target of 8 per cent by March 31, 2001 and 9 per cent by March 31, 2002 and thereafter, the same as those for commercial banks; the norms for non-scheduled SCBs in this regard being slightly less stringent than the former.[3]

Legislative Reforms*:* The Narasimham Committee in its Report had rightly observed that a legal framework that clearly defines the rights and liabilities of the parties to contracts and provides for speedy resolution of disputes is an essential bedrock of the process of financial intermediation and UCBs are no exceptions. Accordingly, the Government had appointed an Expert Group under the Chairmanship of Shri T.R. Andhyarujina, former Solicitor General of India, to suggest appropriate amendments in the legal framework affecting the banking sector. The Committee would address amendments in the various external Acts affecting banking sector such as, the Transfer of Property Act, foreclosure laws, Stamp Act, Indian Contract Act, DRT Act, etc. The Committee, in its Report submitted in April, 2000, recommended inclusion of a new law for granting statutory powers directly to banks (and financial institutions) for possession and sale of securities backing a loan, an enabling framework for securitisation of receivables and strengthening the recovery mechanism. While these recommendations will need to be scrutinised to glean their implications for UCBs, at the micro-level, certain related issues deserve attention. As mentioned earlier, the removal of the duality of controls over UCBs necessitates the amendment of the various Acts in the Central and State statutes, including the BR Act.

Unlicensed and Weak banks: The existence of a large number of unlicensed banks has become a serious cause for concern to regulators. The main reason for proliferation of such banks has been a mild screening process in the past. In view of the regulatory discomfiture that such banks impose on the system as a whole, it has been suggested that these banks be licensed provided they satisfy the quadruple criteria of (a) minimum prescribed CRAR, (b) net NPA ratio not exceeding 10 per cent, (c) have made profits continually for the last three years, and (d) have complied with the RBI regulatory directions.

Incidence of sickness of UCBs has become a source of serious concern for regulators. It has been felt that inadequate entry point capital, lack of professionalism, absence of compliance with prudential norms and the absence of timely identification of sickness have been the major contributory factors behind persistent weakness of certain UCBs. As a need to flash early warning signals of incipient weakness, the Madhava Rao Committee enunciated certain criteria relating to CRAR, NPA and history of losses for the identification of sick and weak banks separately. Post identification, these banks may be placed under moratorium under the provisions of Section 45 of the BR Act and reconstruction/rehabilitation carried out. At the extreme case of reconstruction being impossible, the bank's license to carry on business may be withdrawn. These remedial measures are being examined and their implications for policy formulation carefully studied before arriving at definitive conclusions.

One issue of serious concern regarding UCBs is the delay/ non-submission of returns within the stipulated time frame. In particular, PCBs are required to submit two types of returns (statutory returns and control returns) to the Reserve Bank with a view to exercise adequate supervision over them. Unfortunately, there is often a serious delay in the submission of these returns by individual banks. Non-availability of adequate and timely data would no doubt have serious effect on timely policy action. In this context, PCBs have to improve their statistical reporting system and bridge the wide gap in data availability as compared to that of commercial banks.

IV. Conclusion:

Within the constraints of time at my disposal, I have tried to throw some light on some of the issues that I believe are of primary importance to the urban cooperative banking sector. I believe that many of you will ponder over these issues and provide us with important feedback as inputs for policy making. Thank you for being kind enough to spare your time and listen to me.

*** Inaugural address by Shri Jagdish Capoor, Deputy Governor, Reserve Bank of India, at the 8th All India Conference of Urban Cooperative Banks and credit societies at Delhi on April 20, 2000.**

[1] Stiglitz, J.E. (1999) : "Principles of Portfolio Regulation: A Dynamic Portfolio Approach", Lecture delivered at NCAER.

[2] Lindgren, C-J, G.Garcia, and M.Saal (1996) : "Bank Soundness and Macroeconomic Policy", Washington, International Monetary Fund.

[3] For non-scheduled UCBs, it has been suggested that the CRAR discipline be fixed at 6 per cent as on March 31, 2001, to be raised subsequently to 7 per cent and 9 per cent, respectively, by March 31, 2002 and March 31, 2003, respectively.