Introduction

1.1 The Urban Cooperative Banks (UCBs), along with other cooperative banks, were brought under the regulatory ambit of RBI by extending certain provisions of Banking Regulation Act, 1949, (B.R.Act) effective from March 1, 1966. Since then, the urban banking sector has witnessed phenomenal growth in terms of reach, size, volume of operations and the quantum of public deposits held by it. In the past, two Expert Committees had examined the role assigned to UCBs and the regulatory issues related to them. Report of the Committee on Urban Cooperative Banks, 1978 (Madhava Das Committee) provided a well-documented study of urban banking sector in India and set standards of viability for sustained growth of urban banks. The last Committee on UCBs (Marathe Committee) which submitted its Report in 1992, had come out with far reaching recommendations, and it had, primarily aimed at removal of “fetters” on UCBs’ freedom. RBI has accepted most of these recommendations and implemented them.

1.2 RBI felt that it should take stock of the performance of urban cooperative banking sector after the introduction of a fairly deregulated regime in 1993 in the light of the recommendations of Marathe Committee Report and the more deregulated scenario of the commercial banking sector consequent to the recommendations of Narasimham Committee Report on Banking Sector Reforms. This review is to particularly focus on the entry point capital prescription, proliferation of weak banks, implementation of prudential norms, inadequate legal provisions and problems created by dual control of UCBs by RBI under B.R.Act, and State Governments under the respective State Cooperative Societies Acts. While announcing the monetary policy for the year 1999-2000, the Governor, Reserve Bank of India desired to constitute a High Power Committee to address these issues. Accordingly, the present High Power Committee was constituted by the Governor, Reserve Bank of India, in May 1999 to review the performance of urban cooperative banks and suggest necessary measures to strengthen them.

Composition of the Committee

1.	Shri K. Madhava Rao Ex-Chief Secretary to the Government of Andhra Pradesh, Hyderabad	Chairman
2.	Shri Y.H. Malegam Director, Central Board of RBI and Chartered Accountant, Mumbai	Member
3.	Shri Subhash S. Lalla Commissioner for Cooperation & Registrar of Cooperative Societies Government of Maharashtra, Pune	Member
4.	Dr. Sawai Singh Sisodia President, National Federation for Urban Cooperative Banks & Cooperative Societies New Delhi	Member

5.	Dr. Mukund L. Abhyankar Director, Cosmos Co-op. Bank Ltd., Pune	Member
6.	Shri P.S. Vyas Managing Director Gujarat State Co-op. Bank Ltd., Ahmedabad	Member
7.	Shri M.M.S. Rekhrao Chief General Manager Reserve Bank of India Urban Banks Department Central Office, Mumbai	Member
8.	Shri O.P. Sharma Chief General Manager Reserve Bank of India Urban Banks Department Mumbai Regional Office. Mumbai	Member-Secretary

1.3 Terms of Reference :

i) To evolve objective criteria to determine the need and potential for organising urban cooperative banks, review the existing entry point norms and examine the relevance of special dispensation for less/least developed areas etc.
ii) To review the existing policy pertaining to branch licensing and area of operation of urban cooperative banks.
iii) To consider measures for determining the future set up of weak/unlicensed banks.
iv) To examine the feasibility of introducing capital adequacy norms for UCBs.
v) To examine the need for conversion of cooperative credit societies into primary cooperative banks.
vi) To suggest necessary legislative amendments to B.R.Act and Cooperative Societies Act of various states for strengthening the urban banking movement.

Approach of the Committee

1.4 The Committee's approach to the task assigned to it by the RBI is governed by three important considerations viz.,

(i) Preserving cooperative character of UCBs,
(ii) Protecting depositors' interests and
(iii) Ensuring systemic stability of the banking sector.

Preserving Cooperative Character

1.5 It is necessary to recognise the strengths and weaknesses of urban cooperative banks in the field of much needed micro credit and how best to foster and encourage UCBs in rendering this service to the small borrower who is not as welcome at the doors of commercial banks, as at the hands of UCBs. The representatives of UCBs and their federations constantly claim that they have a distinct role in the banking sector as they and the small borrower are made for each other and that any amount of expansion of branch net work of commercial banks, including RRBs, will not solve the problem of the small borrower without the presence of UCBs. The Committee made conscious efforts to go into the veracity of this claim of UCBs. The Committee organised a survey of 103 clients that approached 13 UCBs on two different dates. The response of these clients is a resounding confirmation of the claims of UCBs. 85% of the clients said that they had come to UCBs because they are not entertained by the commercial banks; 85% of the clients stated that UCBs provide faster service and 82% of clients felt that UCBs provide more personalised service than commercial banks.

1.6 Not satisfied with this evidence, the Committee talked to the field officers of RBI who are now in service as well as some who retired from service. They also confirmed that UCBs predominantly cater to the persons of small means and they unhesitatingly stated that UCBs must be encouraged to continue and expand. Our interaction with some of the senior level officers of commercial banks netted the same result. The State Government Officers have the same word of praise for the UCBs. The data with RBI also shows that 84.1% of UCBs fulfill the stipulated priority sector lending of 60% of the banks' total advances. Very few UCBs asked for reduction of 60% target though the priority sector target for commercial banks is only 40% and which is not always achieved. This shows what darlings UCBs are in the context of giving micro credit to a multitude of small borrowers.

1.7 The yeomen service being rendered by UCBs to micro credit enterprises and small borrower comes as sweet music to the ears of the Committee. But the Committee also hears some harsh and unpleasant notes in the background. Some of them are too jarring to be ignored even as one loves to concentrate on hearing the sweet notes.

1.8 Enormous increase in the number of UCBs in the last 6 years is something which requires a serious focus by the RBI. If the increase is due to relaxed entry norms and the promoters are genuine cooperators, we can relax. If the new entrants are not genuine cooperators and if some of them are promoted by the people who had to quit the NBFC sector because of stringent regulatory framework put in place by RBI, then we have a lot to worry about. The Committee has no wherewithal to go into this sensitive but important aspect. It would urge RBI to take appropriate steps to probe into the whispers we hear that some of the NBFCs are getting into UCB sector through the backdoor.

1.9 The second cause of our concern is the number of weak UCBs. It is just not the number. We should also look at the causes for the sickness. If the sickness is due to some genuine commercial decisions going wrong, the problem is less serious. But if a large number of banks became weak due to motivated actions of the Managing Committees, then there is greater cause for concern.

Theoretically, Managing Committees are answerable to the General Body. This answerability works if the membership of the UCBs is genuine and the members take active interest in the affairs of the UCBs. Here again we hear some "deep throats" conveying things to the contrary that low entry capital norms have facilitated small group of persons or a few families establishing UCBs by raising the capital and taking names of voiceless persons on the membership rolls. We also hear more open complaints that the attendance at the General Body meetings is alarmingly low. If the low turn out at the General Body meetings is due to the confidence of the genuine members in the impartiality, integrity and efficiency of Managing Committee to deliver the goods, the problem is less serious. But if it is because of bogus membership, the problem becomes acute.

1.10 The third cause for concern is the quality of professionalism. If there is predominant presence of genuine cooperators in the Management Committee and General Body, their experience, common sense and commitment to the bank can partly compensate for lack of professionalism. But if what the "deep throats" say is true, lack of professionalism can be fatal to the health of the UCBs.

1.11 Thus, we find that UCBs have their great strengths but not without their share of deficiencies. The Committee has, therefore, to keep this mixed bag in mind while recommending certain facilities and concessions from RBI and State Governments and at the same time suggest stringent norms to be fulfilled by UCBs.

Protecting Depositors' Interest

1.12 An UCB is not like any other cooperative society. The good and bad aspects of a normal cooperative society benefit or harm only its members, since these societies are organised and run by the members and for the members. But UCBs do more than that. UCBs accept deposits from the public and, hence, their actions affect the interests of the depositors. Since depositors place their funds with UCBs in good faith, the UCBs become trustees of the depositors' money. Hence, service to depositors becomes a higher duty than service to members. Thus, the moment a cooperative society graduates into a bank, its actions and discipline have to be judged in altogether a different context. Champions of cooperative movement claim that since cooperatives are democratic organisations, they should be left to self-discipline and outside bodies should not trample their democratic rights. This argument makes perfect sense as long as they remain normal cooperative societies. But when they aspire to take on banking functions their democratic rights have to be subordinated to the interests of the depositors. Safeguarding the interest of depositors cannot be left only to the Management Committee and General Body. We need an external agency to play the role of an umpire. If the cooperators are not prepared to accept external discipline they are free to remain as normal cooperatives. If some existing UCBs feel uncomfortable with external discipline they have all the freedom in the world to return the deposits of the public and revert to the status of a normal society. The banking function necessitates subordination of democratic rights of the members to the duty of serving the depositors. Even the Fundamental Rights of an individual enshrined in the Constitution of a great democratic country like India are subject to the similar rights of another individual. The inalienable and the unalterable Fundamental Rights of one individual end when the Fundamental Right of another individual begins. UCBs, therefore, can not complain when stricter financial norms are prescribed or professional content in the composition of Management Committee is stipulated to safeguard the interests of the depositors.

Ensuring systemic stability

1.13 No bank can act in isolation. Banking activity is by nature a network. Acts of one bank have a ripple effect on the system as a whole. Moreover, the banking activity of UCBs is fairly large. The deposits and advances of UCBs constituted 7% and 8.8% respectively of the deposits and loans of scheduled commercial banks as at the end of 31 March, 1999. What is more, the rate of growth of deposits as well as loans of UCBs is much higher than commercial banks. With such considerable share in banking sector, failure or serious sickness in UCB sector will have serious adverse effect on banking system. Failure of a bank like BCCI in U.K., Loans and Saving Societies in U.S. became a matter of great concern for other countries. It is, therefore, of utmost importance that the regulator prescribes and strictly enforces financial and managerial discipline in such a way that the performance of UCBs contributes to the over all stability of the banking sector. Each UCB may not know or may not care for the consequences of its action on the systemic stability. Herein lies the role of the Regulator to delineate the road map and install the green, amber and red lights.

Objectives before the Committee

1.14 In making its recommendations, the Committee has been guided by the following objectives

i) to preserve the cooperative character of the institutions
ii) to protect the depositors' interests
iii) to reduce the systemic risks to the financial system
iv) to put in place a strong regulatory prescription at the entry level so as to sustain the operational efficiency of UCBs in a competitive environment and evolve measures necessary to strengthen the existing UCBs' structure particularly in the context of ever increasing number of weak banks.
v) to align urban banking sector with the other segments of the banking sector in the context of application of prudential norms in toto and removing the irritants of the "dual control" regime.

Obviously these objectives flow out of our approach indicated in the previous paras.

1.15. The essence of the cooperative character is that a cooperative bank is an institution where there is an identity between the owners and the customers, whether they be depositors or borrowers and that each member has one vote irrespective of his/her shareholding. The preservation of this character, therefore, influences :

(i) the area of operation of the bank;
(ii) the extent of ownership of the bank by an individual member; and
(iii) the extent to which non-members can be allowed to participate in the functioning of the bank either as depositors or as borrowers.

It should not, however, influence the nature of its activities so long as such activities are not in conflict with the cooperative character.

1.16 In making our recommendations regarding the area of operation of the bank we have, therefore, been guided by the principle that a bank will initially operate within a district or within adjoining districts because it is mainly people within a district or within adjoining districts who are likely to have a common need and a common identity which creates the environment in which it becomes necessary for an UCB to emerge. As the bank extends its area of operation, this cooperative character tends to weaken and it assumes more and more the character of a commercial bank. Therefore, such extension must be accompanied by prescription of conditions under which commercial banks are allowed to operate.

1.17 Ideally, the members of an UCB should have the same or nearly the same stake in the capital of the bank. However, the need to build up a sizeable capital structure and the unequal borrowing needs of the members inevitably result in some members holding a larger part of the capital than others. This also weakens the cooperative character and, therefore, creates the need to have some restriction on individual holdings.

1.18 Ideally also, all depositors and borrowers should be members. However, the need to increase the deposit base as also to gainfully employ the funds generated have made it necessary for an UCB to have a large number of depositors and borrowers. If all borrowers become members it would place a considerable strain on the administrative requirements attached to the rights of members to elect the Board of Directors and to participate in the governance of the bank. Therefore, the concept of nominal membership has developed whereby such members do not enjoy the essential rights of membership to participate in the governance of the bank. This development also weakens the cooperative character of the bank and, therefore, it becomes necessary to restrict the extent of nominal membership.

1.19 To protect the interests of the depositors it is necessary to ensure that:-

(i) only those banks are licensed which are financially sound and efficiently managed;
(ii) there are systems in place to identify, at an early stage, incipient signs of weakness in the bank;
(iii) timely remedial action is taken so that a weak bank is not allowed to become a sick bank; and
(iv) sickness in a bank is not allowed to progress beyond the stage where it would prejudice the interests of the depositors.

1.20 At the inception, financial soundness of the bank can be ensured by adequate entry point norms. These norms have to be evolved taking into account relevant criteria like the location of the bank and the area of its operation. Entry point norms can also be used as an instrument to encourage the growth of such banks in areas where greater need exists and to discourage their growth in areas where such a need is not perceived. Efficient management of the bank could also be ensured by initially specifying other non-financial criteria like the composition of the board of directors, the suitability of the promoters and the adequacy of the proposed management.

1.21 The systems to identify, at an early stage, incipient signs of weakness require:-

(i) reliability and adequacy of the financial information periodically produced by the bank;
(ii) an independent and efficient audit;
(iii) periodic and adequate inspection by the regulatory authority; and
(iv) a set of tools by which the financial strength of the bank can be measured.

1.22 It is, therefore, necessary that the annual financial statements of UCBs are, in terms of their context and disclosure, comparable, as far as possible, with the financial statements of commercial banks and that they are prepared with the same discipline as regards provisioning and valuation norms. It is also necessary that these financial statements are subjected to audit by independent external auditors in exactly the same manner as the financial statements of commercial banks are subjected to audit. UCBs also need to be inspected by the regulatory authority in exactly the same way as commercial banks are inspected and, in so far as off-sight inspection is concerned, they must be required to furnish to the regulatory authority the same information as is required from commercial banks.

1.23 Finally, the tools by which the financial soundness of commercial banks is measured must also be made applicable to UCBs. These would include (i) capital adequacy norms, (ii) permissible limits of non-performing assets, (iii) exposure limits, (iv) avoidance of interest rate and maturity mis-matches and the like.

1.24 In the case of commercial banks, the regulatory authority i.e. the RBI has a number of options by virtue of the powers conferred on the RBI by the Banking Regulation Act, 1949 to adequately monitor performance, control the development of sickness and take remedial action. These include :

(i) The power to give directions to the bank (Section 35A);
(ii) The need for RBI approval for appointment or re-appointment or termination of appointment of the Chairman, Managing or Whole-time Director, Manager or Chief Executive Officer (Section 35B);
(iii) The power to caution or prohibit a banking company from entering into any particular transaction or class of transactions, to appoint an observer on the Board of Directors and to require the banking company to make desired changes in the management (Section 36);
(iv) The power to remove managerial and other personnel and to appoint additional directors (Part II - A),
(v) The power to acquire undertakings of banking companies in certain cases (Part II-C), and
(vi) The power to ask the High Court to order suspension of the business of the banking company or its winding up or to ask the Government of India for an order for reconstitution or amalgamation of the banking company (Part III).

1.25 These options provide the RBI with the tools, whereby, after weakness in a banking company is detected, it can take timely action to prevent a weak bank becoming sick. Unfortunately Sections 35B, 36 (in so far as it relates to changes in management) and Parts II-A, II-C and the relevant clauses of Part III have been made inapplicable to urban cooperative banks. Therefore, the tools available to the RBI to rehabilitate weak UCBs are severely restricted.

1.26 However, RBI's obligation to ensure that sickness in an UCB is not allowed to spread beyond the point at which the interests of the depositors are not prejudiced, remains. If, therefore, RBI is not *able or willing* to stop the urban cooperative bank from carrying on banking business when it has become sick, it becomes equally incumbent on the RBI to provide that a scheme is formulated which ensures that any further sickness does not prejudice the interests of the depositors.

1.27 Urban cooperative banks form a significant segment of the financial system both in terms of their number and also their share in the total deposits of the banking system. Continued weakness or failure of a significant number of urban cooperative banks reflect adversely on the financial system as a whole. Therefore, RBI has a responsibility to ensure that the UCB sector functions in a healthy manner.

1.28 As pointed out by the Marathe Committee, with greater liberalisation of the commercial banking sector, the urban cooperative banking sector will need to operate in a more competitive environment. It is, therefore, necessary that it has a reasonable " ground level" treatment and is not saddled with irksome restrictions regarding its operations.

1.29 Perhaps the most significant factor which adversely affects the performance of urban cooperative banks and which prevents timely and adequate remedial action to prevent sickness is the dual control over the urban cooperative banking sector. The Committee is convinced that unless the dual control, is replaced by unitary control, it will not be possible for a healthy urban cooperative banking sector to subsist. This unitary control must recognise that whereas the cooperative character of UCBs may be controlled by the Registrar of Cooperative Societies, its banking functions must necessarily be under the sole control of the RBI.

1.30 It is equally important to recognise that an UCB can function effectively in a competitive environment only if it has freedom to operate and is allowed to carry on all the activities which are permissible to a commercial bank. The forms of business in which banking companies may engage are spelt out in Section 6 of the Banking Regulation Act. The judicious exercise of these powers is controlled by the RBI through its power to give directions (Section 35A) and its power to caution or prohibit a banking company from entering into any particular transaction or class of transactions (Section 36). All these sections are equally applicable to an UCB. Subject to the normal regulatory safeguards, an UCB must be allowed to operate in all lines of business available to a commercial bank and must be given such freedom in its operating practices as is necessary, so long as it does not dilute the essential cooperative character of the bank.

1.31 In its interaction with a cross section of the representatives of State Governments, the urban cooperative banking sector, and eminent cooperators connected with urban banking movement, the Committee dwelt on certain operational and regulatory issues raised by these participants which are strictly not within the realm of Terms Of Reference of this Committee but which have a considerable bearing on the Terms Of Reference and healthy functioning of UCBs. These issues are addressed by the Committee in the Chapter titled “Other Related Issues”.

1.32 The Committee has more or less followed the methodology adopted by the earlier two Committees. It has devised a comprehensive questionnaire on each of the Terms Of Reference to elicit the views of select urban banks, select commercial banks, Indian Banks Association, Government of India, State governments, State and National Federations of Urban Cooperative Banks, eminent cooperators and people interested in the UCB sector. (Annexure I)

1.33 The Committee also had extensive interaction with a cross section of the above groups at Ahmedabad, Bangalore, Bhopal, Calcutta, Chennai, Delhi, Guwahati, Hyderabad, Mumbai and Pune (Annexure II) to have a grass root feel on the Terms Of Reference and the region specific issues concerning urban cooperative banks. These interface sessions have provided invaluable inputs to the Committee. The Committee also had an opportunity, in these interface sessions, to gauge the efficacy of the existing regulatory dispensation and irritants therein. Besides, the responses to questionnaire (Annexure III) and interface sessions, the Committee has also relied on reports of various Expert Committees and circulars issued by RBI.

1.34 With a view to have a focussed study on the Terms Of Reference, the Committee constituted three Working Groups to separately examine the issues pertaining to Terms Of Reference. After an indepth examination of existing policies, these Working Groups have submitted their approach papers to the Committee. The approach papers were deliberated at length in the meetings of the Committee and, thereafter, it arrived at its recommendations set out in this Report.

Structure of the Report:
1.35 The Report separately deals with each of the Terms Of Reference and other issues related to them in the following Chapters:

Chapter No.

I Introduction
II Genesis and Architecture of Urban Cooperative Banks
III Licensing Policy of new Urban Cooperative Banks
IV Branch Licensing Policy and Area of Operation of Urban Cooperative Banks
V Policy on Unlicensed and Weak Urban Cooperative Banks
VI Application of Capital Adequacy Norms to Urban Co-operative Banks
VII Conversion of Cooperative Credit Societies into Urban Cooperative Banks
VIII Legislative Reforms in Statutes
IX Other Related Issues.

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1.36 The Committee is grateful to officials of State Governments / Government of India, commercial banks, urban cooperative banks, their state and central federations and eminent cooperators for their valuable inputs provided during personal interaction, through replies to

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1.37 The Committee would also like to acknowledge the help rendered by the Regional Directors of Reserve Bank of India in organising meetings at various centres.