

Application of Capital Adequacy Norms to Urban Cooperative Banks

6.1 Some people call UCBs as "wall flowers" of finance, thus, reflecting the general feeling that till recently this sector of the banking system has remained as an insulated segment mostly unaffected by reforms in the financial sector. After the implementation of recommendations of Committee on Financial Sector Reforms (Narasimham Committee Report I) in respect of the commercial banks, urban cooperative banks have also been subjected to some semblance of prudential regulation viz. income recognition and asset classification norms etc. However, application of capital adequacy norms to UCBs was kept in abeyance for some time by RBI due to certain reasons.

6.2 The Committee on Banking Sector Reforms (Narasimham Committee, 1998) has rightly pointed out that "Adequacy of capital has traditionally been regarded as sign of banking strength irrespective of whether the institution is owned by Government or otherwise".¹⁷ The Basle Committee on banking supervision has underscored the following twin fundamental objectives of the Basle accord: First, the framework should serve to strengthen the soundness and stability of international banking system and secondly the framework should be fair and there should be a high degree of consistency in its application to banks in different countries with a view to diminishing the existing source of competitive inequality among international banks.¹⁸ Most regulatory authorities have adopted allocation of capital to risk assets ratio system as the basis of assessment of capital adequacy which takes into account the element of risk associated with various types of assets reflected in the Balance Sheet as well as in respect of off-Balance Sheet assets. The Committee on Financial Sector Reforms (Narasimham Committee I), while highlighting the importance of setting out minimum capital adequacy norms, recommended that the Basle standards may be made applicable to Indian banks in a phased manner. Reserve Bank of India accepted the recommendations and introduced minimum capital to risk asset ratio (CRAR) in 1993, in a phased manner in respect of commercial banks.

6.3 Interestingly, the capital adequacy to risk assets ratio, may be said to be already put in place for UCBs though in a primitive fashion. A cooperative organisation is essentially a member driven agency. Hence every member should and is required to have a stake in its management process. This cannot be done unless he/she has a stake in the capital of the institution. With this object in view, there is a unique system of sharelinking to borrowing in vogue in cooperative credit institutions in general and urban cooperative banks in particular. Every borrower, who is a member is required to contribute a particular ratio of loan amount towards capital contribution. Under the existing RBI policy, subject to relaxation in respect of certain categories of loans, the following ratio of sharelinking to borrowing is prescribed:

- i) Every borrower is required to contribute 2-1/2% of the loan amount to share capital, if such a loan is a secured advance
- ii) Every borrower is required to contribute 5% of the loan amount towards share capital, if such an amount is an unsecured advance.

However, nominal members, irrespective of the size of the loan amount pay only a nominal admission fee and do not contribute to share capital.

The Approach of the Committee

6.4 The Committee believes that the continued financial stability of UCBs cannot be ensured unless they are subjected to the discipline of maintenance of prescribed minimum CRAR. There are a number of reasons why this is necessary, the most important of these being the following :

- (i) CRAR serves as a buffer which can absorb the unforeseen losses a UCB may incur in the future;
- (ii) The UCB sector is an important segment of the financial system and the exclusion of this segment from the CRAR discipline would undermine the stability of the whole system;
- (iii) UCBs perform the same banking functions as commercial banks and are subject to similar risks. To exempt UCBs from the CRAR discipline would, therefore, be untenable.
- (iv) Entities similar to UCBs in other countries, where the cooperative movement has taken strong roots, (for example, Credit Unions in USA, Building Societies in the U.K. and Cooperative Banks in Germany) are all subject to CRAR discipline and exclusion of UCBs from this discipline would undermine the efficacy of regulation.

6.5 With a view to making a quick review of the extent of compliance by UCBs to CRAR discipline, the Committee commissioned a sample study of 50 UCBs excluding weak banks and representing UCBs of different sizes located in metro, urban and semi-urban centres. To its pleasant surprise, the Committee found that as on 31 March 1998, as many as 38 out of the 50 banks covered by the sample (i.e., 76%) had CRAR which was above the minimum of 8% currently stipulated for commercial banks. Moreover, whereas 10 out of the 16 scheduled banks (i.e.,62.5%) covered in the sample achieved the minimum CRAR of 8%, 28 out of 34 non-scheduled banks (i.e.,82.3%) covered in the sample had reached that level. It may, however, be difficult for UCBs to comply if certain CRAR norms are made applicable to the whole UCB sector, at one go.

6.6 It has been represented to the Committee that the ability of UCBs to raise additional capital to meet CRAR norms is limited by certain features which are peculiar to UCBs and are not applicable to commercial banks. Unlike commercial banks, UCBs cannot go for a public issue and can, therefore, raise capital only from their members. Moreover, the size of the capital can fluctuate and can even decrease as any member can redeem his share in the capital subject to a ceiling on the aggregate redemption which the bank can effect in a year. The difficulty is further compounded by the fact that under the various State Cooperative Societies Acts, there is a ceiling on the amount of shares which can be held by an individual member, at present it ranges from Rs.5000 to Rs. 5 lakh. As a result of this ceiling, borrowers are sometimes not able to adhere to the sharelinking to borrowing ratio prescribed by RBI.

6.7 RBI had advised State Governments in December 1996 to amend the State Co-op. Acts to remove the quantitative ceiling on individual holdings but most State Governments have not carried out necessary amendments to their statutes. Under the Multi-State Cooperative Societies

Acts, 1984 also, there is a provision that an individual member cannot hold such portion of the share capital of a cooperative society (not exceeding twenty percent) as may be prescribed.

6.8 The Committee is unanimously in favour of removing the quantitative ceiling on individual shareholding as that will help UCBs in augmenting their capital and thereby improving the CRAR. However, all members of the Committee, other than Dr. M.L. Abhyankar, ([Annexure XIV](#)) believe that this quantitative restriction should be replaced by a restriction on the maximum percentage of share capital of an UCB that can be held by an individual member. These members believe that the cooperative character of the UCB will be damaged if a single individual is allowed to hold a substantial proportion of the share capital of an UCB. In the opinion of these members the ceiling of 20% prescribed under the Multi-State Cooperative Societies Act 1984 is too high even though the Central Government has to prescribe a portion within that limit and even though irrespective of the shareholding an individual member has only one vote. These members, therefore, feel that irrespective of the quantitative ceiling prescribed under the State Acts or the Multi-State Cooperative Societies Acts and irrespective of the percentage ceiling which may be prescribed in the future under the Multi-State Cooperative Societies Act 1984, RBI should stipulate that no individual member can hold more than 5% of the capital of UCBs.

6.9 Dr. M.L. Abhyankar does not agree with the above recommendation. He is of the firm opinion that there should not be any ceiling on the value of individual shareholding i.e, the total value of shares that can be held by a person in any UCB. (Please see his dissent note in [Annexure XIV](#)).

6.10 In their interaction with the Committee, a majority of UCBs have responded favourably to the extension of CRAR discipline to UCBs. In response to the questionnaire circulated by the Committee, an overwhelming 83.1% of responding UCBs have expressed their agreement to the proposal to extend the CRAR discipline to UCBs. A majority of the State Governments who have interacted with the Committee through the Registrar of Cooperative Societies have also expressed their agreement. However, all parties have requested that the implementation should be in a phased manner.

6.11 The Committee recognises that implementation of CRAR discipline to commercial banks was done in stages and there is merit in the suggestion that implementation in respect of UCBs should also be done in a phased manner. Commercial banks are currently required to maintain a minimum CRAR of 8%. As per the recommendations of the Committee on Banking Sector Reforms (Narsimham Committee II) made in 1998, this has to be increased from 8% to 10% in a phased manner with an intermediate target of 9% by March 2000. The Committee is of the view that for scheduled UCBs, the minimum CRAR may be fixed at 8% by 31 March, 2001 and 9% by 31 March, 2002. This Committee also recognises that non-scheduled UCBs may find it difficult to meet this target immediately. It therefore, suggests that initially the minimum norm fixed for such banks may be 2% lower than the norm fixed for scheduled UCBs.

6.12 It has also been suggested to the Committee that UCBs may also be allowed to issue bonds and other instruments available to commercial banks to tap Tier II capital. The Committee finds merit in this suggestion that UCBs may be allowed to raise Tier-II capital by issue of suitable

instruments of such nature as RBI considers appropriate and subject to such safeguards in respect of individual UCBs as RBI considers necessary.

6.13 While recommending the implementation of CRAR discipline in a phased manner in respect of UCBs, consideration has also to be given to the discipline to be imposed on UCBs until they attain the specified norms. In the opinion of the Committee, UCBs which have not attained the specified norms should be required to take measures which will help them to achieve these norms in the shortest possible time. Currently, under the respective State Acts, UCBs are required to transfer 20% of their net profits to Reserve Fund. This helps the UCBs to build up their net owned funds (NOF). The Committee recommends that until an UCB attains the required CRAR norm, it should be required to transfer not less than 50% of its net profits to the Reserve Fund and there should also be a ceiling of 20% on the percentage of dividend, which an UCB not meeting the CRAR norm, can distribute.

Recommendations

6.14 The Committee, therefore, makes the following recommendations:

- (i) Scheduled UCBs should maintain the same CRAR as would be applicable to commercial banks by 31 March,2003.
- (ii) Non-scheduled UCBs should maintain the same CRAR as would be applicable to commercial banks by 31 March,2004.
- (iii) The requirement to maintain the minimum CRAR should be phased out in the following manner:

Date	Scheduled UCB	Non-Scheduled UCB
31 March 2001	8%	6%
31 March 2002	9%	7%
31 March 2003	As applicable to commercial banks	9%
31 March 2004	-do-	As applicable to commercial banks

- (iv) Until an UCB attains the required CRAR norms :-
 - (a) It should transfer not less than 50% of its net profits to the Reserve Fund.
 - (b) It should not, without the permission of RBI, declare dividend in any year in excess of 20% .
- (v) To help UCBs achieve the CRAR norms:
 - (a) The quantitative ceilings on individual shareholdings should be removed but no individual member together with his immediate relatives and HUF in which he is a member or a firm in which he is a partner or a company (in which he and his immediate family holds more than 10% of the capital) should be allowed to hold more than 5% of the capital of the UCB.
 - (b) An UCB should, with the prior sanction of RBI, be allowed to issue bonds and such other instruments as RBI may specify in order to raise its Tier II capital.

17. Committee on Banking Sector Reforms, 1998

18. International Convergence of Capital Measurement and Capital Standards. BIS Publication
1988