Licensing Policy of New Urban Cooperative Banks

Present Licensing Policy

3.1 The existing licensing policy of RBI is broadly based on the recommendations of the Marathe Committee.[11] At present, organisation of a new UCB is allowed on the basis of the need and future potential for mobilisation of deposits and purveying of credit, so that the new institution becomes a viable proposition and satisfies the felt banking needs of local people. To determine the need and potential for UCBs, presence only of urban cooperative banks functioning at a given centre is taken into account and presence of all other banking network is excluded. This is done as the clientele of UCBs are supposed to be distinct from those of commercial banks. Another criterion for determining the adequacy of banking network is to take into account the average population served by the existing UCBs. The present policy also prohibits organisation of UCBs in the rural centres on account of distinct credit delivery system already in place for rural centres.

Approach of the Committee

3.2 The Committee observes that there are no quantifiable, objective criteria for determining the need for an UCB in a given area. The Committee has also noted the recommendations of the Marathe Committee, which felt that "the Reserve Bank may address itself to the task of prescribing quantitative definitions for the key indicators like `need', `potential' and `adequacy' or otherwise of the `banking cover'. The Marathe Committee was of the view that while "need" for the organisation of a new UCB refers to concepts such as population coverage, spatial and geographical spread of existing banks etc., the "potential" criterion relates to an assessment whether, in the area of operation proposed, the new entity would be able to achieve the norms of viability within a reasonable period of time. Marathe Committee also felt that the determining basis for such an assessment should be the `credit gap' in the functional area and suggested the following guidelines for assessing the same.

i) Industrial activity present and proposed; setting up of new industrial estates etc;
ii) Level of trading activity; emerging markets and market yards;
iii) Sub-urban areas - existing and proposed;
iv) Existing banking network, deposits, advances, credit-deposit ratio;
v) Average population served by existing bank offices.

3.3 The Committee has examined these factors in the context of a substantially deregulated regime and policy posture of RBI with reference to organisation of new Private Sector Banks and Local Area Banks (LABs). The Committee is of the view that in a market driven regime, focus of the regulator should be on strong start-up capital, compliance to prudential norms, adherence to CRAR ab initio and professional character and integrity of management. If these factors are given due weightage before granting licence for a banking entity, there may not be any need to prescribe other parameters.

3.4 While responding to the questionnaire on this issue, a section of urban cooperative banks, their federations, and state cooperative banks have suggested that ‘credit gap' criterion should be a determining factor to establish the need for a bank, in a given locale specific. The Committee has examined this aspect and in its view, ‘credit gap' in a given area cannot be determined on unidentifiable parameters. The concept has to be well defined, structured and universally acceptable. Hence, in the absence of precise, measurable and scientific tools to determine exact quantum of credit gap, prescription of ‘credit gap' criterion for assessing the need, will only result in a laborious exercise without any tangible results. The suggestion that the credit gap may be determined on the basis of Potential Linked Credit Plan (PLP) of NABARD has also been examined by the Committee. The objective behind the preparation of Potential Linked Credit Plan is to bring to the notice of the planners, government, developmental agencies, bankers, farmers, private sector agencies etc, the need for infusion of specific infrastructure and non credit inputs to facilitate planned development of the district. The focus of PLP is essentially on rural development with the thrust on district as a whole. Since UCBs initially start at an urban centre, it is difficult to arrive at credit gap of an exclusive urban locale from PLP. Given the weak conceptual relevance of ‘credit gap', the Committee is not inclined to agree with this criterion for determining the need for a new urban cooperative bank at a given centre.

3.5 Yet another suggestion put forth by respondents to the questionnaire circulated by the Committee is, that the adequacy or otherwise of banking network at a given centre can be determined by the conventional arithmetical formula viz., Average Population Per Bank Office (APPBO). The APPBO is arrived at by application of following formula :

$$\frac{\textbf{Population of a given centre}}{\textbf{No. of banks offices (branches)}}$$

3.6 At present, RBI is following this norm and if the Average Population Per Bank Office (excluding commercial and other banking network) at a given centre is less than 10000, the centre is deemed to be adequately banked. The Committee has tried to assess the merits of this norm. In the opinion of the Committee, adequacy of banking network, at a given centre, cannot be gauged purely by statistical or arithmetical formula like APPBO. To a great extent, it depends on the level of economic activity, infrastructure, degree of urbanisation, buoyancy of service sector and the credit absorption capacity of the centre as a whole. These factors are not static and keep changing with reference to govt. policy, entrepreneurial capabilities and emergence of new economic activities. A cursory glance at urban banking network in 5 districts of Maharashtra viz. Pune, Nasik, Sangli, Satara and Kolhapur reveals presence of a large network of UCBs. By application of APPBO norm most of the towns in these districts at present appear to be over banked. Still the cooperative initiative has not diminished. It is understood that RBI continues to receive applications from promoters for organisation of new banks and for opening branches in these districts. On the other hand, in the states like Orissa and Bihar, there are as few as 14 and 6 UCBs respectively notwithstanding the liberal policy stance of RBI. Given the thin presence of urban banking sector in these states, it appears that there is scope for the growth of urban cooperative banking movement. But, disparity in the presence of urban banking movement point to the fact that adequacy of banking network cannot be gauged exclusively by mechanical application of APPBO. Rightly, no such norm is applied by RBI while giving approval for organisation of new Commercial Banks or Local Area Banks. Moreover, excluding the non-urban banking sector in an area for gauging adequacy of banking network may not be an objective criterion. Selective prescription of population criterion only for UCBs leads to imposing artificial barriers on their growth besides going against the principle of equity.

3.7 The Committee feels that the licensing policy should not only be transparent but also precise and objective. The procedures have to be simple and minimal. In this context, the Committee agrees with the core principles enunciated by the Basle Committee on Banking Supervision that "the licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process at a minimum should consist of an assessment of the banking organisations, ownership, structure, directors and senior management, its operative plan and internal controls, and its projected financial condition, including its capital base".[12] Thus, licensing process should be minimal but rigorous. Further, in a market driven system, the regulator is neither expected to carry out such an exercise to assess the viability of a bank nor it has the wherewithal to go into micro level assessment of an individual entity. Moreover, if the viability norms to be achieved within a specified period are stipulated, once a bank is licensed and starts operating, there is no practical way in which compliance with such norms can be enforced. The Committee is, therefore, of the view that the regulator has only to lay down appropriate entry point norms and leave the issue of need, potential and viability of a bank to the promoters' judgement.

Recommendations

3.8 In the light of the above discussion, the Committee recommends that the policy for granting licence to new urban cooperative banks should be based on the following twin criteria:

i) Strong start up capital base and

ii) Professional background of promoters with proven track record

Marathe Committee Methodology on EPN

3.9 The RBI had attempted the formulation of broad norms of viability for urban banks in 1971. The Madhava Das Committee and Marathe Committee had also dwelt at length on this issue in the past and evolved viability standards for UCBs located in different population strata and, thereafter, suggested the entry point capital and membership norms.

3.10 The methodology of Marathe Committee was quintessentially similar to Madhava Das Committee approach. In arriving at viability standards, the Marathe Committee had taken into account the minimum complement of staff and an ideal organisational set up required to adequately tap the potential, both by way of mobilisation of deposits and purveying of credit, as related to the particular centre where the bank had to operate. The above exercise involved working out the margin available to banks in raising and deployment of resources as well as cost of establishment expenditure to be incurred on the minimum staff requirement, and the quantum of loan business which would be necessary to generate the income requisite to meet such costs. For this purpose, the Committee had assessed the financial data of 104 urban cooperative banks. These UCBs were operating in different population strata in the country and the study covered information on their assets, liabilities, cost structure, operating results, branch and manpower economics. The Committee analysed the operative economics of the sample with special reference to the breakeven operations in relation to the structure of costs, assets and liabilities. Based on these parameters, the Marathe Committee worked out viability norms to be achieved by urban cooperative banks in 4 population strata and gave alternative models but finally suggested following viability standards.

Table 3.1

(Rs. in lakhs)

	Metropolitan (large) A category	Metropolitan (others) B category	Urban C category	Semi-urban D category
Share capital	50.00	30.00	18.00	8.00
Reserves	20.00	12.00	7.20	3.20
Deposits	430.00	258.00	154.80	68.80
Advances	350.00	210.00	126.00	56.00
Working capital	500.00	300.00	180.00	80.00

3.11 These viability standards were required to be achieved by urban cooperative banks within a period of 3 years from the date of issue of licence. Based on the above viability standards, Marathe Committee suggested the following entry point norms for new UCBs.

Table 3.2

Type of centre	Initial share capital (Rs. lakhs)	Initial membership (Nos.)	Membership after 2 years (Nos.)
A	30	2000	5000
B	18	1500	3000
C	12	1000	2000
D	5	500	1000

3.12 Based on the recommendations of Marathe Committee, the Reserve Bank had prescribed viability standards and entry point norms effective from May 1993. (Annexure VIII). Taking into account the inflation factor since 1993 and also low level of entry point norms, it was again decided to raise entry point norms effective from 1 April, 1998 as shown in Annexure IX.

Approach of the Committee

3.13 This Committee feels that the concept of viability standards needs to be examined de novo. Assumptions with reference to fixed and variable costs will not only vary from centre to centre but also on account of extreme heterogeneity in the volume of operations of banks in urban cooperative banking sector. In some centres, particularly in metros, like Mumbai, there are some large size UCBs with assets of over Rs.500 crores at one end of the spectrum, and smaller banks with just Rs.5 to Rs.10 crores of assets at the other end. Hence, it is an extremely difficult exercise to arrive at exact cost of fixed and variable expenditure for a heterogeneous group of entities and arrive at the viability standards. Besides, absolute quantitative standards have inherent conceptual weakness. Hypothetically, if an UCB achieves all the viability standards prescribed for a given centre, but its networth is eroded to the extent of 25% , its NPAs are over 20% and it is incurring consistent losses, it cannot be said that the bank is viable by any regulatory yardstick. The Committee, therefore, feels that in the post financial sector reforms era, these absolute quantitative viability standards have lost their regulatory relevance. Instead, entry point norms should be based on twin criteria of financial strength and efficient management. In respect of proposed new banks, financial strength can be ensured by the adequacy of entry point capital. In the case of existing cooperative societies which intend to convert themselves into UCBs, additional criteria would be capital adequacy norms, limits on NPAs, positive past operating results etc. In addition, for all entities there must be minimum institutional arrangements to provide assurance of future efficient management.

3.14 Why do banks hold capital? This may seem a very banal question. "Capital for banks cannot be compared with simple creditor protection for normal companies, which requires simply that the difference between assets and liabilities be positive"[13] . According to a scholastic perception, the role of capital in a bank is to act "as a buffer against future, unidentified, even relatively improbable losses, whilst leaving the bank able to operate at the same level of capacity."[14] This holds good for a bank with international presence as also for a localised entity like an UCB. In the opinion of the Committee, the twin functions of start-up capital of an UCB are;

(i) to meet the initial infrastructure expenditure and;
(ii) to provide an adequate margin against the erosion of bank's assets in the event of future losses which would have otherwise endangered depositors' money.

3.15 To determine an ideal start-up capital for an Urban Cooperative Bank is an extremely difficult task. However, the regulator has a responsibility to fix a reasonable level of entry point capital. This startup capital, the Committee feels, should have some relation to the level of entry capital fixed for Local Area Banks (LABs) and RRBs as the area of operation and nature of clientele of these two institutions and UCBs are to a great extent homogenous. The start-up capital for RRBs was fixed at Rs.1 crore way back in 1974; entry point capital for LABs is Rs.5 crores. Though it is not an analogous comparison, even NBFCs are required to start their operations with a threshold capital of Rs. 2 crores. Compared to the minimum capital structure prescribed for these entities, the Committee feels that the existing level of entry point capital norms for UCBs are rather low. Given the level of rental values of premises in Metros like Mumbai, Delhi, Chennai and major state capitals, cost of automation, preliminary arrangements for safe keeping of cash, furnishing of the premises and capacity to meet the fixed and variable costs during the first 2 years till the UCB reaches break even point, the existing entry point capital norms require upward revision.

3.16 Although it cannot be conclusively established that a high entry point capital, per se, will prevent a bank from becoming weak, experience has shown that a low entry point capital prescription is one of the main reasons for banks turning weak. Critics of high entry point norms argue that higher start-up capital inhibits the cooperative initiative since UCBs are essentially meant for lower and middle income groups. However, this argument overlooks the difference between a cooperative credit society and an UCB. There are a number of cooperative credit societies, functioning with excellent track record to take care of the credit needs of these groups of people. However, when these societies wish to convert themselves into UCBs and, thereby, acquire right to accept deposits from non members, the protection of the interests of depositors becomes a paramount consideration.

3.17 It is also pertinent to note that while reviewing the performance of the urban cooperative banking sector, Committee on Banking Sector Reforms (Narasimham Committee) unequivocally expressed its resentment over low entry point norms for UCBs. It felt "........the current entry norms, specially the capital requirements are much too liberal and RBI should urgently undertake a review of these norms and prescribe revised minimum capital norms for these banks".[15] The Advisory Group constituted by Reserve Bank of India for suggesting reforms in Deposit Insurance in India, has also expressed its concern over the existing licensing policy for cooperative banks and cautioned that the policy needs a thorough review.

Recommendations

3.18 Taking into account the above factors, the Committee recommends that the entry point norms for urban cooperative banks in different categories of centres should be as under:

Table 3.3
(Entry Point Norms for UCBs other than unit banks)

		Category of Centre	**Capital (Rs. in crores)**	**Membership**
A	-	population over 15 lakhs	5.00	3000
B	-	population over 10 lakhs but not exceeding 15 lakhs	2.50	2500
C	-	population over 5 lakhs but not exceeding 10 lakhs	2.00	2000
D	-	population over 2 lakhs but not exceeding 5 lakhs	1.00	1500
E	-	population not exceeding 2 lakhs	0.50	1000

3.19 The Committee has suggested recategorisation of the existing 3 categories of centres based on population into 5 categories taking into account the problems cooperators may encounter in smaller centres if these centres are clubbed with centers having higher entry point norms. The Committee also feels that if a bank desires to function initially as a unit bank then the start-up expenses and the scale of operations would be relatively less and the aforesaid entry capital norms need to be scaled down. It, therefore, recommends that if the promoters desire to confine operations to unit banking (one office only), then the entry point capital can be fixed at 50% of requisite level of entry point capital suggested at Table 3.3. The Committee, therefore, recommends the following entry point norms for unit banks :-

Table 3.4
(Entry Point Norms for unit banks)

Category of Centre	Capital (Rs. in crores)	Membership
A	2.5	3000
B	1.25	2500
C	1.00	2000
D	0.50	1500
E	0.25	1000

3.20 However, if an UCB desires to open an additional branch/ branches in a district other than the district in which it is registered but within the state in which it is registered, it has to necessarily have networth equivalent to the capital prescribed for the highest category in that state.

3.21 One of the members (Dr. S.S. Sisodia) suggested lower entry point norms as indicated in Annexure X.

Registered office

3.22 As urban cooperative banks are generally organised to cater to the credit needs of semi-urban/urban populace, the Committee recommends that their registered offices should invariably be located in semi-urban/urban areas.

Efficient Management

3.23 It is not possible for a regulatory authority to guarantee that every proposed cooperative bank will be efficiently managed. However, it can stipulate that before a bank is licensed, there are in place, certain minimum institutional arrangements which will contribute towards efficient management. One of the major reasons attributed to the prevalence of weakness in UCBs is the low level of professionalism of the promoters. Under the present policy, RBI advises the promoters of new banks to induct one or two members having cooperative/ commercial banking background in the boards of the banks. The Committee is given to understand that in order to comply with this requirement, promoters induct one or two retired bank officials who may have served at a relatively base level in a bank. This compliance is generally viewed by promoters as a formality rather than giving a professional content to the board. It has been further brought to the notice of the Committee that during the onsite inspection of UCBs, the RBI Officials have often found that the observance of detailed guidelines on ‘Dos and Donts' issued by RBI for directors of UCBs are not seriously adhered to due to lack of professional banking background of the members of board of directors. Low-level of professionalism results in non-compliance with CRR/SLR prescription and absence of adequate loan policies in many small and even medium size UCBs.

3.24 It is, therefore, necessary that before an UCB is licensed, the RBI should satisfy itself about the acceptable background of the promoters, the presence in the board of persons who have suitable banking experience or professional skills in related fields and the suitability of the chief executive officer. While it may be argued that such prescription goes against the ‘quintessential element' of cooperation i.e., democratic spirit, this element has necessarily to be tempered with considerations of protection of the interests of the members and depositors.

Recommendations

3.25 The Committee, recommends that:

(i) there should at all times be at least 2 directors with suitable banking experience or persons with relevant professional qualifications.

(ii) In so far as promoters are concerned :

(a) they should not be defaulters to any financial institution/ bank/cooperative bank/cooperative society, etc.

(b) no criminal proceedings should have been instituted against them

(c) their financial means and standing should also be got verified through bankers' reports.

(d) they should not be associated as director with any chitfund/ NBFC/Co-op. bank/commercial bank.

(iii) Chief Executive Officer of a proposed bank should be adequately qualified.

Relevance of special dispensation to certain categories -Present policy stance

3.26 Uniform prescription of entry point norms for banks irrespective of the level of socio-economic development and geographical location was perceived as a deterrent for the growth of urban cooperative banking movement in less/least developed areas, tribal terrains and inhibiting the growth of socially and economically deprived sections such as mahilas, SCs/STs, in organising UCBs. RBI had, therefore, extended certain relaxations in entry point norms for these categories of banks (Annexures VIII & IX).

Need for continuance of relaxations

3.27 A majority of banks, federations and state governments were unanimous in their response to the questionnaire circulated by the Committee that relaxations to special categories of banks as indicated above should continue. The advocates of relaxations in entry point norms argue that socially deprived sections such as SCs/STs and Mahilas are not coming to the fore due to general reluctance of commercial banks to lend to them. If these sections exhibit cooperative initiative by organising themselves to form UCBs, it would be appropriate to relax the entry norms instead of the state contributing to the share capital of these ventures. They also feel that due to low level of per capita income in some parts of the country, the cooperators will not be able to organise UCBs due to relatively high entry norms.

3.28 Some independent observers of cooperative movement have, on the other hand, expressed their disagreement with special dispensation to these categories of banks. They are of the view that, banks being financial entities, no special dispensation should be shown to any category of bank, whether organised in cooperative or corporate fold, as it would only undermine their financial stability. They also feel that there is no justifiable reason for setting up banks in every centre/ area. Credit needs of the people can as well be taken care of by cooperative credit societies if the promoters are not able to mobilise requisite entry capital. The success stories of micro credit agencies in some parts of the country amply demonstrate that credit needs of low income strata of society need not necessarily be taken care of by banking sector alone. Critics of relaxations also argue that relaxation in entry point norms is one of the causative factors of weakness in UCBs. Though low entry point prescription, per se, is not the sole factor for banks turning weak, the statistical profile of weak banks suggests that it is one of the major reasons leading to weakness. Of the 48 UCBs organised in less/least developed areas, as many as 29(60.4%) banks are weak. Similarly, 16.8% of mahila banks have turned weak. It is also too early to be sanguine about this figure since 78 of 113 mahila banks have come up only during the last 3 years. Of 9 UCBs organised by SCs/STs, 3 have become weak. (Annexure XI).

3.29 At present, RBI allows certain relaxations in the entry point norms for banks organised in areas classified as less/least developed based on state governments' notification to that effect. The consideration for declaring an area as backward by the state governments essentially depends on the socio-economic indices of that area. Some representations have been made to the Committee specifically by the federations of UCBs that categorisation of less/ least developed area should be based on the growth of urban banking movement in a given region/state rather than the level of economic development. The Committee has examined this issue but is not inclined to agree with this contention for the sole reason of its impracticability. Urban banking movement essentially being a peoples' endeavour, is not necessarily a function of the level of economic development in a given region. Thin spread of urban banking movement in some states, Committee feels, may not necessarily reverse if relaxations are allowed. The classic example in support of this line of thinking is that the states with high per capita income, such as Punjab, Haryana and western Uttar Pradesh which are pioneers in progressive farming, have not witnessed urban banking growth as is evident from the accompanying table, despite entry point norms being quite low.

Table 3.5

(Position as on 31 March 1999)

State	No. of UCBs
Haryana	8
Punjab	6
W. Uttar Pradesh	14

3.30 The Committee also feels that low entry point norms, per se, do not necessarily give a fillip to urban banking growth. A case in point is the urban banking scenario in states with large tribal tracts. Despite extending entry point capital relaxation to the tune of 66% to tribal regions, the number of urban cooperative banks remained stagnant in Orissa (14 banks) for over a decade. Despite a large tribal tract in Bihar, there are only 6 UCBs in the entire State. Of the 26 districts which have predominant tribal populace in Madhya Pradesh, as many as 13 districts are devoid of urban banking presence.

3.31 Madhava Das Committee, which had also dwelt with this issue, did not recommend relaxations in entry point capital norms. On the other hand, it felt "new banks to be organised in backward areas or by weaker sections of the community may not be able to collect the initial minimum share capital required for obtaining a licence from the Reserve Bank to commence banking business. Governmental assistance in the form of share capital contribution for such new banks would, therefore, hasten the pace of organisation of urban banks."[16]

Recommendations of the Committee

3.32 Notwithstanding the arguments of the critics of relaxations, the Committee is inclined to agree with the policy of grant of relaxations in EPNs due to following reasons :

> (i) Relaxation can be abolished if State participation in share capital is forthcoming. Given the current thinking of the State Governments to gradually phase out grants and subsidies and divest their stake in PSUs, it is unlikely that State Governments would come forward to contribute share capital of UCBs. Moreover, government's participation in share capital would necessarily lead to its control over UCBs, thereby, stifling their autonomy.
>
> (ii) Empowerment of weaker sections and dispossessed segments is a constitutional obligation. The Committee notes that constitutional safeguards for reservation for SCs and STs in Government jobs and for political offices in State Assemblies and Lok Sabha were given for good and valid reasons after a serious debate in the Constituent Assembly on the pros and cons of the issue. The idea is not to have the reservation permanently but for a limited period to help these sections to come up on at par with general populace. Such initial and limited reservation is considered warranted because of socio economic backwardness of these sections. For the same reasons, Committee feels, SCs & STs do require relaxation in Entry Point Norms for a few more years to enable them to start UCBs.
>
> (iii) The Committee also notes that there is a conscious effort by Union and State Governments to empower women in socio economic fields, as at present such participation is at a low level. Enabling women to start their own urban cooperative banks will go a long way in such empowerment. Relaxation in Entry Point Norms is one good way of doing it.

3.33 Hence, the Committee recommends that :-

> (i) Relaxations, as allowed at present, for organisation of new UCBs by SCs/STs/Mahilas and those established in less/least developed / tribal / N.Eastern Regions may be continued for a further period of 5 years and, thereafter, a review may be made. Accordingly, the relaxed entry point capital norms for these categories of banks would be as under :
> (ii) For unit banks the above norms should be reduced by 50% . However, the relaxations specified above are not cumulative and not more than one relaxation can be given to any single group of promoters at one time.

	(Rs. in crores)	Category of Centre				
		A	B	C	D	E
1.	Banks set up by SCs/STs, Mahilas and in less developed areas	2.5	1.25	1.00	0.50	0.25
2.	Banks set up in least developed/ Tribal/N.E. regions	1.67	0.83	0.67	0.33	0.17

11. Committee on Licensing of New Urban Cooperative Banks (1992)
12. Basle Core Principles for Effective Banking Supervision (Press Release April 1997).
13. Managing Bank Capital - Chris Matten.
14. Managing Bank Capital - Chris Matten.
15. Report of the Committee on Banking Sector Reforms (Narasimham Committee Report II) - 1998.
16. Report of the Committee on Urban Cooperative Banks, 1978.