Urban Co-operative Banks : Agenda for Future Reforms *

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It is very gratifying to note that Federation of Indian Chambers of Commerce and Industry (FICCI) as the apex representative body of Indian Trade and Commerce has evinced keen interest in Urban Co-operative Banks (UCBs), the purveyors of credit to small and medium enterprises.

As urban co-operative banking sector is under focussed scrutiny of media and observers of co-operative credit movement, I feel it is very apt that organisers chose 'Reforms in Urban Banking Sector' as the theme for today's discussion. Before approaching the subject proper, I would make a brief mention about the size, role and reach of the urban co-operative banks in the map of Indian banking system.

Urban Banking Sector - A Bird's Eye-view

The High Power Committee on Urban Co-operative Banks constituted by the Reserve Bank in 1999, has aptly commented that the co-operative credit endeavour was the first ever attempt at micro credit dispensation in India. UCBs were essentially designed to tap the resources of lower and middle income groups and extend credit support to their economic activities. Over a century old urban co-operative credit movement today has a network of 2,084 urban co-operative banks with 7,368 branch outlets spread over the country. Their total deposit sources aggregated Rs.71,701 crore and outstanding loans accounted for Rs.45,856 crore as at the end of June 2000.

The deposits of UCBs are equivalent to 9 per cent of commercial banks' deposits. Few States such as Maharashtra, Gujarat, Karnataka, Andhra Pradesh and Tamil Nadu account for over 80 per cent of urban cooperative banks' presence and 75 per cent of their total deposits. Predominant concentration of UCBs in these five States is mainly on account of emergence of strong co-operative leadership. UCBs normally confine their area of operation to localised geographical regions. But over a period of time, their areas of operation have crossed the frontiers of districts and in some cases the States of their registration. The client profile of UCBs predominantly comprises priority sector segments *viz.,* small business establishments, small scale industries (SSIs), retail traders, professional, self-employed persons and state road transport operators (SRTOs), etc. who would not normally find it easy to have access to large commercial banks. There are weak banks also in the total population of urban co-operative banks but most of the banks may be rated as satisfactory to very good banks. Many of them are highly computerised. We should, therefore, judge each entity on its performance. Wrong doings by a few should not make us berate the entire lot as it would hurt the honest managements who should, in fact, get encouragement.

As regards their regulation, which has become a subject of intense debate in the recent past, UCBs essentially being cooperative societies are governed by their respective State Governments out of the powers derived from respective State Cooperative Societies Acts. Being banking institutions, they are also governed by the Reserve Bank of India by virtue of powers conferred on it under the Banking Regulations Act. As UCBs are member driven institutions, every member has to have stake in the capital and irrespective of a member’s shareholding, each member has only one vote.

Agenda of Reforms

The urban co-operative banking sector being an integral part of financial system, the Reserve Bank has brought in a series of reforms for it. The recent Madhava Rao Committee which is also called High Power Committee (HPC) on UCBs, has dwelt extensively on certain regulatory issues related to UCBs’ licensing policy, future set up of weak and unlicensed banks, application of capital adequacy norms, resolution of conflicts arising of dual control over UCBs, etc. The Reserve Bank has accepted these recommendations and implemented them. However, issues related to dual control necessitate legislative changes to State and Central Acts and there is hardly any progress in this area. In the backdrop of the present scenario, future agenda for reforms in urban co-operative banking sector, as I perceive, is four-fold :

(i) Aligning urban co-operative banking sector with the rest of the financial system,
(ii) Deciding the future of weak entities,
(iii) Improving governance, and
(iv) Resolving the issues emanating from dual control.

(a) Aligning UCB sector with rest of financial system

Unlike the other segments of cooperative credit sector, UCBs today undertake multifarious banking activities. Some of them have also been permitted to undertake forex and merchant banking activities. There is a view emerging in the recent past that UCBs, being members of payment system, beneficiaries of deposit insurance scheme and enjoying unlimited access to public deposits, it is an imperative necessity to apply exactly the same regulatory rigours to UCBs as applicable to commercial banks. While broadly agreeing with this argument, I feel that their institutional framework, size of operations and balance sheet, nature of business, product mix and above all the skill levels, may have necessarily to be kept in view while deciding on the supervisory and regulatory rigours. Therefore, without undermining the regulatory efficacy, there is a need to fine-tune the prudential prescription. The view expressed by my distinguished colleague, Deputy Governor Dr. Y.V. Reddy, in the context of implementation of Financial Standards and Codes in India is equally applicable in UCBs’ adoption of prudential standards. He said “although the notion of a code of good practices is intuitively appealing, the temptation to prescribe universally valid model codes which do not allow for differences in institutional development, legislative framework and more broadly, different stages of development must be avoided”. Notwithstanding cultural differences between UCBs and commercial banks, the Reserve Bank has been gradually attempting at regulatory convergence for both. To begin with, in 1993, the Reserve Bank introduced Income Recognition and Asset Classification Norms to UCBs. In 1995, the prudential exposure norms to single/ group borrowers were also made applicable to them. However, introduction of capital adequacy norms was delayed due to statutory limitations on UCBs’ right to raise unlimited capital but these are also now going to be implemented from March 31, 2002, in a phased time-frame. The future agenda for reforms, as I visualise, should focus on these following issues:

(i) Today, main risk exposure of UCBs' is not the credit risk but interest rate risk. Most of the UCBs' interest rates particularly on deposits are out of sync with the rest of the banking sector. In this backdrop, observance of Risk and Asset Liability Management guidelines assumes importance. The Reserve Bank has recently constituted a Working Group to evolve guidelines keeping in view the specifics of UCB sector. The Group is expected to submit its recommendations very soon.

(ii) As market discipline is an important supervisory tool in approach to new capital adequacy framework, prescription of disclosure standards for UCBs, perhaps is of imminent necessity. UCBs, therefore, should be able to disclose their level of owned funds, unimpaired networth, CRAR, Gross/Net NPAs, operating results, ROA, compliance with reserve requirements, per employee productivity, etc. with balance sheet figures. This issue is engaging the attention of the Reserve Bank.

(iii) Strengthening the audit systems is of paramount concern for the Reserve Bank as it is an important tool in its supervisory kit. It had taken a lead in appointing an expert panel in 1995 for reforming the audit systems in vogue in UCBs. The panel suggested professionalisation of audit, mandatory concurrent audit for larger banks, redesigning audit format, etc. The Reserve Bank had accepted these recommendations and advised States to initiate measures. Unfortunately, many State Governments have yet to respond positively despite five years of persistent persuasion by the Reserve Bank.

(iv) Yet another important issue which is engaging the attention of the observers of co-operative banking movement is defining the frontiers of UCBs. Whether they should have unlimited access to inter-bank markets? Whether their reach should be nation-wide? Whether they can have access to capital market?

In view of special role assigned to UCBs, in the recent Monetary and Credit Policy Statement made by the Governor, it was decisively stated that they should not have unrestricted access to inter-bank markets as resorting to this avenue is essentially to meet their temporary liquidity mismatches rather than raising short term resources to fund their long term assets. By their sheer volatile nature, neither capital market nor its instruments can be investment avenues for UCBs which are representatives of small depositors. As regards their area of operation, we have very recently taken a decision to allow only such UCBs with Rs.50 crore owned funds to go beyond their State of jurisdiction.

(v) Whether UCBs' membership of Payment System should be unconditional? This issue has come into focus in the wake of Madhavpura Mercantile Co-operative Bank crisis. In case of commercial banks, in the event of payment crisis, CRR balances would be available besides SLR securities, whereas in respect of UCBs, their SLR investments need not entirely be in government securities and in case of non-scheduled banks maintenance of CRR balances with the Reserve Bank is not mandatory. Whether a system can be evolved whereby fire-walls can be erected to avert payment crisis of co-operative banks by way of lodging certain government securities, mandatory cash deposits with clearing houses for meeting payment obligations in the event of liquidity crisis? Whether such an act would further pre-empt the resources of UCBs? Or these deposits would constitute part of SLR funds? This issue needs extensive enquiry.

Well, these are issues which require informed deliberations for crystalising into policy inputs.

(b) Future set-up of weak Banks

The sheer number of weak banks which is well over 200 is a cause of concern. In a large number of cases, licenses have already been cancelled and the banks have been closed down. This process is taken up very cautiously so as not to create panic in the society. Closure is decided only after all other options are exhausted. Level of capital, history of losses and size of NPAs are some of the factors which weigh with us in taking a decision on closure. Possibilities of rehabilitation are invariably explored before such a decision is arrived at. Rehabilitation may involve the following strategies :

(i) Registrars should direct the cooperative courts for speedy recovery process and execution of decrees,
(ii) Unviable branches should either be relocated or closed down,
(iii) Avenues should be explored for the bank getting additional capital, and
(iv) Merger with a well-managed bank. However, a forcible merger should be strictly avoided.

(c) Improving Governance

It is extremely important that there is a mechanism to ensure that an effective system of internal governance is in place. Chief Executive should be a person of clean image and display a professional attitude. Board should consist of knowledgeable persons who are aware of their responsibilities as board members. There should be a board level committee which should focus attention on the findings of audit and inspection teams and ensure compliance thereof. The committee should also ensure compliance with various regulatory instructions issued by the Reserve Bank as also State Governments. It is ultimately the Board's responsibility that all prudential norms of governance are observed by the bank.

(d) Dual control dilemma

Duality of command over UCBs perhaps has become an intense issue of debate in co-operative circles. Academics, co-operators and bankers made vociferous representations to the Madhava Rao Committee that dual control over UCBs must end as that was instrumental in stifling their growth. Narsimham Committee II had also unequivocally recommended for ending dual control regime over UCBs. Is dual command the causative factor for the ills of UCBs? Is it an impediment in effective supervision over them? Having been closely associated with the regulation of the co-operative banking structure for quite some time, I am indeed inclined to agree with the Madhava Rao Committee recommendation on this issue. The Committee aptly observed "…. that dual control regime, *per se*, need not cause any hindrance to the growth of urban banking movement. It is the absence of clear cut demarcation between functions of the Reserve Bank and that of State Government that adversely affects the smooth functioning of UCBs." Most of the issues emanating out of dual control regime are due to overlapping jurisdiction of the Reserve Bank and State Governments. It, therefore, recommended demarcation of banking related functions and such of those which warrant only State Governments' action. The Reserve Bank has concurred with the recommendations of the Madhava Rao Committee and is impressing upon the State Governments for bringing in legislative amendments. Duality in command does come in the way of effective supervision. In the case of commercial banks, the Reserve Bank has the wherewithal under the Banking Regulation Act for dealing with crucial aspects of functioning of commercial banks. In the case of co-operative banks, however, many areas which directly relate to supervision over them have been kept beyond the Reserve Bank's authority. Situation gets somewhat messy as may be indicated by a few illustrations as follows:

(i) The Reserve Bank has no authority to deal with delinquent management in a co-operative bank. This requires intervention of the Registrar of Co-operative Societies.
(ii) Making investments out of surplus resources being clearly a banking function should be entirely within the decision making powers of cooperative banks subject to the Reserve Bank guidelines but this needs approval of the Registrar.
(iii) Similarly, writing off an unrealisable debt also requires permission of the Registrar.
(iv) There was an instance where on request made by the Reserve Bank, the Registrar superseded the board of a co-operative bank. But subsequently the State Government in its wisdom annulled Registrar's orders and restored the Board. It is strange but true.
(v) It is open for a bank whose licence has been cancelled to appeal to the Government. The Reserve Bank is required to appear before the Appellate Authority. Often, the Reserve Bank is advised to review its decision. It is a matter of satisfaction, however, that the Reserve Bank's decisions have been supported by Government and in no case the Reserve Bank's decision has been struck down. Nevertheless, the exercise has to be gone through.

I feel there are three ways of resolving dual control issues:

(a) One approach is by bringing in the subject of co-operation under concurrent list so as to enable the Union Government to legislate in matters pertaining to co-operative banking. But such a move involves amendments to the Constitution.

(b) Another way of approaching this issue is the States enacting progressive legislations thereby making Registrars confine their acts only to register and accept byelaws. As a result, dual command over UCBs will be ceased automatically. Though a lead has been taken by the Governments of Andhra Pradesh and Karnataka in this direction, most of the States are yet to follow. Even in Andhra Pradesh and Karnataka, it does not make any change in the status of existing banks unless they are registered under the new legislation. Unless a uniform initiative is taken by all the States, perhaps it would be difficult to remove irritants of dual control regime.

(c) Yet another approach is to demarcate the regulatory roles of State Governments and the Reserve Bank in the State Acts, as suggested by the Madhava Rao Committee. I rather tend to agree with this approach since it is the best way to resolve dual control dilemma. There have also been suggestions that the Banking Regulation Act, which is a central statute may be amended in a manner that it enables the Reserve Bank to assume certain powers which are at present available to State Governments under the respective State

Co-operative Societies Act.

However, the legal advice given to the Reserve Bank does not support such a move. Here I would like to make it clear that while the Reserve Bank is in favour of ending the dual control, as far as Madhavpura episode is concerned, the immediate cause of its problems did not arise out of the present regime of dual control. What happened in the case of Madhavpura was ostensibly due to lack of observance of prudential banking practices.

Case for a Separate Supervisory Structure

As an institution, co-operative banks have made a place for themselves and by and large doing very well in their respective areas. Their strongest point is their easy accessibility by their clients. However, their number being very large puts a severe strain on the supervising and monitoring system. Most of the banks keep a low profile and go about their job without much fanfare. The Reserve Bank inspects them usually once in two years unless there are any supervisory concerns in which case the frequency of inspection is increased. One may, however, question this and say that Madhavpura would not have happened had our inspections been annual like in the case of commercial banks. My humble submission is that Madhavpura episode did not have much to do with frequency of inspections for, it is always possible for managements to indulge in objectionable practices during the gap between two inspections. It needs to be appreciated that it is not possible for the Reserve Bank to oversee day-to-day transactions of banks.

The Reserve Bank has recently mooted the idea of supervision of UCBs to be entrusted to a separate apex authority. The reason is that these banks number more than 2,000 and are spread across the country. The sheer magnitude of their number and geographical spread as also the level of professionalism generally available in these banks perhaps needs a separate agency for focussed supervision. The issues that would need to be addressed in this connection are the status, structure and management of this body, its relationship with the Reserve Bank, its resources, staffing and location. No final view has yet been taken as the proposal has to go through a consultative process.

Concluding Remarks

Friends, urban co-operative banking sector has come to occupy a formidable place in the Indian financial system. However, sustenance of its growth is attendant to professionalisation of its management, inculcating good corporate governance, technology absorption and scrupulous adherence to regulatory framework. I hope the sector will learn from its past experiences and adjust to new realities since banking is risky business.

I thank the FICCI and all of you for having given me this opportunity to share my views on this important segment of our financial system.

*** Keynote Address by Shri Jagdish Capoor, Deputy Governor, Reserve Bank of India at a Seminar on Urban Co-operative Banks: Future Reforms organised by FICCI at New Delhi on May 10, 2001.**