Co-operative Banks In India: Strengthening Through Corporate Governance
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I deem it a privilege to have been invited to address this gathering on a topic of tremendous relevance, focus and significance in today's context. Needless to say, for the co-operative banks in India these are transitional times. Never before has the need for restoring customer confidence in the cooperative sector been felt so much. Never before has the issue of good governance in the co-operative banks assumed such criticality. The literature on corporate governance in its wider connotation covers a range of issues such as protection of shareholders' rights, enhancing shareholders' value, Board issues including its composition and role, disclosure requirements, integrity of accounting practices, the control systems, in particular internal control systems. Corporate governance especially in the co-operative sector has come into sharp focus because more and more co-operative banks in India, both in urban and rural areas, have experienced grave problems in recent times which has in a way threatened the profile and identity of the entire co-operative system. These problems include mismanagement, financial impropriety, poor investment decisions and the growing distance between members and their co-operative society.

2. The purpose and objectives of cooperatives provide the framework for cooperative corporate governance. Co-operatives are organised groups of people and jointly managed and democratically controlled enterprises. They exist to serve their members and depositors and produce benefits for them. Co-operative corporate governance is therefore about ensuring co-operative relevance and performance by connecting members, management and the employees to the policy, strategy and decision-making processes.

3. In fact, the very definition of corporate governance stems from its organic link with the entire gamut of activities having direct or indirect influence on the financial health of corporate entities. For the Nobel Prize-winning economist Milton Friedman, who was one of the first to attempt a definition, corporate governance is to conduct business in accordance with owner or shareholders' desires which generally will be to make as much money as possible while conforming to the basic rules of the society embodied in law and local customs. In subsequent definitions, the scope of corporate governance has got expanded. While some experts say corporate governance means doing everything better, to improve relations between companies and their shareholders, to encourage people to think long-term, to ensure that information needs of all shareholders are met and to ensure that executive management is monitored properly in the interest of shareholders, the Former President of World Bank, Mr. James Wolfensohn had said that corporate governance is about promoting corporate fairness, transparency and accountability. A more comprehensive definition has come from the Organisation of Economic Co-operation and Development (OECD) which identifies corporate governance as the system by which business corporations are directed and controlled. Here the corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the Board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions on corporate affairs. By doing this, not only does it provide the structure through which the company objectives are set, it also provides the means of attaining these objectives and monitoring performance.

4. It will certainly not be out of place here to recount how issues relating to corporate

governance and corporate control have come to the fore the world over in the recent past. The seeds of modern corporate governance were probably sown by the Watergate scandal in the USA. Subsequent investigations by US regulatory and legislative bodies highlighted control failures that had allowed several major corporations to make illegal political contributions and bribe government officials.

While these developments in the US stimulated debate in the UK, a spate of scandals and collapses in that country in the late 1980s and early 1990s led shareholders and banks to worry about their investments. Several companies in UK which saw explosive growth in earnings in the ’80s ended the decade in a memorably disastrous manner. Importantly, such spectacular corporate failures arose primarily out of poorly managed business practices.

5. This debate was driven partly by the subsequent enquiries into corporate governance (most notably the Cadbury Report) and partly by extensive changes in corporate structure. In May 1991, the London Stock Exchange set up a Committee under the Chairmanship of Sir Arian Cadbury to help raise the standards of corporate governance and the level of confidence in financial reporting and auditing by setting out clearly what it sees as the respective responsibilities of those involved and what it believes is expected of them. The Committee investigated accountability of the Board of Directors to shareholders and to the society. It submitted its report and associated ‘code of best practices’ in December 1992 wherein it spelt out the methods of governance needed to achieve a balance between the essential powers of the Board of Directors and their proper accountability. Being a pioneering report on corporate governance, it would perhaps be in order to make a brief reference to its recommendations which are in the nature of guidelines relating to, among other things, the Board of Directors and Reporting and Control.

6. The Cadbury Report stipulated that the Board of Directors should meet regularly, retain full and effective control over the company and monitor the executive management. There should be a clearly accepted division of responsibilities at the head of the company which will ensure balance of power and authority so that no individual has unfettered powers of decision. The Board should have a formal schedule of matters specifically reserved to it for decisions to ensure that the direction and control of the company is firmly in its hands. There should also be an agreed procedure for Directors in the furtherance of their duties to take independent professional advice.

7. On Reporting and Control, the Cadbury Report recommended that the Board should ensure that an objective and professional relationship is maintained with the auditors. It is the Board’s duty to present a balanced and understandable assessment of the company’s position, the report said. The Board should establish an Audit Committee with written terms of reference which deal clearly with its authority and duties. The Directors should explain their responsibility for preparing the accounts next to a statement by the auditors about their reporting responsibilities. The Directors should also report on the effectiveness of the company’s system of internal control. The report also stipulated that the Directors should report that the business is a going concern with supporting assumptions or qualifications as necessary.

8. The Cadbury Report generated a lot of interest in India. The issue of corporate governance

was studied in depth and dealt with by the Confederation of Indian Industry (CII), Associated Chamber of Commerce and Industry (ASSOCHAM) and Securities and Exchange Board of India (SEBI). These studies reinforced the Cadbury Report's focus on the crucial role of the Board and the need for it to observe a Code of Best Practices. Co-operative banks as corporate entities possess certain unique characteristics. Paradoxical as it may sound, evolution of co-operatives in India as peoples' organisations rather than business enterprises adopting professional managerial systems has hindered growth of professionalism in cooperatives and proved to be a neglected area in their evolution.

9. Professionalism reflects the co-existence of high level of skills and standards in performing duties entrusted to an individual. The absence of a proper system of placement and skill upgradation inputs constrain professional management in co-operative banks. Though there is a system of training in place in many co-operative banks, attempts are seldom made to match them with the current and future staff requirements. It is desirable that the training programmes encompass skill upgradation and aptitude development in full measure. It is also necessary to keep the staff sufficiently motivated through periodic job rotation, job enrichment and recognition of performance. The co-operative banks should indeed work like professional organisations on sound managerial systems in tune with the needs of the time taking care of future projections of requirements to retain and improve their market share and identity in the long run. It is in this context that professionalism and accountability of the banks' boards assume such critical significance.

10. Regulators are external pressure points for good corporate governance. Mere compliance with regulatory requirements is not however an ideal situation in itself. In fact, mere compliance with regulatory pressures is a minimum requirement of good corporate governance and what are required are internal pressures, peer pressures and market pressures to reach higher than minimum standards prescribed by regulatory agencies. RBI's approach to regulation in recent times has some features that would enhance the need for and usefulness of good corporate governance in the co-operative sector. The transparency aspect has been emphasised by expanding the coverage of information and timeliness of such information and analytical content. Importantly, deregulation and operational freedom must go hand in hand with operational transparency. In fact, the Reserve Bank Governor's April 2002 Monetary and Credit Policy announcements have made it clear that with the abolition of minimum lending rates for co-operative banks, it will be incumbent on these banks to make the interest rates charged by them transparent and known to all customers. Banks have therefore been asked to publish the minimum and maximum interest rates charged by them and display this information in every branch. Disclosure and transparency are thus key pillars of a corporate governance framework because they provide all the stakeholders with the information necessary to judge whether their interests are being taken care of. We in the Reserve Bank see transparency and disclosure as an important adjunct to the supervisory process as they facilitate market discipline of banks.

11. Another area which requires focused attention is greater transparency in the balance sheets of co-operative banks. The commercial banks in India are now required to disclose accounting ratios relating to operating profit, return on assets, business per employee, NPAs, etc. as also maturity profile of loans, advances, investments, borrowings and deposits. The issue before us now is how to adapt similar disclosures suitably to be captured in the audit reports of co-

operative banks. The Reserve Bank had advised Registrars of Co-operative Societies of the State Governments in 1996 that the balance sheet and profit & loss account should be prepared based on prudential norms introduced as a sequel to Financial Sector Reforms and that the statutory/departmental auditors of cooperative banks should look into the compliance with these norms. Auditors are therefore expected to be well-versed with all aspects of the new guidelines issued by the Reserve Bank and ensure that the profit & loss account and balance sheet of co-operative banks are prepared in a transparent manner and reflect the true state of affairs. Auditors should also ensure that other necessary statutory provisions and appropriations out of profits are made as required in terms of Cooperative Societies Act/Rules of the state concerned and the bye-laws of the respective institutions.

12. Appropriate internal control systems become even more critical in the context of the growing emphasis on diversification of business products as the prime need at all levels in co-operative credit institutions. It is indeed necessary for co-operative banks to devote adequate attention to maximising their returns on every unit of resources through an effective funds management strategy and mechanism. One prime component of the investment portfolio of the co-operative banks which has attracted a lot of attention -unfortunately for all the wrong reasons - is their transaction in government securities. So much so that it has even triggered the holding of today's Convention.

13. The financial sector reforms in India have sought to achieve, among other things, improvement in the financial health and competitive capabilities by means of prescription of prudential norms. The cooperative banks have also thus been put under the prudential norms regime to bring about the desirable level of transparency in their balance sheets. While urban co-operative banks (UCBs) have been subjected to income recognition, asset classification, provisioning and other related norms in a phased manner beginning April 1992, these prudential norms including asset classification and provisioning (excluding the capital adequacy ratio) were made applicable to the State Co-operative Banks (SCBs) and District Central Co-operative Banks (DCCBs) from the year 1996-97 and extended to Agriculture and Rural Development Banks (ARDBs) from 1997-98.

14. The Reserve Bank had also issued comprehensive guidelines transactions in securities to all co-operative banks - both urban and rural - as early as in September 1992. Detailed guidelines have been given therein on transactions through brokers, Subsidiary General Ledger (SGL) facility, issue of Bankers Receipts, internal control systems, audit and review systems, etc. As per the guidelines in force, each bank is required to formulate an investment policy, with the approval of its Board. Banks have been advised that all transactions in Government Securities for which SGL facility is available should be put through SGL accounts only. Certain discipline has also been introduced for transactions through SGL accounts for minimising settlement risks through a framework for penal action against bouncing of SGL transfer forms for want of sufficient balance in the SGL account or current account.

15. Banks were advised that only brokers registered with National Stock Exchange (NSE) or Bombay Stock Exchange (BSE) or Over the Counter Exchange of India (OTCEI) should be utilised for acting as intermediary. If the deal is put through a broker, the role of the broker should be restricted to that of bringing the two parties to the transaction together. The settlement

of the transaction, namely, both funds settlement and security settlement should be made directly between the counter parties. With a view to ensuring that a disproportionate volume of transactions is not routed through one or a few broker, a prudential ceiling of 5 per cent of the total transactions (both purchases and sales) has been prescribed for routing transactions through an individual broker. In case any bank is required to exceed the prudential ceiling of 5 per cent for any broker, the bank is required to inform the Board indicating the reasons therefor post-facto. Banks have also been advised to have proper internal control measures for monitoring the transactions in government securities.

16. Regulatory policy can however only set the broad contours of an appropriate investment strategy. It is no guarantee for articulation and implementation of commercially sound investment decisions by lending institution(s). Even the most comprehensive regulatory framework and effective supervisory system need not be a foolproof mechanism against a pliant management acting in collusion with unscrupulous clients. Supervision is only periodic and therefore it cannot be a substitute for effective and continuous internal control backed by an independent and efficacious audit system. Towards this, it is imperative to have in place Audit Committees of the Board independent of the management in cooperative banks. It may well be recalled that with the extension of the Banking Regulations (BR) Act to the UCBs in 1966 and deposit insurance in 1971, people's confidence in the co-operative sector had taken a big leap forward. So much so that today the non-member deposits in urban banks far exceed member deposits. Nothing would be more tragic if we fritter away these advantages and allow indiscipline and lack of commitment in these banks make people's trust in the cooperative sector a casualty.

17. One important issue that has engaged much attention in the recent past is the duality of control over co-operative banks. In terms of the Co-operative Societies Acts of respective States, the Registrar of Co-operative Societies was the sole regulator and supervisor of all the societies registered in his State including societies carrying on banking business. With the application of BR Act, 1949 (AACS) to cooperative banks, this position has since changed. While the Reserve Bank now regulates and supervises banking activities carried on by urban co-operative societies, supervision of State Co-operative Banks and District Central Co-operative Banks is carried out by National Bank for Agriculture and Rural Development (NABARD). The core principles of supervision in relation to co-operative banks have thus to be formulated and implemented by the Reserve Bank in respect of UCBs and by NABARD in respect of SCBs and DCCBs and there is an emergent need to constantly beef up the supervisory system through proper on-site monitoring and adequate off-site surveillance. We also need to analyse and pick up early warning signals, if any, in respect of any such irregularities in the investment portfolio of these banks from the periodic review reports on such transactions which are received from them. There is also an urgent need for clarity in defining the roles of various control institutions by streamlining processes, procedures, etc. for removing overlapping of controls over cooperative banks presently vested with State Governments, the Reserve Bank and NABARD, as the may be. It is in this context that the Governor's Monetary and Credit Policy announcement in April 2001 had stressed the need for a separate regulatory agency for the co-operative banks. This issue is being debated in various quarters.

18. Credit institutions are linked to each other through a complex chain of inter-bank

relationships which - as recent instances have showed - in any event of difficulty become mechanisms for spread of the contagion effect. Signs of financial mismanagement in an institution or a group of institutions regardless of the reasons is liable to set off similar problems in other institutions and open serious risks in the financial system. It is in this context that good corporate governance assumes critical importance. Power and decision-making in co-operative banks are all too often concentrated at the top in too few hands. Cooperative performance has therefore been for a long time characterised by lack of participation and sense of involvement. Active members who feel that they are part of an organisation that has goals in harmony with their own and clear roles for constructively engaged, competent governing bodies and management would be a powerful force to build co-operative identity and excellence. It is perhaps time that the State Governments refashioned management in co-operative banks by picking up threads of good corporate governance.

19. Success of economic decisions depends after all on the human resources at the disposal of any organisation. A change is needed today in the co-operative banks which is built on confidence in human capital - the most important of all resources - in commitment, creativity and innovation brought about by proactive management, membership and employees. Strong corporate governance that takes its obligations seriously can truly be a source of strength to the management. The ability to capture knowledge and wisdom gives co-operative banks their competitive advantage. A prerequisite is that participants from all parts of a co-operative organisation know and understand its purpose, core values and visions.

20. In the years to come, the Indian financial system will grow not only in size but also in complexity as the forces of competition gain further momentum and financial markets acquire greater depth. I can assure you that the policy environment will remain supportive of healthy growth and development with accent on more operational flexibility as well as greater prudential regulation and supervision. The real success of our financial sector reforms will however depend primarily on the organisational effectiveness of the banks, including co-operative banks, for which initiatives will have to come from the banks themselves. It is for the co-operative banks themselves to build on the synergy inherent in the co-operative structure and stand up for their unique qualities. With elements of good corporate governance, sound investment policy, appropriate internal control systems, better credit risk management, focus on newly-emerging business areas like micro finance, commitment to better customer service, adequate mechanisation and proactive policies on house-keeping issues, co-operative banks will definitely be able to grapple with these challenges and convert them into opportunities. I am sure all of you will bring your experience and knowledge to bear upon the afore-discussed issues in course of the deliberations in the next two days.

*** Inaugural Address delivered by Shri Vepa Kamesam, Deputy Governor, Reserve Bank of India at the National Convention of Urban Co-operative Banks, organised by Academy of Corporate Governance, Hyderabad supported by Administrative Staff College of India, Hyderbad, at Mumbai on July 5, 2002.**