

Executive Summary

1. Background

The urban cooperative banking sector has witnessed phenomenal growth during the last one and a half decades. Certain infirmities have, however, manifested in the sector resulting in erosion of public confidence and causing concern to the regulators as also to the well functioning units in the sector. One of the factors significantly affecting the financial health of the Urban Cooperative Banks (UCBs) is their inability to attract equity / quasi equity investments. At present, UCBs have limited avenues for raising such funds and even their share capital can be withdrawn. Against this backdrop, an announcement was made in the Annual Policy Statement for the year 2006-07 to constitute a Working Group to examine the issue of share capital of UCBs and identify alternate instruments / avenues for augmenting the capital funds of UCBs. Accordingly, a Working Group was constituted under the Chairmanship of Shri N.S. Vishwanathan, Chief General Manager-in-Charge, Urban Banks Department, Reserve Bank of India.

2. Methodology

The Group deliberated on the various issues relating to its terms of reference on the basis of presentations made by its members. It also met Chairmen/ CEOs of a few medium/ large UCBs. The areas deliberated included international practices and structures for issue of bonds by cooperatives, adaptability of the provisions of Indian Companies Act, 1956 for issue of preference shares, State Government perspective on the issues involved and provisions of select State Cooperative Societies Acts and Multi State Cooperative Societies Act, 2002 pertaining to issuance of shares and debentures including their transferability, SEBI Act, 1992 and Securities Contract Regulation Act, 1956 (SCRA).

3. Findings

The Group observed that a large number of UCBs are short of the prescribed regulatory capital. Out of 217 UCBs with deposits of over Rs.100 crore, 30 banks, i.e. 15% of the banks in the sample were under-capitalized. Therefore, the need for analyzing the issues involved in and identification of alternate sources of capital cannot be over-emphasized.

There were legal and structural issues affecting enhancement of capital of UCBs. They are governed by the respective Cooperative Societies Act of the State under which they are registered; besides there are 33 UCBs registered under the Multi State Cooperative Societies Act (Multi State Act). While the Acts are in essence similar, they differ in details in respect of several matters including those relating to freedom to raise and price various financial instruments. The financial instruments issued by UCBs cannot be listed on a stock exchange.

In certain countries the financial intermediaries in the cooperative sector are strong and socially effective. The federated structure in countries such as Netherlands (Rabobank Group), France (Credit Agricole Group) and Finland (OKO Group) lent financial strength to all the cooperative entities forming part of the structure. While the federal arrangement differed in details, it revolved around a strong apex level entity, which had even supervisory powers and responsibility. Bringing such a system in India would require an enabling legislative framework. Further, in some countries including Netherlands, Trust Preferred Securities (TPS) are used to raise long term stable funds. Trust preferred securities are undated cumulative preferred securities issued out of a special purpose vehicle (SPV), usually a trust formed by a bank holding company (BHC). The SPV would issue preferred securities to the prospective investors. There is no legal bar on Multi State UCBs raising funds through this process excepting the limit placed on the extent to which funds can be raised by way of

debentures. To enable other banks to raise funds through TPS, the states concerned may be required to bring suitable amendments in the Acts to facilitate formation of trust by UCBs.

4. Recommendations

The major recommendations of the Group are as under:

- Where UCBs with low capital or negative net worth are able to identify potential investors, the monetary ceiling prescribed in the Acts on individual share holding comes in the way of shoring up the share capital through this route. As such, the State Governments be requested to exempt the UCBs from the existing monetary ceiling on individual shareholding either through a notification or through amendment to the Act, where necessary.
- To provide instruments and avenues for raising stable and long term funds having equity or quasi equity characteristics:
 - UCBs may be permitted to issue unsecured, subordinated (to the claims of depositors), non-convertible, redeemable debentures / bonds, which can be subscribed to by those within their area of operations and outside. Funds raised through such instruments may be treated as Tier II capital, subject to the instruments conforming to certain prescribed features. These bonds could be transferable by endorsement and delivery.
 - UCBs may be allowed to issue special shares on specific terms and conditions. Banks can also be allowed to issue these shares at a premium, which could be approved by the respective RCS, in consultation with Reserve Bank. The special shares will be non-voting, perpetual and transferable by endorsement and delivery. They would rank

senior to only the ordinary shares and may be treated as Tier I capital.

- Reserve Bank may make an exception with regard to rating requirement to enable the commercial banks to invest in the special shares and Tier II bonds issued by UCBs within the ceiling prescribed for investment in unlisted securities. UCBs may also be permitted to invest in Tier II bonds of other UCBs. Reserve Bank may prescribe an appropriate limit linked to the investing bank's and recipient bank's Net Owned Funds.
- UCBs may be allowed to issue redeemable cumulative preference shares on specific terms and conditions with the prior permission of the respective RCS, granted in consultation with Reserve Bank. They may be treated as Tier II capital subject to conforming to certain prescribed features.
- There is a need to amend the Multi State Act to remove the limit prescribed on raising of funds by way of non convertible debentures / bonds. Wherever such limits are prescribed in other State Acts, necessary amendments may be made.
- UCBs may be permitted to raise deposits of over 15 year maturity and such deposits can be considered as Tier II capital subject to their meeting certain conditions, which inter alia include that they shall be subordinate to other deposits and ineligible for DICGC cover.
- Where banks with negative net worth raise Tier II capital by way of bonds, preference shares and long maturity deposits, through conversion of existing deposits, Reserve Bank may, as an exception to the general rule, treat these

as part of regulatory capital even though Tier I capital is negative.

- As retained earnings form the only source of owned funds, Reserve Bank could suggest to the Government of India to defer the application of income tax on UCBs for a period of three years by which time the alternate instruments may also take concrete shape.
- Since UCBs are brought under the regime of linking capital adequacy in terms of a ratio to risk assets, prescribing a share to loan ratio on a borrower-to-borrower basis may not be necessary and hence the extant instructions on share linking to loans may be dispensed with.
- As for International Accounting Standard Board's proposed standard requiring share capital of cooperatives to be treated as outside liabilities, in view of the restrictions placed on withdrawal of capital in Cooperative Societies Acts and taking into account the empirical evidence of share capital of UCBs being by and large stable, it may continue to be treated as equity and reckoned as Tier I capital for regulatory purposes.
- As creating a federated structure would not only require amendments to the Cooperative Societies Acts but also entails changes to the supervisory and regulatory practices, the entire issue of creating an appropriate legislative and supervisory framework for the purpose be separately examined taking into consideration the international experiences and systems.

Chapter I

Introduction and Approach

1. Introduction

1.1 The urban cooperative banking system has witnessed phenomenal growth during the last one and a half decades. From 1307 urban cooperative banks (UCBs) in 1991, the number of UCBs rose to 2105 in the year 2004. Deposits increased from Rs.8,600 crore to over Rs.1,00,000 crore, while advances had risen from Rs.7,800 crore to over Rs.65,000 crore during the same period. Along with this spectacular growth certain infirmities have, however, manifested in the sector resulting in erosion of public confidence and causing concern to the regulators as also to the well functioning units in the sector. A significant step in the recent past for addressing the problems of UCBs was the formulation of the draft Vision Document, which was placed in the public domain in March 2005.

1.2 One of the factors significantly affecting the financial health of the UCBs is their inability to attract equity / quasi equity investments. At present, UCBs have limited avenues for raising such funds and even their share capital can be withdrawn. In the context of the competition that the UCBs are facing from other financial intermediaries, including the commercial banks, both on the asset and the liability sides, strengthening the ability of the banks to raise capital funds in order to expand their business has become all the more critical for the sector. Therefore, the various steps initiated in pursuance of the proposals of the draft Vision Document for UCBs would need to be supplemented with measures that enable them to strengthen their capital base so as to achieve the objectives set out therein.

1.3 Against this backdrop, the constitution of a Working Group to examine the issue of share capital of UCBs and identify alternate instruments / avenues for augmenting the capital funds of UCBs was announced in the Annual Policy

Statement for the year 2006-07. Accordingly, a Working Group was constituted under the Chairmanship of Shri N.S. Vishwanathan, Chief General Manager-in-Charge, Urban Banks Department, Reserve Bank of India. The members of the group were:

- (i) Shri Anil Diggikar*, Commissioner for Cooperation & Registrar of Cooperative Societies, Government of Maharashtra
- (ii) Shri J.C. Sharma, Commissioner for Cooperation & Registrar of Cooperative Societies, Government of Andhra Pradesh
- (iii) Shri D. Krishna, Chief Executive, National Federation of Urban Cooperative Banks and Credit Societies Ltd (NAFCUB)
- (iv) Prof. Mukund Ghaisas, Chairman, Maharashtra State Urban Cooperative Banks Federation
- (v) Shri K. D. Zacharias, Legal Adviser, Reserve Bank of India

* In place of Dr. S. K. Sharma, who was initially the member of the Working Group in his capacity as Commissioner for Cooperation & Registrar of Cooperative Societies, Government of Maharashtra.

1.4 The terms of reference of the Working Group were as under:

- (i) To consider whether the paid up share capital can be treated as core capital for capital adequacy purposes in the light of International Accounting Standards Board's standard IAS 32 and if not to suggest a time frame to implement the proposed standard.
- (ii) To suggest alternative avenues for raising capital particularly in the light of recent guidelines on newer instruments issued to commercial banks by the Reserve Bank.
- (iii) To look into international experiences of cooperative banks/ credit unions in raising capital and to suggest measures that can be implemented in the context of primary (urban) cooperative banks in India.
- (iv) To make such other recommendations as the Group may deem relevant to the subject.

A copy each of the notification on the constitution of the Working Group and the nomination of Shri Anil Diggikar in place of Dr. Sharma are given as Annex I & II respectively.

1.5. Approach adopted by the Group

1.5.1 Initially, specific responsibilities were assigned to each member for undertaking in-depth study of relevant issues and making presentations before the Group. Accordingly, the members made presentations on the following topics:

- a) International practices and structure for issue of bonds by cooperatives.
- b) Provisions of the Indian Companies Act, 1956 in regard to issue of preference shares and the feasibility of their adoption for UCBs.
- c) State Government perspective on issues relating to shoring up of capital base of UCBs.
- d) Cooperative Societies Acts of significant states and Multi State Cooperative Societies Act and analysis of provisions of the Indian Companies Act, 1956, Securities Contract Regulation Act (SCRA), 1956 and the SEBI Act, 1992 in so far as they relate to issue of various financial instruments.

In addition, views of Chairmen/ Chief executive Officers of a few large and medium sized UCBs were ascertained.

1.5.2 The Working Group had five meetings in which the presentations were made and the issues raised in the presentations were discussed in detail. The major findings and the recommendations of the Group are given in the ensuing chapters.

CHAPTER II

Important Findings

2.1 The Group observed that a large number of UCBs are short of the prescribed regulatory capital. Out of 217 UCBs with deposits of over Rs.100 crore, 30 banks had reported CRAR below 9 %, 20 of which reported CRAR of less than 5%. Thus, 15% of the banks in the sample were under-capitalized. The extent of under-capitalization could be higher in the smaller banks. Therefore, the need for analyzing the issues involved in and identification of alternate sources of capital cannot be over-emphasized.

2.2 There are both legal and structural issues that affect the enhancement of capital of UCBs. Therefore the Group studied the legal issues as also a few successful international models to examine the possibility of their being adopted in the context of the legislative framework obtaining in India. The Group also examined a suggestion made by NAFCUB for setting up a private screen based platform for trading of financial instruments, counting for capital, issued by UCBs. The International Accounting Standards Board's (IASB) recommendations regarding non eligibility of share capital of cooperative societies to be treated as equity on account of it being eligible for withdrawal was also studied with reference to the provisions of the Cooperative Societies Acts. These issues are discussed in the ensuing paragraphs.

2.3 Legal Framework

2.3.1 UCBs are not operating under any one single legislation, i.e., they are governed by the respective Cooperative Societies Act of the State under which they are registered; besides there are 33 UCBs registered under the Multi State Cooperative Societies Act (Multi State Act). While the Acts are in essence similar, they differ in details in respect of several matters including those relating to freedom to raise and price various financial instruments. Extracts of relevant provisions of a few State Acts and the Multi State Act are given in

Annex III. It may be observed therefrom that while the Maharashtra State Cooperative Societies Act, 1960, (Maharashtra Act) has no specific provisions as to the nature of instruments through which funds can be raised, which is left to the rules and bye-laws, the Multi State Act has specific provisions in this regard prescribing a limit of 25% of the share capital for raising funds by way of non-convertible debentures etc. The pricing of share capital is another important issue where the provisions of the law are not uniform. The Maharashtra Act does not specify either the value at which the share capital has to be issued or the value at which it should be redeemed. These are provided for in the rules. However, the Multi State Act is specific that the share capital can be issued only at face value. There are also differences between Acts on the limits up to which one can subscribe to the share capital of UCBs. In the Maharashtra Act, for example, apart from a prohibition on holding more than one-fifth of share capital of the society, a monetary ceiling of Rs.5 lakh per individual shareholder is prescribed, while in the Multi State Act there is no such monetary ceiling. It was, therefore, evident that it may be extremely difficult to identify instruments that are legally permissible across all Cooperative Societies Acts. However, because of concentration of UCBs in five states viz. Maharashtra, Gujarat, Karnataka, Tamil Nadu and Andhra Pradesh, making requisite amendments in the Acts of these States and the Multi State Act would cover 85% of the banks by number and asset size.

2.3.2 Market for a financial instrument is enhanced by its transferability. The Cooperative Societies Acts, in general, require that a share be transferred only to an existing member or to a person whose application for membership has been accepted. This restriction on transfers comes in the way of marketability and therefore, adversely affects the liquidity of shares of UCBs.

2.3.3 Another legal aspect relates to listing of financial instruments issued by UCBs. As per SEBI Act, 1992 and Securities Contract Regulation Act, 1956 (SCRA), for a financial instrument to be eligible to be listed in the Stock

exchange, it should have been issued by a *body corporate* as defined under the Companies Act, 1956. A cooperative society is a body corporate as per the Cooperative Societies Acts. However, as per the Companies Act it is not a body corporate. As such the financial instruments issued by UCBs cannot be listed in a stock exchange.

2.4 International Systems

The Group analyzed the systems / structures obtaining in countries where the financial intermediaries in the cooperative sector are strong and socially effective. In particular, the federated structures of Rabobank Group (Netherlands), Credit Agricole Group (France) and OKO Group (Finland) were examined based on literature available and information provided by the institutions in their web sites. The features of Trust Preferred Securities, an instrument popular in countries like USA / Netherlands, were also looked into for examining their feasibility in India. The findings of the Group in these matters are briefly outlined in the following paragraphs.

2.5 Federated Structure

2.5.1 Rabobank Group

(i) Rabobank Group is the largest financial services provider in Netherlands and has an extensive network worldwide. Rabobank Group is a cooperative banking organization comprising Rabobank Netherland, Rabobank Netherlands' local member credit institutions (Local Banks) and numerous other subsidiaries like Rabobank International. While Rabobank Netherlands is a legal entity, the Rabobank Group is not a legal entity. The cooperative structure and local involvement have been the cornerstones of the Group for more than a century.

(ii) The local Rabobanks, which are cooperatives, are members of Rabobank Netherlands. Membership is subject to the Articles of Association having been approved in advance by Rabobank

Netherlands. As of December 31, 2005, there were 248 Local Rabobanks as members and shareholders of Rabobank Netherlands. Further, while Rabobank Netherlands is a subsidiary of the local Rabobanks, it is in fact at the head of an inverted pyramid. The Local Banks serve their customers with the support of Rabobank Netherlands and not vice versa. The latter provides managerial, operational and advisory services, which include credit approvals, cost sharing and other centralized functions such as IT, human resource management, liquidity, capital and risk management, etc. Further, in accordance with the Credit System Supervision Act, 1992, it is responsible for supervising the financial health and professionalism of the Local Rabobanks. It also acts as treasurer to the Group and a holding company of a large number of subsidiaries. Rabobank Group is treated as a consolidated entity for regulatory and supervisory purposes.

(iii) Local Rabobanks do not have any shareholders and as such do not pay dividends. Hence they retain all profits after net payments on trust-preferred securities and membership certificates (Please refer paragraph 2.6.1 and note to paragraph 3.4.2).

(iv) In accordance with the Credit System Supervision Act, 1992 an internal Cross-Guarantee System is in place whereby certain entities within the Rabobank Group are liable for the other participants' financial obligations in case of a shortfall of funds. Participating entities within the Rabobank Group include Rabobank Netherlands and the Local Rabobanks. This cross guarantee system, in a way, provides, to any bank within the structure, access to the resources of the entire Group, facilitating support in times of need. In effect they all have joint and several liability for each other's commitment.

2.5.2 Credit Agricole Group

(i) Originally, the Credit Agricole Group was the banker of the French agricultural sector and farming communities. However, it has evolved

and broadened its activities to service all sectors of the economy and all types of clients.

(ii) The organization has a three-tier structure. There are more than 2,500 Local Banks grouped into 48 Regional Banks, which in turn hold a majority of the capital of Credit Agricole S.A., the central bank of the Group. The Federation Nationale du Credit Agricole is the representative body of the Group. The Federation also offers support and services to the Regional Banks, such as occupational training and human resources management. Credit Agricole S.A. is the largest bank of France having a unified, yet decentralized, organization.

(iii) The Local Banks own most of the capital of Regional Banks, and form the base of the group. The Regional Banks are co-operative entities and undertake all banking activities. Some of the Regional Banks have obtained funds from capital markets by issuing non-voting shares (certificats cooperatifs d'investissement). Regional Banks, via SAS Rue La Boetie, hold a majority stake in Credit Agricole S.A. Credit Agricole S.A. in turn, holds 25% of the share capital of each Regional Bank.

(iv) As a result of Credit Agricole's desire to embrace the market while strengthening its mutual identity, Credit Agricole S.A. was floated on the stock market in December 2001. Credit Agricole S.A. is a universal bank, present across the entire spectrum of banking and insurance activities. Credit Agricole S.A. represents all Group business lines and entities, and has three main roles within the Group, i.e. lead institution, central banker and the entity responsible for ensuring consistent development. It manages the treasury operations of Credit Agricole and raises and lends funds on the international capital markets. It also provides many of the international services offered by the Group as well as a number of technical and financial services through its specialized subsidiaries. Credit Agricole S.A. designs the products marketed by the Regional Banks and is responsible for its subsidiaries and for international growth.

(v) Credit Agricole S.A. owns 25% of the Regional Banks' capital and all Group interests in foreign banks and operating subsidiaries specializing in particular business lines. In view of Credit Agricole S.A.'s stake in the Regional Banks, 25% of the Regional Banks' results are accounted for in the results of Credit Agricole S.A. using the equity method. Credit Agricole S.A. coordinates the implementation of commercial strategy, in particular by defining broad marketing and communications policy. As the Group's lead body, it also is in charge of managing centralized savings and advances for the Regional Banks apart from audit and risk management.

2.5.3 OKO Bank Group (Finland)

(i) OKO Bank Group comprises 239 independent member cooperative banks and the Group's statutory central institution, OP Bank Group Central Cooperative. OKO Bank is the largest subsidiary of the Central Cooperative. OKO Bank is a commercial bank, which also acts as the OKO Bank Group's central bank. The OKO Bank Group Central Cooperative and its 239 member cooperatives own 41.3% of shares and have 55.8% of votes.

(ii) OP Bank Group Central Cooperative is the group's know-how and service centre. It is a cooperative owned by the member banks and its function is to produce services for the member cooperative banks. The most notable subsidiary of the Central Cooperative is OKO Bank.

(iii) OKO Bank acts as an independent commercial bank and financial institution for the member cooperative banks. It has three subsidiaries. The OKO Bank is the central financing institution of the cooperative banks and as a commercial bank it engages in the business operations set forth in the Credit Institution Act. The special purpose of the Bank is to promote and support, as a central financing institution, the activities of the cooperative banks and other institutions belonging to the Cooperative Banks Group. The bank can offer investment services as well as

custodial and asset management services. The bank is responsible for the debts and commitments of the central institution and its member banks and other Cooperative Credit Institutions. The central institution and its other member banks are in turn responsible in the same way for this bank's debts and commitments. The central institution has the right to issue instructions to OKO Bank on its operations in order to ensure the Bank's liquidity, capital adequacy and risk management as well as the right to supervise the bank's operations.

(iv) OKO Bank issues two categories of shares. Series A are intended for the public and are listed on the Helsinki Exchanges. Each Series A share entitles its holder to one vote at the general meeting of shareholders. Series K shares can only be owned by a Finnish cooperative bank and the central institution, OKO Bank Group Central Cooperative. Each Series K share gives its holder five votes. The Series K share can be converted into Series A share upon a demand of the shareholder or, in respect of nominee-registered shares, subject to certain conditions and the Articles of Association. The majority of Supervisory Board members are elected from among the members of the Supervisory Board of the OKO Bank Group Central Cooperative. One of their duties is to appoint the Chairman of the Executive Board and the President.

(v) OKO Bank, through its issuance of two categories of shares, presents a hybrid model that blends the benefits of a listed entity and those of a cooperative. While the Series A shares enable raising capital on stock exchange, the Series K share ensures cooperative control over the institution.

2.5.4 Observations of the Group on the above models

The similarity in the above three models is the presence of an Apex level entity to which the cooperatives are federated. In the Indian context, such an apex level entity could be either at the State level, the national level or at any other level. However, as per the provisions of the Banking Regulation Act 1949,

Reserve Bank can grant license to a primary cooperative bank as defined in Section 5(ccv) of the Act and the Central / State Cooperative Banks as defined in the NABARD Act, 1981. As the apex level entity required for the adoption of the above models would not fall in any of these categories that RBI can license, the creation of such an entity would require that an enabling legislative framework be created.

2.6 Trust Preferred Securities (TPS)

2.6.1 Trust preferred securities are undated cumulative preferred securities issued out of a special purpose vehicle (SPV), usually a trust formed by a bank holding company (BHC). The SPV would issue preferred securities to the prospective investors. The SPV shall pass on the proceeds of the preferred security issuance and loan them to the BHC. The BHC would issue debentures/subordinated note to the SPV to reflect its indebtedness to the latter. The trust preferred securities generally allow for at least twenty consecutive quarters of dividend deferral, after which the investors have the right to take hold of the sole asset in the trust, viz. a deeply subordinated note issued by the BHC. The note, which is subordinated to all obligations of the BHC other than its common and preferred stock, has terms that generally mirror those of the trust preferred securities, except that the subordinated debt has a fixed maturity of at least 30 years. The SPV, in the form of a Trust, is preferred to the principal issuing the securities directly, possibly, because of the accompanying tax benefits for the investor. In the U.S.A., because trust preferred securities are cumulative, the Federal Reserve Board limits them, together with directly issued cumulative perpetual preferred stock, to no more than 25% of a BHC's core capital elements.

2.6.2 Observations of the Group

The feasibility of allowing issue of Trust Preferred Securities was examined and it was found that it would require UCBs to float an SPV in the form of a trust.

Except for the Multi State Act, most of the other Cooperative Societies Acts do not specifically provide for a cooperative society forming an organization registered under any other Act. As such, in order to enable the co-operative banks registered, other than under Multi State Act, to raise funds through TPS, the states concerned may be required to bring suitable amendments in the Acts. There is no legal bar on Multi State UCBs raising funds through this process excepting the limit placed on the extent to which funds can be raised by way of debentures. The Group observed that through trust preferred pool arrangements, the small BHCs have been successful in raising capital in U.S.A. It would be ideal to have such a system in the Indian context because it would help small UCBs to raise resources from the market through this route. However, this would require an enabling legislative framework.

2.7 Suggestion of NAFCUB for Separate Trading Platform

2.7.1 As mentioned in paragraph 2.3.3, the financial instruments issued by the cooperative banks are not eligible to be listed in the Stock Exchanges. There was a view that since the equity or equity like financial instruments would normally have a long maturity period, absence of liquidity might come in the way of such instruments being subscribed to. As such a proposal was made by NAFCUB to create a separate screen based platform under its aegis for trading of securities issued by UCBs. Through this platform NAFCUB sought to facilitate issue of certain long maturity redeemable instruments. (For detailed proposal please see Annex IV).

2.7.2 The Group found that the following issues, both legal and structural, need to be addressed first if the arrangement is to be put in place.

- (i) The platform was akin to a stock exchange. It would require a regulator on the lines of SEBI, since it would not fall within the purview of SEBI Act.

- (ii) It will require such regulator to have control on all the participants of the "exchange". The Group found that there was no existing authority with such powers.
- (iii) It requires a mechanism by which the transactions put through in the exchange will be reflected in the books of the various participating banks.

2.8 Accounting of Share Capital

2.8.1 The exposure draft issued by International Accounting Standard Board (IASB) on International Accounting Standard (IAS) 32, proposes that membership shares be presented as liabilities and not equity. The rationale for the proposed treatment is that an equity instrument is a contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities, a requirement not met by share capital contribution of members of cooperative societies, as they can be withdrawn.

2.8.2 The Cooperative Societies Acts provide for the share capital to be withdrawn after a lock in period of three years subject to such withdrawals in a year not exceeding 10% of the share capital at the beginning of that year. The withdrawal of capital under this provision would result in the violation of the normal principle of the equity holders being entitled to residual value of an entity. To this extent, the share capital contribution in the Indian context fails the test of definition of equity referred to in IAS 32.

2.8.3 The Working Group found that share capital of UCBs has generally been stable. In respect of 217 UCBs with deposits of more than Rs.100 crore, it was observed that over a three-year period between 2003-2006, the share capital remained the same or had increased in respect of 200 banks. Moreover, at the time of liquidation, the share capital held by the members of a bank ranks junior to all other creditors. Whenever a bank with negative net worth is merged with a sound bank, the acquirer bank does not give any compensation to the

shareholders of the target bank in preference to the depositors and other creditors of that bank (target bank)

2.8.4 It is evident from the foregoing that while the share capital contributed by members has some features which are not in consonance with those associated with equity, in practice, it has been fairly stable and there are checks and balances to prevent it being withdrawn freely.

CHAPTER III

Recommendations

3.1. At present, the sources of owned funds for UCBs are share capital subscribed by the shareholders and retained earnings. At the same time, as observed in paragraph 2.1, given the presence of a number of under-capitalized banks, there was a felt need for alternate sources for long term capital/ quasi-capital funds. Therefore, the various options for raising capital funds for UCBs were examined in the context of the legal and structural issues referred to in the preceding chapters. The recommendations of the Group on the issues referred to it as also a few other incidental matters are elaborated in the ensuing paragraphs.

Recommendations of the Group

3.2 To remove the monetary ceiling prescribed on subscription to share capital

3.2.1 As a prudential measure, Reserve Bank has prescribed certain minimum share to borrowings ratio. Normally, share capital of UCBs is subscribed to by the borrowers to meet this requirement. In fact, shares of UCBs are generally not purchased as an investment option. Where these are attractive as an investment, the UCBs concerned are reluctant to issue shares as they are a costly source of funds in view of the high dividend payout by the profit making UCBs, coupled with the statutory requirement of having to issue share only at face value, i.e. without any premium. In such cases there is a scope for arbitrage by borrowing from the bank for investment in its shares.

3.2.2 There are certain UCBs with low capital or negative net worth. Such banks do not pay dividend. Shares of such banks are not likely to be an attractive source of investment. However, several institutions having close allegiance to the prominent shareholders of a UCB might be willing to invest in

the share capital of the bank as a part of their support to strengthen it even if it amounts to an investment without any return in the immediate future. The Group observed that where such UCBs are able to identify potential investors, the monetary ceiling prescribed in the Acts on individual share holding comes in the way of shoring up the share capital through this route. The Group therefore recommends that:

- **The State Governments be requested to exempt the Urban Cooperative banks from the existing monetary ceiling on individual shareholding either through a notification or through amendment to the Act, where necessary.**

3.3 To Permit issue of Tier II bonds

3.3.1 As discussed in Chapter I, the sources for raising stable and long term funds having equity or quasi equity characteristics are virtually absent for UCBs. At the same time, in the current deregulated environment and inter sector and intra sector competition, the UCBs need access to such funds. In this context, the Group recommends that:

- **UCBs may be permitted to issue unsecured, subordinated, non-convertible, redeemable debentures / bonds, which can be subscribed to by those within their area of operations and outside.**

3.3.2 These bonds could have the following features.

- (i) The minimum maturity of the bonds should be 10 years. There need be no upper limit on maturity
- (ii) The liability of the bank to the bond holders would be subordinated to the claims of depositors and other creditors but would rank senior to shareholders, including holders of special shares (please see paragraph 3.4 below), if any.

- (iii) The bonds can have a fixed or floating interest rate. The interest rate can also be a combination of fixed and floating rates with the latter part being linked to factors like rate of dividend declared for ordinary shareholders etc.
- (iv) The Bonds will not have any put option but can have a call option exercisable by the bank, not before five years, with prior permission of the Reserve Bank, which may be granted if it does not result in the regulatory capital falling below the prescribed level.
- (v) The bonds will be ordinarily redeemed upon maturity. However, in the case of banks whose CRAR is below the prescribed minimum at the time of redemption, since the depositors have preferential claim over the bondholders, the redemption of the bonds would not be permitted, except against fresh issue of such bonds.
- (vi) The bonds will be subjected to a progressive discount for capital adequacy purposes as under:

	Remaining Maturity	Rate of discount
a)	Less than one year	100%
b)	More than one year and Less than two years	80%
c)	More than two years and less than three years	60%
d)	More than three years and less than four years	40%
e)	More than four years and less than five years	20%

- (vii) The bank cannot give loan against its own bonds.
- (viii) The bank would normally be required to maintain CRR and SLR against the liabilities covered by the bonds. However, Reserve

Bank may consider granting exemption from the reserve requirements.

- (ix) The bonds may be transferable by endorsement and delivery.
- (x) The bonds will be treated as Tier II capital, subject to the total Tier-II capital not exceeding Tier I capital. However,
 - **Where banks with negative net worth raise funds by way of such bonds through conversion of existing deposits, Reserve Bank may make an exception to this rule and treat these as part of regulatory capital even though Tier I capital is negative.**

3.4 To permit UCBs to issue special shares

3.4.1 Subscription to the ordinary shares of UCBs entitle the subscriber to the membership of the society and voting right on one member one vote basis. The membership is restricted to the area of operations of the bank. Very often, as already mentioned in paragraph 3.2.1, the shares of UCBs are not subscribed to as investment but to meet the share-linking norms. The financially strong banks are reluctant to issue ordinary shares both because it inflates its membership size and also is costly. In view of the above constraints in issuing ordinary shares, the group recommends that:

- **UCBs may be allowed to issue special shares on specific terms and conditions. Banks can also be allowed to issue these shares at a premium, which could be approved by the respective RCS, in consultation with RBI.**

3.4.2 The broad features of the special shares could be as under:

- (i) Subscription to these shares will be on a non-voting basis.
- (ii) They may be issued either at par or at a premium.

- (iii) These shares may be issued in predetermined quantities over a specified period of time. They can as such be either wholly or partly underwritten.
- (iv) They may be subscribed to by members, non-members including those outside the area of operations of the UCB concerned.
- (v) They will be perpetual with a call option that can be exercised only after ten years, with prior permission of RBI, which may be granted in the event of the redemption not resulting in the CRAR falling below the prescribed minimum.
- (vi) They will carry return by way of dividend, which shall not be less than the rate of dividend paid on ordinary shares, in terms of return on face value. However they shall be subject to a lock-in clause in terms of which the issuing bank shall not be liable to pay dividend, if
 - a) the bank's CRAR is below the minimum regulatory requirement prescribed by Reserve Bank ; or
 - b) the impact of such payment results in CRAR falling below or remaining below the minimum regulatory requirement prescribed by Reserve Bank of India. However, banks may pay dividend with the prior approval of Reserve Bank when the impact of such payment may result in net loss or increase the net loss, provided the CRAR remains above the regulatory norm.
- (vii) The amounts raised by way of special shares would be treated as Tier-I capital.
- (viii) The bank cannot give loan against the shares issued by itself.
- (ix) These shares may be transferred by endorsement and delivery.

Note:

The Rabobank raises fund through Membership Certificates (MCs) with infinite maturity period issued through an SPV, which is an investment institution. These are tradable through the bank once in a month. The returns are linked to

interest rates of specified gilts. The Rabobank Netherlands has raised a sum of Euro 5.8 billion through this instrument, which is considered as Tier-I capital. The detailed features of MCs are given in Annex V. It may be observed that the features of the special shares proposed above are fairly akin to those of MCs. Since the return is linked to performance and not to any external benchmark, the special shares have a greater proximity to equity than the MCs, which also justifies the recommendation to allow the issue of the special shares at a premium.

3.5 To permit UCBs to issue preference shares

3.5.1 The Group observed that the better managed medium sized UCBs may be provided an instrument, which is neither a debt instrument like a bond nor a perpetual security like special shares referred to above. The Group, therefore, recommends that:

- **UCBs may be allowed to issue redeemable cumulative preference shares on specific terms and conditions with the prior permission of the respective RCS granted in consultation with RBI. The funds raised through such shares may be treated as Tier II capital.**

3.5.2 The broad features of the preference shares are as under:

- (i) Subscription to these shares will be on a non-voting basis.
 - (i) The minimum maturity of the preference shares should be 10 years. There need be no upper limit for maturity.
 - (ii) The dividend shall be fixed and can be cumulative.
 - (iii) The liability of the bank to the preference shareholders both for dividend and principal would rank senior only to the ordinary shareholders and holders of special share, if any.
 - (iv) The preference shares will not have any put option but can have a call option exercisable by the bank not before five years from the date of issue, with prior permission of the Reserve Bank which

may be granted if, inter alia, it, does not result in the regulatory capital falling below the prescribed level.

- (v) The preference shares will be ordinarily redeemed upon maturity. However, in the case of banks whose CRAR is below the prescribed CRAR at the time of redemption, since the depositors have preferential claim over the preference shareholders, the redemption would not be permitted, except against fresh issue of such shares.
- (vi) The preference shares will be subjected to a progressive discount for capital adequacy purposes as under:

	Remaining Maturity	Rate of discount
a)	Less than one year	100%
b)	More than one year and Less than two years	80%
c)	More than two years and less than three years	60%
d)	More than three years and less than four years	40%
e)	More than four years and less than five years	20%

- (vii) The bank cannot give loan against its own shares.
- (viii) The bank should create a sinking fund @ 20% of the principal in the last five years to maturity.
- (ix) The bank would be required to maintain CRR and SLR against the liabilities covered by the preference shares. However, Reserve Bank may consider granting exemption from the reserve requirements.
- (x) The preference shares will be treated as Tier-II capital, subject to the total Tier-II capital not exceeding Tier-I capital. However,

- **Where banks with negative net worth raise funds by way of such shares through conversion of existing deposits, Reserve Bank may make an exception to this rule and treat these as part of regulatory capital even though Tier I capital is negative.**

3.6 Issues involved in raising funds through special shares and the Group's opinion/ recommendations thereon

There are certain issues involved in accessing funds through special shares, some of which would have relevance to tier II bonds as well. The Group's recommendations and opinion thereon are as under:

3.6.1 Cooperative Societies Acts / Rules

(a) There is a need to amend the Multi State Act to remove the limit prescribed on raising of funds by way of non convertible debentures / bonds. Wherever such limits are prescribed in other State Acts, necessary amendments may be made. In some of the states like in Maharashtra, the limits are prescribed in the rules, in which cases the government may have to exempt the UCBs from the provision or amend the rules, as required.

(b) The Group is of the opinion that issue of special shares at a premium and the rate at which dividend can be declared thereon would not be violative of the existing provisions of the Acts / Rules in this regard as these are applicable only to ordinary shares. However, if in any Act there is a specific bar on issue of securities other than ordinary shares, necessary amendments would be called for.

3.6.2 Public Issue and Private Placement

In terms of SEBI Regulations, a public issue requires issue of a prospectus, appointment of Merchant Banker, etc., besides obtaining acknowledgment from SEBI. This provision would not be applicable for funds raised through private placement. However, a private placement cannot have more than 50 investors.

Since SEBI Regulations would not cover the securities issued by UCBs, the Group opines that the limitation on the number of investors would not be applicable to instruments issued by UCBs. In other words they may raise funds through these instruments on a private placement basis without being subject to restrictions prescribed by SEBI.

3.6.3 Listing and Transferability

As the SEBI Act and the Securities Contracts and Regulation Act do not cover the instruments issued by the UCBs, they cannot be listed in a stock exchange and to that extent free tradability would not be possible. After due deliberations, the group came to the conclusion that listing is not *sine qua non* for transferability. A financial instrument can be transferred by endorsement and delivery. Therefore, the Group has suggested that the bonds and special shares be transferable by endorsement and delivery.

3.6.4 Investment by UCBs

UCBs may be permitted to invest in Tier II bonds of other UCBs. Reserve Bank may prescribe an appropriate limit linked to the investing bank's and recipient bank's Net Owned Funds.

3.6.5 Rating

Rating of an instrument may be left to the discretion of the issuer. Incidentally, commercial banks are allowed to invest in unlisted bonds to the extent of 10% of their non-SLR investments. In this context, the Group recommends that the

- **Reserve Bank may make an exception in this regard to enable the commercial banks to invest in the special shares, preference shares and Tier II bonds issued by UCBs within the ceiling prescribed for investment in unlisted securities.**

3.7 To permit UCBs to issue long maturity deposits

3.7.1 At present banks are not permitted to raise deposits for periods over 10 years. As an alternate to Tier-II bonds and to provide a simpler method for raising long-term funds, it is recommended that

- **UCBs may be permitted to raise deposits of over 10 year maturity and such deposits can be considered as Tier II capital subject to their meeting certain conditions.**

3.7.2 The features to be fulfilled by the long term deposits to be eligible for being treated as Tier II capital could be as under:

- (i) Minimum maturity will be 15 years.
- (ii) It will be subordinated to the claims of depositors and other creditors but would rank senior to shareholders, including holders of non-voting shares, if any and will be subject to RBI approval for repayment which will be given as long as banks assessed CRAR exceeds 9 per cent.
- (iii) It should have floating rate of interest. Premature withdrawal will not be permitted. However, banks would have the option to repay anytime after 10 years with prior permission of RBI.
- (iv) The deposits will not be eligible for DICGC cover
- (v) The bank cannot give loan against these deposits.
- (vi) The bank would be required to maintain CRR and SLR against the liabilities covered by the deposits. However, Reserve Bank may consider granting exemption maintaining the reserve requirements.
- (vii) These deposits will be subjected to a progressive discount for capital adequacy purposes as proposed in paragraph 3.3.2 (vi).
- (viii) These deposits will be treated as Tier-II capital, subject to the total Tier-II capital not exceeding Tier-I capital. However, the Group recommends that :
 - **Where banks with negative net worth raise such long term deposits through conversion of existing deposits, Reserve Bank may make an exception to this rule and treat these as**

part of regulatory capital even though Tier I capital is negative.

3.8 To grant exemption from Income Tax

There are several constraints in the way of UCBs being able to raise stable long-term equity / quasi equity funds. The suggestions for issue of Tier-II bonds and special and preference shares would require amendments to Acts / Rules which may be time consuming. In the circumstances, the only source of own funds for the UCBs is retained earnings. The Group therefore recommends that:

- **Reserve Bank could suggest to the Government of India to defer the application of income tax on UCBs for a period of three years by which time, the alternate instruments may also take concrete shape. The waiver of Income Tax can be subject to appropriate restriction on declaration of dividend to ensure that the consequent savings are used to shore up the capital base.**

3.9 To dispense with the share linking norms

The regulatory provision requiring a certain percentage of borrowings to be contributed to share capital is intended to ensure a minimum capital for the UCBs. This requirement was prescribed to ensure that capital was earmarked whenever a loan is disbursed so that the UCBs did not create risk assets disproportionate to their capital. However, now that UCBs are brought under the regime of linking capital adequacy in terms of a ratio to risk assets, prescribing a share to loan ratio on a borrower-to-borrower basis may not be necessary. The Group therefore recommends that:

- **The extant instructions on share linking to loans may be dispensed with.**

3.10.1 Accounting of Share Capital

3.10.1 The various features of the share capital contribution have been discussed at length in paragraph 2.8. As observed therein, while the share capital does not have all the characteristics of equity, it has been by and large stable. In respect of treatment of member contribution as share capital, World Council for Cooperative Credit Unions (WOCCU) has, in a letter addressed to International Accounting Standards Board, suggested that the member's shares should be deemed as equity if

(i) An entity has the unconditional right to refuse redemption of members' shares,

or

(ii) An entity may be prohibited by law or its governing charter from redeeming members' shares if doing so would cause the number of a members' shares or amount of paid-in capital from members' shares to fall below a specified level.

3.10.2 The Group opined that the above stand taken by WOCCU is logical. In the Indian context, the Cooperative Societies' Acts provide for limiting withdrawal of share capital in a year to 10% of total share capital at the beginning of the year. It could be argued that this limit of 10% of share capital or the minimum lock-in period can be circumvented by non payment of residual amount of loan to the extent of share capital held. However, it needs to be understood that this does not tantamount to withdrawal of capital. If the share capital cannot be adjusted on account of non-compliance with either of the two conditions stipulated by law, the residual loan would be a liability of the borrower and would continue to accrue interest. The borrower would not be eligible for non-application of interest on the residual loan amount on the grounds of having share capital of like amount. As a corollary, the said borrower would also be eligible to get dividend on his share capital.

3.10.3 In view of the above as also the empirical evidence of share capital of UCBs being by and large stable, the Group recommends that:

- **Share capital contribution may continue to be treated as equity and reckoned as Tier I capital for regulatory purposes.**

3.11 Federated Structure

A reference is invited to the observations in paragraph 2.5.4 relating to the international systems. The Group opines that creating a federated structure on the lines of the one obtaining in Netherlands or in Finland may be faced with legal hurdles as also in bringing the UCBs under the fold of an umbrella of one organisation in view of the different cultural and social settings they are now working in. However, creating a legal framework for facilitating the emergence of such umbrella organisation(s) appears to be the only long term solution to enhance the public and depositors' confidence in the sector. As this would not only require amendments to the Cooperative Societies Acts but also entails changes to the supervisory and regulatory practices, the Group recommends that:

- **The entire issue of creating an appropriate legislative and supervisory framework be separately examined taking into consideration the international experiences and systems.**

3.12 Trading Platform

The Group considered the suggestion of NAFCUB for having a separate trading platform for securities issued by UCBs. The Group noted that the suggestion was made by NAFCUB for providing a mechanism for transfer of instruments and liquidity to the investors. However, the Group has suggested a few instruments, which could be transferred through endorsement and delivery. As such, the legal and structural issues referred to at paragraph 2.7.2 apart, it was of the view that the efficacy of having a separate trading platform for these securities could be examined, if and when, on the basis of experience gained from issue of such instruments by UCBs, a need is felt.

3.13. Concluding Remarks

3.13.1 As discussed in Chapter I, the spectacular growth of the UCB sector has affected the performance of the banks, which has led to large number of banks turning weak and sick. As on March 31, 2006 almost 30 % of the banks were still in Grade III and Grade IV signifying weakness and sickness (Reserve Bank Annual Report 2005-06). The Group noted that over the last couple of years the UCBs sector has been witnessing a gradual decline in terms of rate of growth of business. However, as growth of business is linked to capital, the additional instruments suggested by the group seek to reverse this trend and improve the growth potential of the UCBs without adversely affecting depositor interest. This would also facilitate the realization of the goal for strengthening the sector as set out in the draft Vision Document for UCBs.

3.13.2 The instruments proposed by the Working Group are universally applicable for all UCBs. However, it could be argued that these do not address the problems of weak banks which may find it difficult to raise resources through these instruments. This may not be true in all cases. The High Networth Individuals, for example, who may be willing to invest in UCBs for turning them around, may find, in the special shares and other instruments proposed, a feasible and attractive avenue. Moreover, consolidation in the sector is an effective instrument for resolving the issues of non-viable banks. At present there are not many UCBs with the financial strength required to take over other weak banks. The alternate instruments suggested would facilitate the emergence of a larger number of financially strong UCBs that would have the ability to absorb the losses occurring in the process of take over of weak banks. The Group opined that this would enable the regulators to play a proactive role in resolving, through mergers, the problems posed by the non-viable entities.

3.14 Acknowledgements

The Working Group thanks the management of the Reserve Bank for having provided it an opportunity to examine a vital issue, which could have far reaching impact on the overall health of the UCB sector. The Group has benefited immensely from the suggestions made by Shri A.K. Khound, Chief General Manager, Urban Banks Department (UBD), Reserve Bank, Central Office and Shri S.S. Barik, General Manager, UBD, who also provided important background material for facilitating the deliberations of the Group. Shri Ashok Narain, Deputy General Manager, UBD, provided valuable inputs during the deliberations and assisted in the initial draft of the report. Shri G.N. Rath, Deputy General Manager, UBD, handled coordination with the members and provided administrative support. Shri Anup Kumar, Asst. General Manager, UBD, did a commendable job of collecting and providing to the Group valuable information relating to international experiences and systems. Last but not the least, Shri Sanjeev Khadke, Deputy Registrar of Cooperative Societies, Maharashtra, helped the Group by providing critical inputs relating to the law and practice of Cooperative Societies Act in Maharashtra. The Group acknowledges the efforts made and support rendered by the above officials in making this report possible.

(N.S. Vishwanathan)

(Anil Diggikar)

(J.C. Sharma)

(D. Krishna)

(Prof. Mukund Ghaisas)

(K.D. Zacharias)

NOTIFICATION

**Working Group to Examine Issues Concerning
raising of capital by Primary(urban) Co-operative Banks**

As announced in the Annual Policy Statement for the Year 2006-07, it has been decided to constitute a Working Group, as under, to examine the issues relating to treatment of paid share capital as core capital and identifying alternate avenues for raising capital by primary (urban) co-operative banks:

1.	Shri N.S. Vishwanathan	CGM-in-Charge, UBD,RBI	Chairman
2.	Shri S.K. Sharma, I.A.S	Commissioner for Co-operation & RCS, Maharashtra	Member
3.	Shri J.C. Sharma, I.A.S.	Commissioner for Co-operation & RCS, Andhra Pradesh	Member
4.	Shri D. Krishna	Chief Executive, NAFCUB	Member
5.	Shri Mukand R. Ghaisas	Chairman, Maharashtra Urban Co-operative Banks' Federation	Member
6.	Shri K. D. Zacharias	Legal Adviser, RBI	Member

The terms of reference of the Working Group are as under:

- (i) To consider whether the paid up share capital can be treated as core capital for capital adequacy purposes in the light of IASB 32 standards and if not to suggest a time frame to implement the proposed standard.

- (ii) To suggest alternative avenues for raising capital particularly in the light of recent guidelines on newer instruments issued to commercial banks by RBI.
- (iii) To look into international experiences of co-operative banks/credit unions in raising capital and to suggest measures that can be implemented in the context of primary (urban) co-operative banks in India.
- (iv) To make such other recommendations as the Group may deem relevant to the subject.

The Working Group will commence its work immediately and submit its report by July 15, 2006 Urban Banks Department of Reserve Bank of India will provide secretarial assistance Working Group.

(V.S.Das)
Executive Director
Reserve Bank of India
April 21, 2006

Chief General Manager-in-Charge

DO.UBD.CO.13441/09.18.200/05-06

June 28, 2006

Dear Shri

**Working Group to Examine Issues Concerning raising
of capital by Primary(urban) Co-operative Banks**

As announced in the Annual Policy Statement for the year 2006-07 by RBI, a Working Group had been constituted to examine the issues relating to treatment of paid up share capital as core capital including avenues for raising fresh capital by primary (urban) co-operative banks with Commissioner for Co-operation & RCS, Maharashtra as one of its members. The 1st meeting of the Working Group was held on May 24, 2006 and was attended among others, by your predecessor Shri S.K.Sharma, IAS.

2. It gives me pleasure to invite you to join the Working Group. The date and venue of the next meeting will be conveyed to you shortly.

Yours sincerely

(N.S.Vishwanathan)

Shri Anil Diggikar, IAS.
Commissioner for Co-operation &
RCS, Government of Maharashtra
Central Building Annexure
Pune- 411001.

Extract of legal provisions from select Cooperative Societies Act on share* capital and borrowing

Sl. No.	Provisions relating to shares, debentures, etc.	Restrictions on holding of shares	Restrictions on transfer of shares	Redemption of shares	Restrictions on borrowing
1	Multi State Cooperative Societies Act, 2002	<p>Section 33 No member shall hold such portion of the total share capital as may be prescribed in the by-laws; but in no case more than one fifth of the total share capital</p>	<p>Section 34 Transfer of share should be within the maximum limit on holding as prescribed at Section 33 of the Act.</p>	<p>Section 35 1)Shares held can be redeemed as per the provisions of the by-laws 2)Redemption of shares at face value</p>	<p>Section 67 1)As may be prescribed in the by-laws, subject to the condition that the total amount of deposits and loans received during any financial year should not exceed ten times of the sum of subscribed share capital and accumulated reserves. 2)A society may issue non-convertible debentures or other instruments to the extent of 25% of its paid-up share capital</p>

2	Maharashtra Cooperative Societies Act, 1960	<p>Section 28 1)No member shall hold such portion of the total share capital as may be prescribed; but in no case more than one fifth of the total share capital 2)The amount of shares should not exceed Rs.5 lakh</p>	<p>Section 29 1)Subject to the restriction on holding of shares(Sec 28), a member shall not transfer any share held by him, unless such share is held for not less than one year, 2) Transfer can be made only to a member or a person, whose application has been accepted</p>	<p>Rule 23 1)Where a member ceases to be a member, the value of the share to be paid should be the book value as per the last audited balance sheet, but not exceeding the actual amount received on such share. 2)Amount to be paid on allotment of share should not exceed the face value notwithstanding anything contained in the by-laws. 3)In case of transfer to any member, the transferee shall not be required to pay any thing in excess of book value or face value, whichever is less.</p>	<p>Rule 46A No society shall raise loans from non-members without the authorization from the RCS</p>
3	Gujarat Cooperative Societies Act, 1961	<p>Section 29 No member shall hold such portion not exceeding one fifth of the total share capital or not exceeding rupees twenty thousand.</p>	<p>Section 30 1)Subject to the restriction on holding of shares(Sec 29), a member shall not transfer any share held by him, unless such share is held for not less than one year,</p>		<p>Section 44/Rule24 No urban bank can borrow more than 25 times the amount of its paid up capital, accumulated reserve funds and building fund minus accumulated losses, without the prior sanction of RCS.</p>

			2) Transfer can be made only to a member or a person, whose application has been accepted 3)The committee has approved such transfer		Rule 25 A society can raise funds by issue of debentures and bonds, subject to framing of regulations with the prior sanction of RCS
4	Karnataka Cooperative Societies Act, 1959	Section 22 Restrictions stipulated at this section were withdrawn w.e.f. 15.8.1998	Section 23 No transfer shall be valid unless 1)the share is held for not less than one year, 2) transfer is made only to a member of the society 3)the transfer is approved by the committee .		Rule 25 The deposits and loans from members non-members not to exceed 30 times the paid up share capital, accumulated reserve fund and building fund minus accumulated losses.
5	Andhra Pradesh Cooperative Societies Act, 1964	Section 26 No member* shall hold such portion not exceeding one fifth of the total share capital	Section 27 No transfer shall be valid unless 1)the share is held for not less than one cooperative year, 2) transfer is made only to a member of the society		Section 47/Rule 40 1)As prescribed in rules and by-laws 2) Rules authorizes the RCS to fix the limit

*Not applicable to share holding by Government

RAISING CAPITAL THROUGH ISSUE OF 'NON-VOTING' SHARES BY URBAN CO-OPERATIVE BANKS-CONCEPT OF PRIVATE EXCHANGE

D. Krishna, Chief Executive, NAFCUB

In order for urban co-operative banks to access larger number of investors without going to the capital market, a system that would bring together all the members of a group of urban co-operative banks to invest in any of, or in more than one urban bank has been drawn up in this presentation. This class of investors called “non-voting shareholders” will be different from existing “regular” and “nominal” members. While like “nominal” members, the “non-voting shareholders” will also not have the voting rights, the essential difference will be:

- (a) they can be from outside the area of operation of banks; and
- (b) each investor can own “non-voting shares” of more than one urban bank.

The salient feature of the scheme would that a bank in a small center with limited scope of making members from its area of operation can sell non-voting shares to a large number of investors that are members of other banks across the Country.

The Model

We want to create a ‘private screen based exchange’ of their own wherein shares of Non Voting types can be issued and traded amongst all members of participating cooperative banks.

To start with, we want to restrict the number of issuing banks. So, in the beginning only those banks having a deposit base of more than 100crore and falling in Grade I or Grade II bracket in Tier II category will be allowed to issue the instrument. Later the other banks can also join by issuing this instrument. All the members of the issuing banks will be allowed to participate in subscribing and trading.

So, at an initial stage we can look at an approx. number of 500 Banks issuing shares. These 500 Banks have an approx. 5 million members. If we consider that even if 2% of the members subscribe to the shares issued then we would have an investor base of approx. 1 lakh.

Instrument

The instrument that we have proposed is a **Non Voting Preference Share**.

This is with reference to the minutes of the last meeting, wherein we had found out that Maharashtra State Cooperative Act does not bar the issuance of Preference Shares by cooperative banks.

The features of the same are as follows:

- **Non Voting** – The instrument holders would not get voting rights like equity shareholders
- **Fixed Dividend** – The instrument holders would be entitled to get a fixed dividend on the face value
- **Cumulative** - The dividend would be cumulative
- **Tradable/Transferable** – The instrument can be traded in the secondary market created for it

Rules and Regulations

How much to issue?

The banks would be allowed to issue a minimum of 20% of the Net Own Funds or Rs. 1 Crore, whichever is less.

The maximum limit upto which banks can issue Non Voting Shares will be 100% of their Net Owned Funds.

How much dividend should the cooperative bank pay?

The dividend would be decided by the banks on an individual basis and the bank has an option to reset the dividend after every 3 years with cap and floor of the change being 200 basis points.

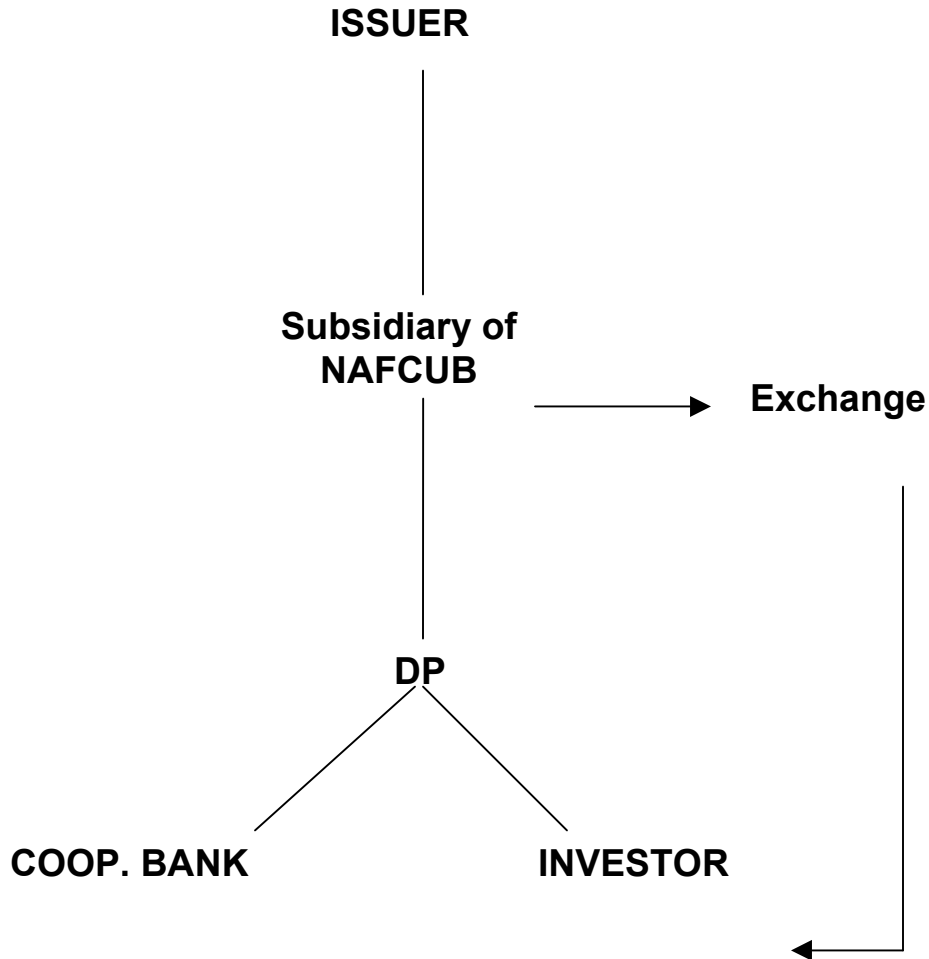
What are the Exit Options available to the investor?

- **Secondary Market** – the investor can sell his/her shares on the exchange created and get out of the market
- At the end of the 5th year of issue the investor will have a PUT Option, i.e. the investor will have an option to sell 20% of his holding to the issuing bank at the Market Price or the Face Value, whichever is lower
- At the end of the 8th year of issue the bank will have a CALL Option, i.e. the bank will have an option to buy 20% of the Preference Shares issued at the Market Price or the Face Value, whichever is higher
- Starting from the 8th year, every 3rd year there would be an alternate CALL/PUT Option having the above conditions

Why would the members subscribe to Non Voting Preference Shares?

- The members would have a chance to invest in the shares of other cooperative banks
- The members holding these Non Voting Preference Shares would get a fixed dividend every year
- There would be Capital Appreciation of the Non Voting Preference Share Value

To establish such a model a sound networking structure should also be in place.
We have proposed a networking structure also for this model –



In the model we have tried to keep the Preference Shareholder at par with the equity shareholder and the depositor in terms of advantages and disadvantages.

Features of Rabobank Membership Certificates

What are Membership Certificates?

Rabobank Membership Certificates enables one to invest in certificates of shares in Rabobank Ledencertificaten N.V. This institution invests the majority of its capital in subordinated loans extended to Rabobank Nederland. It invests the remainder of its capital in loans to creditworthy borrowers, such as the State of the Netherlands. The certificates are offered exclusively to Rabobank members.

What are subordinated loans?

A subordinated loan means that if Rabobank Nederland is unable to meet its payment obligations, all creditors' claims will be paid first. Membership certificate holders will consequently only receive their investment including any accumulated dividend back after the creditors have been paid.

Returns

Rabobank Ledencertificaten N.V. is expected to pay a dividend four times a year. The dividend payment is linked to the average effective return on the most recent ten-year Dutch state loan. over a specified period. Should the effective return rise, the dividend payment will rise in tandem. As such there is no market risk. No or less dividend will be paid if Rabobank fails to make a profit or make insufficient profit or if the Rabobank Group's capital position is insufficient.

Monthly buying and selling

Rabobank Membership Certificates not listed on a stock exchange and are tradable once a month via an internal market. The price is not set and depends on supply and demand. The actual trading price will be updated each month on our site.

Costs

One can buy or sell Rabobank Membership Certificates each month. There are no buying costs and custody fee is not charged. The selling costs depend on the channel used to place order or orders:

Period to maturity –

Rabobank Membership Certificates have, in principle, an infinite period to maturity. Rabobank, is, however, entitled to decide to redeem the certificates on certain specified period and every year thereafter