

Policy on Unlicensed and Weak Urban Cooperative Banks

A. Licensing of unlicensed banks

5.1 Existence of a number of unlicensed urban cooperative banks has become a cause for concern to regulators. It is amazing to note that as at the end of June 1977, out of 1162 UCBs, as many as 1066 banks were unlicensed. Even as at the end of September 30 1999, of 1998 UCBs, as many as 181 were unlicensed. ([Annexure XII](#)) Of these, 97 UCBs have remained unlicensed ever since banking laws were made applicable to cooperative banks in 1966. Existence of such a large number of unlicensed entities for over 3 decades, places the supervisor in a state of 'regulatory discomfiture'.

5.2 Ironically, the main reason for existence of such a large number of unlicensed banks was not on account of a lax licensing policy of RBI. Proliferation of unlicensed banks was statute induced. as evident from the following paragraph. Under the provisions of Section 5(ccvi) of B.R. Act, 1949 (AACS), a "primary credit society" means a cooperative society, other than a primary agricultural credit society.

- (1) the primary object or principal business of which is the transaction of banking business;
- (2) the paid up share capital and reserves of which are less than one lakh of rupees; and
- (3) the by-laws of which do not permit admission of any other cooperative society as a member.

Genesis of unlicensed phenomenon:

5.3 When a primary credit society's owned funds attain a level of Rs. 1 lakh it automatically gets the status of a primary cooperative bank. Thereafter it is required to apply for a licence to carry on banking business. Under the provisions of sub-section (2) of Section 22 of the B.R.Act, 1949 (AACS), a primary cooperative society which was carrying on banking business on 1 March 1966 was required to apply to RBI for grant of licence to carry on banking business within 3 months. Further, even after 1966, as and when the owned funds of a primary credit society reaches Rs. 1 lakh, it has to necessarily apply to RBI for a licence, and pending issue of licence it can carry on banking activity.

5.4 Keeping in view this peculiar syndrome, a small Working Group was set up in RBI in October, 1978 to evolve detailed parameters for issue of licences to unlicensed banks. The Working Group had suggested that such of those banks which complied with the entry point norms and other norms should be issued licences. However, application for issue of licence for such banks were not rejected even if they did not comply with all the norms after statutory inspection of these banks and they were allowed to carry on banking business till such time the banks complied with norms prescribed by RBI. The present policy for licensing of unlicensed banks is delineated below:

- (i) Compliance with certain provisions of B.R.Act, 1949 (As Applicable to Cooperative Societies) i.e., Section 11(1) (Minimum capital requirements), 22(3)(a) (capacity to pay the present and future depositors as and when their claims accrue), Section 18 (Maintenance of prescribed level of cash reserves), and Section 24 (Maintenance of prescribed level of liquid

assets).

- (ii) Compliance with the general directives of RBI issued under Sections 21 and 35A of the B.R.Act, 1949 (As Applicable to Cooperative Societies).
- (iii) Compliance with other important provisions of the Act, *ibid*, i.e., Section 6 (forms of business), 8 (prohibition of trading), 14(A) (Prohibition of floating charge on assets) and 23 (restriction on opening of new places of business).
- (iv) Regularity in submission of statutory returns to the Reserve Bank.
- (v) Satisfactory recovery performance (at present the norm is that gross NPAs should be less than 15% of the total loans and advances outstanding).
- (vi) Non-default in repayment of loans availed from higher financing agencies.
- (vii) Maintenance of adequate provisions against erosion in the value of assets.
- (viii) Should have made profits during the last 2 cooperative years for which audit had been completed.
- (ix) Satisfactory progress in mobilisation of deposits (deposit growth rate should be not less than 5% per annum).
- (x) Prompt and satisfactory compliance in rectification of defects and implementation of suggestions communicated in the Reserve Bank Inspection Reports.
- (xi) a) Formulation of proper rules and regulations governing deposits/advances.
b) Absence of instances of misappropriation/frauds affecting the working and financial soundness of the bank.
- (xii) a) Achievement of required level of share capital and reserves, deposits and loan business etc. as per the viability norms prescribed by the RBI (1986 norms) and at least 75% of viability norms as revised in 1993.
b) Attainment of a minimum of 40% of the total outstanding loans in financing of priority sectors.
- (xiii) Provision in by-laws regarding acceptance of open membership.
- (xiv) Management by an elected Board of Directors and a full-time paid Chief Executive Officer

Approach of the Committee

5.5 Some people have expressed apprehension that a large scale liquidation of unlicensed banks or their reconversion into societies will create a panic situation and result in a run on these banks. The Committee, however, disagrees with this view point. If an UCB has not been able to comply with rudimentary norms for licensing for over 30 years such an entity does not have a place in the banking fold. The Committee feels that adequate time has been given to such banks to demonstrate the financial strength and organisational setup needed before they can be allowed to undertake banking business. However, a further two years may be provided. If during this period of time, an UCB is not able to comply with the requirements, allowing it to continue to do banking business can only endanger the interests of the depositors

Recommendations

5.6 The Committee, therefore, makes the following recommendations:-

- (i) a) All the UCBs which were brought under the purview of Banking Regulation Act, 1949

(As Applicable to Cooperative Societies) in 1966 should be licensed by 31 March 2002, if they comply with norms of RBI, failing which their application for licences should be rejected and they should be stopped from doing banking business.

b) Such of the primary credit societies which became eligible to convert themselves into banks after 1 March 1966, should be licensed by 31 March 2002 or within five years from the date of commencement of their banking business, whichever is later. Such of those which do not comply with these norms within the said time frame their licence applications should be rejected. RBI should give notices to this effect to all the unlicensed banks indicating its policy posture.

(ii) Norms for licensing unlicensed banks should be objective and precise. The following criteria should be applied for issue of licence to unlicensed banks. The banks should :

(a) have attained minimum regulatory level of CRAR

(b) not have net NPAs in excess of 10%.

(c) have made profits during each of the last 3 years

(d) have complied with statutory framework of B.R.Act/ directions issued by RBI from time to time.

(iii) Primary credit societies which intend to convert themselves into UCBs in future should be granted licences only if they satisfy the entry point norms. Licences should be granted or rejected within a period not exceeding six months from the date when application for licence is made. Pending grant of licence, such societies must not be permitted to carry on banking business.

Future set-up of "weak" urban cooperative banks

5.7 Restructuring of weak banks has become the singular most important issue engaging the attention of regulators and the Governments all over the world. Though, in terms of its impact on the financial system, the problem of sickness of UCBs may not be as acute as in the case of large commercial banks, the sheer number of weak urban cooperative banks and the deposits held by them warrants attention by RBI, State Governments & Cooperators. Based on current criteria for classification of weak banks, as many as 293 UCBs have been classified as weak at the end of March 1998 ([Annexure XIII](#)). Of these, 112 banks do not satisfy even the meager capital requirement of Rs. 1 lakh (Section 11 of B.R.Act). Moreover, many banks have remained as 'weak' for more than a decade.

Norms for classification of weak banks

5.8 An urban cooperative bank is classified as weak if any of the following conditions exist :

i) its own funds are eroded to the extent of 25% or more by the unprovided for bad & doubtful debts and other bad assets or its overdues exceed 50% of the outstanding loans and advances.

ii) it does not comply with the provisions regarding minimum share capital in terms of section 11(1) of B.R.Act,1949 (AACS) i.e. the real or the exchangeable value of paid up share capital and reserves has fallen below the stipulated level of Rs.1 lakh; and

iii) it does not comply with the viability standards prescribed by Reserve Bank of India .

Rehabilitation of weak banks

5.9 Alive to the problem of growing sickness in urban cooperative banks, RBI suggested to the State Governments to take up those weak banks for rehabilitation which were either viable or potentially viable and could become viable within a period of 3 to 5 years. Banks which did not comply with the minimum share capital prescribed under section 11 of B.R.Act,1949 (AACs) were excluded from the ambit of the scheme. To facilitate the drawing up of proper rehabilitation programme, RBI had circulated, in November 1972, detailed guidelines to Registrars, SCBs and DCCBs. The State Cooperative Bank, being the leader of cooperative movement in the respective state, was requested to draw up comprehensive rehabilitation programmes for each of the weak urban cooperative bank. However, the progress of the rehabilitation of weak banks in the subsequent six years was extremely slow and tardy. The slow progress was primarily attributed to the lack of interest in the efforts on the part of the respective urban banks to achieve distinct progress in operational results. Some of the State Cooperative Banks also did not constitute a separate rehabilitation cell for monitoring the progress of rehabilitation as envisaged in the rehabilitation scheme.

Reasons for weakness in urban cooperative banks

5.10 There are a number of reasons why so many UCBs are weak. However, the more important of these are:

- (i) Inadequate entry point capital.
- (ii) Lack of professionalism and politicisation of management.
- (iii) Absence of prudential norms like CRAR for maintenance of sound health.
- (iv) Absence of a system for timely identification of weakness.
- (v) Dual control which hampers efficient operation and timely rehabilitation.

Such a situation inevitably leads to increased level of non-performing assets and losses in working results. In addition, there is an inherent weakness in the system which allows setting up of UCBs with very low entry point capital. The low capital base could be wiped out easily by adverse working results for one or two years or by bad debts.

SYSTEM OF IDENTIFICATION OF WEAKNESS IN UCBS AND PERIODICAL REVIEW

(a) Identification of weakness in UCBs

5.11 Weakness in the financial position of UCBs is currently identified as per the assessment of their financial position during statutory inspections conducted by the Reserve Bank or through the system of annual review conducted by the Reserve Bank on the basis of annual financial statements received from the banks. A list of the banks identified as weak is forwarded to the Registrar of Cooperative Societies, the State Cooperative Bank and the State Federation / Association of UCBs of the State concerned.

(b) System of monitoring

5.12 Banks which are classified as "weak" are advised to draw up a time bound action plan for

revival. Registrars of Cooperative Societies in all the States have been advised by the Reserve Bank to constitute a Bank Level Rehabilitation Review Committee (BLRRC) to monitor the progress achieved by the concerned weak bank. Progress achieved in rehabilitation of weak UCBs in a State is reviewed by the State Level Rehabilitation Review Committee (SLRRC) constituted under the chairmanship of the Registrar of Cooperative Societies (RCS) of the State concerned. The Officer-in- Charge of Regional Office, UBD is a member of the SLRRC. Thus, the entire process of rehabilitation of weak UCBs is designed to solicit cooperation from all the agencies concerned with the revival of weak banks. However, the system has not been working in a satisfactory manner, specially in the states where urban banking is still in the developing stages. In order to give more active role to federations/associations of urban banks, in the process of revival of weak UCBs, they were assigned the task of convening the BLRRC meetings in 1998. However, this system failed to deliver the desired results, even in a state like Maharashtra, where the urban banks federation is active. The system of BLRRCs has not been effective even after experimenting with it for over 25 years. With a view to reactivate the SLRRCs, the Reserve Bank took upon itself (in the first quarter of the year 1998) the responsibility of convening the SLRRCs in all the states except Maharashtra, Gujarat, Karnataka and Kerala where the State Cooperative Banks have been convening these meetings regularly.

Initiative taken by the Reserve Bank in deciding future set up of weak banks

5.13 The policy of the Reserve Bank has always been that banks which are not able to turnaround within a reasonable period of time be persuaded to merge/ amalgamate with stronger banks and if such efforts fail, such banks be taken into liquidation. The main thrust of the present policy of the Reserve Bank is to weed out weak banks having negative networth. Based on the recommendations of Marathe Committee, the Registrars of Cooperative Societies in all the States have been advised by the Reserve Bank (in June 1993) to take action as indicated below:

- (i) All the weak UCBs under rehabilitation for more than five years should be considered for merger / amalgamation with a strong unit. In case merger/ amalgamation with a strong bank does not materialise, the concerned weak bank may be taken into liquidation.
- (ii) Position of weak banks which are under rehabilitation for less than 5 years should be reviewed periodically. Such banks should be advised to come forward with a specific action plan for coming out of the weak status within a period of two years. In case these weak banks do not show any perceptible improvement and have no prospects of becoming viable units, they should be considered for merger or liquidation as indicated in sub paragraph (i) above.
- (iii) As regards the weak banks which are not complying with the provisions of Section 11 (1) of the B.R. Act, 1949, urgent steps should be taken to identify such banks for merger with stronger units or for liquidation, as the case may be. Since May 1993, 12 UCBs have been amalgamated with stronger units. Another 10 banks have been taken into liquidation from 1 January 1995. Further, the Reserve Bank has either cancelled the banking licence or rejected the applications for issue of licence to carry on banking business in respect of 21 weak UCBs since 1997. Since the Reserve Bank of India does not have any statutory powers for amalgamation or liquidation of cooperative banks, it is essential for the RBI to seek the cooperation of the RCS in such matters. However, inordinate delays are observed in deciding the future set up of weak UCBs resulting in avoidable hardship to their depositors.

One major reason for continuance of these banks is an offshoot of the problems thrown up by the dual control regime.

Approach of the Committee

5.14 The Committee feels that the present criteria for identification of weak banks suffers from the following defects:

- (i) the criteria regarding erosion of owned funds by the extent of unprovided bad and doubtful debts merely measures the extent of non or under provision but does not measure the adequacy of the owned funds which would be available after such provision is made.
- (ii) while the extent of overdues when related to outstanding loans and advances, do reflect financial weakness, the limit of 50% is often reached at the stage when a UCB has reached a point of no return.
- (iii) the criteria ignores the risk weightage attached to assets, the trend of past operating results and other factors which are necessary to determine whether future net worth will be adversely affected.

5.15 The present system does not help in identifying the incipient sickness in UCBs. This fact was underlined by the Marathe Committee which observed that "the present method of identifying and monitoring such banks does not recognise the fact that sickness is not a sudden occurrence, but the end point of a gradual economic decay. In the absence of early warning signals, the rehabilitation initiative probably takes place much later than it should have. This is indicated by the fact a number of sick banks continue to be under rehabilitation for long period of time and the number of successful turnaround cases is not significant." It, therefore, recommended that "Reserve Bank should undertake a comprehensive study to (1) validate the existing criteria for defining sickness on the basis of systematic comparison of healthy and sick banks, (2) devise a quantitative model to predict incipient sickness, and (3) scale all cooperative banks on a financial health scale so as to enable selective and timely intervention."

5.16 It is, therefore, necessary to clearly identify the stage at which an UCB shows the first sign of weakness and to take remedial action. Crucial in this exercise is the maintenance by the UCB of the adequate size of net owned funds required for a minimum ratio of capital adequacy, the quality of the assets and positive operating results. Once these factors are allowed to deteriorate, weak banks get trapped in a vicious circle because of higher NPAs and higher cost of deposits. Consequently they are forced to increase their lending rates which in turn results in deterioration in the quality of borrowers leading to further rise in NPAs. Therefore, at the first sign of weakness, remedial action has to be taken to maintain the required level of capital adequacy and put in place a committed and professional management.

5.17 At the same time, it is necessary to make a distinction between weak banks which can be rehabilitated and sick banks which endanger the interests of depositors. Therefore, sick banks must not be allowed to continue to do banking business.

Proposed Norms for Classification of UCBs as "Weak"

5.18 Taking into account all the factors mentioned above, the Committee recommends that the system of classification of UCBs as 'weak' may be modified to have two distinct groups, viz., (i) "weak" banks and (ii) "sick" banks based on parameters such as capital adequacy, level of NPAs and profitability. An UCB having low capital adequacy and showing increasing trend in NPAs could be classified as a 'weak' unit even if its operations show profits. Similarly, an UCB which has shown losses in operation, after adjustment of shortfall in provisioning towards asset losses and other outside liabilities, may also be classified as a weak unit even if it has achieved the capital adequacy norms. An UCB should be classified as "sick" when there is a further deterioration in its financial position to such an extent that the interests of the depositors are endangered.

5.19 The Committee recommends that the criteria for classification of weak and sick banks should be as under :

System of review of progress made in revival

5.20 The requirement of constitution of Bank Level Rehabilitation Review Committees has been prescribed to assist weak UCBs in preparing action plan for revival and to review the progress made in implementation of the plan. Since the system has failed to take root in most of the States even after 27 years, the Committee is of the view that no useful purpose would be served by continuing the system of BLRRCs and that the primary responsibility of revival of weak banks should rest with the respective banks themselves. The weak banks should, therefore, prepare an action plan for revival with the help of experts, if necessary, and submit the same to the regulators. As regards the periodical monitoring of financial position of weak/ sick UCBs, the primary responsibility of this function is with the regulator / supervisor, viz. the Registrar of Cooperative Societies of the concerned States and the Reserve Bank of India. The latter, especially, has an obligation to ensure that the affairs of a bank are not conducted in a manner detrimental to the interests of its depositors. The Committee, therefore, suggests that the Reserve Bank may, strengthen the system of periodical review of the affairs of weak/sick UCBs.

Parameter	Weak bank	Sick bank
CRAR	If CRAR falls below the level of 75% of the minimum prescription or	If CRAR falls below the level of 50% of the minimum prescription and
Net NPA	10% or more but less than 15% of loans and advances outstanding as on 31 March , or	15% or more of loans and advances outstanding as on 31 March , or
History of Losses	Showing net losses in operation for two years out of the last three consecutive financial years	Showing net losses in operation for the last three consecutive financial years

5.21 The responsibility of convening SLRRCs has now been assigned to the Regional Offices of UBD of the Reserve Bank (except in respect of Karnataka, Kerala, Gujarat, Maharashtra) in respect of weak banks under their jurisdiction to strengthen the system of review/ follow up. The Registrar of Cooperative Societies is the Chairman of SLRRCs in all the States. The Committee is of the view that SLRRCs provide an ideal forum for coordination of activities among the Reserve Bank, Registrars of Cooperative Societies and the UCBs' Federations, wherever they are active. The system may, therefore, be continued.

Deciding Future Set-up of Weak Banks

5.22 The present policy of Reserve Bank is to weed out the weak and nonviable UCBs, especially those which are having negative net-worth. During the course of interaction with the representatives of UCBs and urban banks' federations, a view was expressed that liquidation of a bank should be done as a last resort. While the Committee is generally in agreement with this view, there should be a time limit upto which such banks can be allowed to function. It is a widely accepted fact that the presence of a large number of financially weak banks is detrimental to the growth of the urban cooperative banking sector. Further, Reserve Bank, as a regulator and supervisor, has the primary concern of depositors' interests, which cannot be sacrificed for the sake of allowing financially weak banks to continue. However, all out efforts may be made to revive the ones which have potential for turnaround. The initiative for revival should primarily come from the banks themselves.

5.23 Once an UCB is classified as sick, allowing it to continue banking business would endanger the interests of the depositors and normally action under sub clauses (1), (2) and (3) of section 45 of B.R. Act, 1949 is called for. These clauses, which are applicable to commercial banks provide that

- (i) RBI can apply to the Central Government for a moratorium in respect of an UCB.
- (ii) After considering the application, the Central Government can make an order of moratorium staying the commencement or continuance of all actions and proceedings against the UCB for a period not exceeding six months.
- (iii) During the moratorium the UCB cannot, except as provided in the directions issued by the Central Government, make any payment to any depositors or discharge any liabilities or obligations to the other creditors.

Therefore, this Section provides an opportunity to RBI, within a period of six months, to take steps;

- (a) to rehabilitate the UCB; or
- (b) cancel the licence of the UCB and, thereby, discontinue its banking operations.

5.24 In the case of a commercial bank, there are a number of options available to RBI for rehabilitation of a weak or a sick bank during the period of moratorium. These include the power

to prepare a scheme for reconstitution of the bank or to amalgamate the bank with any other banking institution. However, this power is not available to RBI in the case of a weak or sick UCB and action in this regard can only be taken by the RCS of the state concerned.

5.25 The success of BLRRCs to monitor the progress made towards rehabilitation of weak banks, through quarterly review meetings has reportedly been mixed. Though in a few cases some progress has been achieved, by and large, these Committees have not been successful in providing a long term solution to the problems of the banks and cases of reconstitution and amalgamation of the banks are few and far between. A few cases have been cited to the Committee of the management of weak UCBs being entrusted to other UCBs and even to commercial banks with positive results. As stated above, RBI does not have statutory authority to effect reconstitution or amalgamation of sick UCBs, it has necessarily to recommend to the RCS of the concerned state for necessary action. The Committee is informed that the response has not been encouraging and the whole process is often time consuming and futile.

5.26 While the Committee recognises the difficulties faced by RBI, it also recognises that RBI has a responsibility to protect the interests of the depositors. Therefore, if RBI is unable to persuade the RCS of the state to take steps within the six month period to restructure or amalgamate the UCB, it has no option but to withdraw the UCB's licence and to force the UCB to discontinue its banking business. By doing so, it will ensure that there remain adequate assets with the UCB to discharge its liabilities to the depositors.

5.27 There may, however, exist circumstances where RBI believes that even without reconstruction or amalgamation, a sick UCB can be rehabilitated and should, therefore, be allowed to continue to operate. In that event, it would be necessary for RBI to ensure that the bank's CRAR is not allowed to deteriorate below the ratio which exists when it is identified as a sick UCB. The Committee, therefore, feels that RBI or the GOI create a Rehabilitation Fund which would be used for the purpose of maintaining the CRAR of a sick UCB at the level which existed when it is declared sick. The Fund needed for the purpose would be given to the UCB as an interest free loan which would be subordinated to the claims of the depositors in the event of liquidation, if the rehabilitation effort does not succeed. If the rehabilitation succeeds, the amounts loaned to the said bank would be returned to the Rehabilitation Fund. Since CRAR is not applicable to UCBs at present, it is not feasible to compute the exact quantum of the Fund. Also, there are number of UCBs for whom the necessary data is not available as returns have not been submitted. However, on a rough basis and ignoring UCBs whose networth has already been negative and considering that only some other sick UCBs with positive networth would be considered as capable of rehabilitation, and calculating the minimum net worth needed to be maintained for a sick UCB as equivalent to 4% of its loans and advances portfolio, the size of the Fund needed may be around Rs.40 crores. The grant of assistance from the Fund would be conditional on the UCB and the Registrar of Cooperative Societies, accepting the conditions which RBI considers necessary for rehabilitation within a time bound period. If the UCB cannot be revived within the period specified when the assistance is first granted, its licence must be cancelled at the expiry of the period or earlier if the RBI so considers it necessary.

Recommendations

5.28 The Committee, therefore, makes the following recommendations :-

Parameter	Weak bank	Sick bank
CRAR	If CRAR falls below the level of 75% of the minimum prescription or	If CRAR falls below the level of 50% of the minimum prescription and
Net NPA	10% or more but less than 15% of loans and advances outstanding as on 31 March or	15% or more of loans and advances outstanding as on 31 March or
History of Losses	Showing net losses in operation for two years out of the last three consecutive financial years	Showing net losses in operation for the last three consecutive financial years

- (i) UCBs which do not meet the required criteria should be classified as weak or sick banks on the basis of the following norms;
- (ii) Bank Level Rehabilitation Review Committees should be discontinued and the primary responsibility for revival of weak banks should rest with banks themselves. However, State Level Rehabilitation and Review Committees (SLRRCs) should continue.
- (iii) Once an UCB is classified as a sick bank, action must be taken under the provisions of Section 45 of the BR Act, 1949, to place it under moratorium. During the period of moratorium, it must either be reconstructed or amalgamated with another UCB and if this is not possible, the UCB's licence to carry on banking business must be withdrawn.
- (iv) A Rehabilitation Fund be created by RBI/Government of India on the lines indicated in [para 5.27](#) above. If an UCB is not reconstructed or amalgamated during the moratorium period and its licence is not cancelled, it must be provided interest free assistance from the Rehabilitation Fund. If the UCB cannot be revived within the period specified at the time of granting the assistance, its licence must be cancelled on the expiry of the period or earlier if the RBI so considers necessary.