Usha Thorat: Urban cooperative banks – evolution of the banks, current issues in corporate governance and challenges in their regulation and supervision

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Ladies and Gentlemen,

I am happy and honoured to be here today to deliver the *"Late Shri. R. N. Godbole memorial lecture"* this year. My thanks to the Shivaji University, Kolhapur for extending me the invitation to deliver this lecture.

I have chosen to speak today on Urban Cooperative Banks - a key sector in the Indian Banking scene, which in the recent years has gone through a lot of turmoil. While the ordeal is not as yet over for some banks, the sector on the whole is showing signs of looking up. It is encouraging to note that the Reserve Bank’s initiatives towards the revival of this sector – a unique sector blending banking and cooperation – are bearing fruit. Talking of cooperation, one cannot but recollect the glory of this wonderful district that we are in today – Kolhapur, a leading district in the cooperative movement in Maharashtra, famous for its cooperatives.

Indeed, it is a good time and place to have a detailed discussion on the evolution of the UCBs, governance issues observed in them and the challenges in the regulation and supervision of the sector.

I would like to begin with a brief note on the historical perspective on cooperative movement in India and the origin of UCBs, and then move on to the current issues.

Historical perspective

The cooperative movement in India started a century ago with the enactment of Cooperative Societies Act in 1904. Interestingly, legal status was conferred on credit societies keeping in view, in particular, the needs of the agricultural sector. Nevertheless, Sir Ibbetson, who piloted the legislation observed: "We recognize that artisans, employees on small pay and other persons in towns may very properly be admitted to the benefits of our legislation".

Although joint stock banks opened branches in urban and semi-urban areas, they did not find it advantageous to cater to the banking and credit requirements of the urban middle/lower class comprising small traders/ businessmen, artisans, factory workers, salaried persons with limited incomes etc. The inability of joint stock banks to appreciate and cater to the needs of this class of clientele with limited means effectively drove them to money-lenders and similar agencies for loans at exorbitant rates of interest - this situation was the prime mover for non-agricultural credit cooperatives coming into being in India. The main objectives of such cooperatives were to meet the banking and credit requirements of this section of people and to protect them from exploitation. Thus, urban cooperative banks’ emergence was a result of local response to an enabling legislative environment, unlike rural cooperative movement that was largely State-driven. The origin of cooperative banks can be traced to a small town in South India, called Conjivaram, where in 1904, the Conjivaram Urban Cooperative Bank was set up, to cater to the needs of small businessmen as an alternative to moneylenders.

Little attention had been paid to the development of the urban credit movement until the Maclagan Committee (1914) drew attention to its potentials. Interestingly, a banking crisis in India in 1913-14, when no fewer than 57 joint stock banks collapsed, led to a flight of deposits from joint stock banks to urban cooperative banks. The Maclagan Committee investigating the crisis stated ‘As a matter of fact, the crisis had a contrary effect and in most provinces there was a movement to withdraw deposits from non cooperatives and place them in cooperative institutions, the distinction between the two classes of security being well appreciated and preference being given to latter owing partly to the local character and publicity of cooperative institutions but mainly we think, to the connection of Government with the cooperative movement’.

Urban Cooperative Banks (UCBs)

Urban cooperative banks, also referred to as primary co-operative banks, play an important role in meeting the growing credit needs of urban and semi-urban areas of the country. They mobilise savings from the middle and lower income groups and purvey credit to small borrowers, including weaker sections of the society. These banks in India are financial cooperatives akin to credit unions found abroad, except that they can also accept deposits from non-members and form a part of the payments systems.

Market share of UCBs

As on March 31, 2006 there were 1853 UCBs, 84 scheduled commercial banks, 133 Regional Rural Banks (RRBs) and 398 Rural Cooperative Banks (including 31 State Cooperative Banks and 367 District Cooperative Banks) in India. An analysis of market share of various bank groups indicates that the share of UCBs in total bank deposits is relatively low. Nevertheless, their market share grew steadily from 3.3% in 1990-91 to a high of 6.6% in 1999-2000, but thereafter gradually declined to 4.8% (provisional) in 2005-06, as shown in the following Table.

Table 1

(Market share in percentage)

Market share of deposits of all bank groups to total deposits				
Year ended March 31,	Urban Co-op. banks (UCBs)	Rural Co-op. Banks (RCBs)	Regional Rural Banks (RRBs)	Commercial Banks
1996	4.5	7.2	2.5	85.8
1997	4.9	7.6	2.6	84.9
1998	5.3	7.7	2.8	84.2
1999	5.6	7.8	2.8	83.8
2000	6.6	7.7	2.8	82.9
2001	6.3	7.2	2.9	83.6
2002	6.4	7.2	3.0	83.4
2003	6.3	7.0	3.0	83.7
2004*	5.8	6.6	3.1	84.5
2005*	5.3	6.3	3.1	85.3
2006*	4.8	5.5	3.0	86.7

* Provisional data (Share of RCBs arrived on the basis of projections as their total deposits as on 31.3.2006 is not available)

Growth of UCBs

In 1966 when the Banking Regulation Act was made applicable to UCBs, there were about 1100 UCBs with deposits and advances of Rs.167 crore and Rs.153 crore respectively. As at the end of 1996, the number of UCBs increased to 1501 and their deposits and advances rose significantly to Rs.24,161 crore and Rs.17,927 crore. The UCBs continued to grow at a fast pace till 2003, when their number increased to 1941 and their deposits and advances to Rs.1,01,546 crore and Rs.64,880 crore respectively. Subsequently, the number of UCBs declined in 2006 to 1853 with total deposits of Rs.1,12,237 crore and advances of Rs.70,379 crore. An overview of their growth since the 1990s is given in Table 2 below.

Table 2

(Amounts in crores of rupees)

Growth of Urban Cooperative Banks (UCBs)					
Year ended March 31,	*Nunmber of UCBs*	*Deposits*	*% growth*	*Advances*	*% growth*
1996	1501	24161		17927	
1998	1502	40692	68.4	27807	55.1
2001	1618	80840	98.7	54389	95.6
2002	1854	93069	15.1	62060	14.1
2003	1941	101546	9.1	64880	4.5
2004	1926	110256	8.6	67930	4.7
2005	1872	105021	-4.7	66874	-1.6
2006	1853	112237	6.9	70379	5.2

The spectacular growth of UCBs in the late nineties and up to 2003, which had resulted in increasing their penetration, ironically, also led to certain weaknesses in the sector that adversely affected public perception and thereby, their competitiveness. A major reason for the decline in public confidence was the crisis faced in 2001 by a large multi-state bank in the state of Gujarat, when the bank witnessed a sudden 'run' on its branches, following rumours of its large exposure to a leading broker who had suffered huge losses in the share market. The large-scale withdrawal of deposits within short time had resulted in severe liquidity problems for the bank. The bank was also holding about Rs.800 crore of inter-bank deposits from a large number of UCBs in the State and from other States, which posed a systemic risk. In order to protect the interests of the general public and also that of the other co-operative banks, RBI had issued directions to the bank restricting certain operations (acceptance of fresh deposits, restricting payments to any single depositor to Rs.1000 and ban on fresh lending) and requisitioned the Central Registrar of Co-operative Societies, New Delhi to supersede the Board of Directors and appoint an Administrator. An order of moratorium was also enforced on the bank by the Central Government for a short period. The bank was subsequently placed under a scheme of reconstruction with the approval of Reserve Bank of India.

The Gujarat episode was followed by another major crisis in the state of Andhra Pradesh in 2002, when one of the largest banks in the state faced a run, following a newspaper report regarding an inquiry instituted into the affairs of the bank by the State Registrar of Cooperative Societies. The bank was in a weak position, and ultimately, after attempts for its revival failed, its license was cancelled by the Reserve Bank in 2004.

The decline is public confidence in the UCB sector deepened in the aftermath of the crisis in Gujarat and Andhra Pradesh and concomitantly, the position of UCBs generally deteriorated. As on June 30, 2004, 732 out of 1919 UCBs were categorised in Grade III or IV signifying weakness and sickness. Recognising the systemic risks and keeping in view the needs of its clientele, Reserve Bank reviewed the entire gamut of legislative, regulatory and supervisory framework for these banks, and in March 2005, brought out a draft 'Vision Document for UCBs'. The vision document, which was drawn with the main objective of maintaining the viability and competitiveness of the UCBs, discussed the characteristics of the sector, analysed the problems afflicting the banks and proposed strategies for dealing with problems affecting the sector.

I would first dwell upon the salient features of the UCB sector and, thereafter, elaborate on the vision document and other initiatives of the Reserve Bank for ensuring viability and competitiveness of the banks in this sector.

Salient features of the UCB sector

The UCB sector is unique in that there is significant degree of heterogeneity among the banks in this sector in terms of size, geographical distribution, performance and financial strength. There is also diversity among the urban cooperative banks in the levels of professionalism, standards of corporate governance and access to advanced technology. Most importantly, the banks in this sector are under dual control, with a part of the powers vested in the State Government and a part with Reserve Bank.

The Reserve Bank is, therefore, continuously evolving the regulatory and supervisory framework for UCBs to ensure their soundness without sacrificing their competitiveness. But before, stepping into the realm of regulation/ supervision, I would like to elaborate further on the aspect of heterogeneity of UCBs, which would help in better understanding of the sector.

Heterogeneity

While on the one hand, there are a number of small neighbourhood banks functioning for mutual interest of their members, on the other, there are several large UCBs with a wide network of branches, large number of depositors and borrowers, many of whom are medium/large corporates. In the latter kind of UCBs, the cooperative structure remains only as an organizational arrangement and their business model and goals are more akin to commercial banks. The extent of heterogeneity can be gauged by size-wise, region-wise and grading-wise analysis of the UCBs.

Size-wise distribution

The frequency distribution of UCBs in terms of deposits and advances their relative share is shown in Table 3. It is observed that at the lower end of the spectrum, 36.2% of the UCBs have a deposit base of less than Rs.10 crore and account for only 3.0% of deposits. At the same time, at the top end, only 14 banks had a share of 23% in the total deposits. More than 50% of the UCBs (962 banks) fell in the deposit base range of Rs.10 crore to Rs.100 crore and accounted for 29.5% of total deposits.

Table 3.
Size-wise Distribution of Deposits of UCBs (As on March 31, 2006)

		No. of UCBs		Deposits	
	Amount (Rs. crore)	No.	Share in Total (per cent)	Amount (Rs. crore)	Share in Total (per cent)
1.	>1,000	14	0.8	25,768	23.0
2.	500 to < 1,000	16	0.9	11,153	9.9
3.	250 to < 500	48	2.6	16,947	15.1
4.	100 to < 250	142	7.7	21,910	19.5
5.	50 to < 100	210	11.3	15,164	13.5
6.	25 to < 50	302	16.3	10,525	9.4
7.	10 to < 25	450	24.3	7,374	6.6
8.	5 to < 10	333	18.0	2,486	2.2
9.	<5	338	18.1	910	0.8
	Total	1,853	100.0	1,12,237	100.0

Region-wise distribution

The distribution of urban cooperative banks across the country is skewed, with significant concentration in southern and western regions. Table 4 gives the region-wise distribution of number of UCBs and share of deposits of each region.

Table 4

(Amounts in crores of rupees)

Region-wise Distribution of UCBs/their deposits (As on March 31, 2006)						
Region	No. of Banks	% share in total	Deposits	% Share in total	Advances	% Share in total
West	926	49.97	87063	77.57	54726	77.76
South	613	33.08	16003	14.26	10429	14.82
North	231	12.47	6389	5.69	3544	5.04
East	83	4.48	2781	2.48	1679	2.39
Total	1853	100.00	112237	100.00	70379	100.00

*Provisional Data submitted by banks

Grade-wise distribution

As part of its on-site inspection exercise, Reserve Bank has a system of categorizing banks into four grades based on objective parameters relating to capital adequacy, asset quality, earnings, compliance with CRR/SLR requirements and adherence to RBI guidelines and/ directives*.* While Grade I covers banks with no major supervisory concerns, the other three grades would indicate existence of supervisory concerns in increasing degree. Table 5 gives the grading-wise distribution of banks as on March 31, 2006 (as per provisional data). It is seen that 37% of UCBs in the country, accounting for 25.60% of total deposits, were in Grades-III and IV signifying weakness/and sickness, while the remaining major portion (63%) of UCBs, accounting for 74.40% of total deposits, were in Grades-I and II, indicating good/satisfactory performance/ financials.

Table 5

(Amounts in crores of rupees)

Grading-wise Distribution of UCBs (As on March 31, 2006)				
Grade	**No. of banks**	**% share in total**	**Deposits**	**% to Total**
I	716	39	64941	57.86
II	460	25	18580	16.54
I + II	**1176**	63	**83521**	74.40
III	407	22	13879	12.38
IV	270	15	14838	13.22
III+IV	**677**	37	**28717**	25.60
I+II+III+IV	1853	100	112237	100.00

Dual control

Urban co-operative banks are regulated and supervised by both, the State Governments, through the Registrars of Co-operative Societies, and by the Reserve Bank of India. The Registrars exercise powers in regard to incorporation, registration, management, amalgamation, reconstruction or liquidation. In case of banks having presence in more than one state, the Central Registrar of Co-operative Societies, on behalf of the Central Government, exercises such powers. The banking related functions such as issue of license to start new banks or branches, matters relating to interest rates, policies on loans and investments, prudential norms etc. are regulated and supervised by the Reserve Bank of India. Duality of command is not unique to India, and requires delicate coordination for obtaining synergies in regulatory and supervisory functions.

Competition and UCBs

Market scenario

Since 1991, the financial system has seen several reforms. The process of liberalization was set in motion with gradual removal of restrictions on the operation of the pricing mechanism, especially interest rates and statutory liquidity and reserve requirements – a process which is still underway. Enhanced competition in both banking and non-banking financial sectors has been gradually introduced – through a dynamic mix of public and private as well as domestic and foreign ownership – along with deregulation or adaptive regulations. Simultaneously, regulation and supervision of banks, financial markets and infrastructure were improved to increasingly align them with international standards and best practices. The market driven economy, through deployment of more capital, advanced technology and skilled human resources, is posing stiff and increasing competition to all traditional institutions.

UCBs position

Market competition and the need to retain good clientele are affecting the UCBs too leading to squeezing of the margins on many banks, especially the larger ones. The larger private sector commercial banks, with their ability to invest more in technology and offer better remuneration to attract skilled persons, are better off in fending competition. Understandably, therefore, the UCBs that are competing in the same space, especially in cities and towns, are also being aggressively targeted by the commercial banks and face tough competition. The smaller unit banks on the other hand, by and large, manage to retain their niche role through personalized service and informal approach.

Corporate governance issues in UCBs

Most of the problems faced by the UCBs are due to governance issues and connected lending. In UCBs borrowers have a significant say in the managements of the banks. This has the potential of influencing the Boards to take decisions that may not always be in the interest of the depositors who constitute the most important stakeholders of a bank. Also, unlike the case of institutions the shares of which can be listed in a stock exchange and can change hands without affecting the capital base, in case of UCBs, the shareholders can withdraw their contribution to capital and shrink the capital of the bank and thereby limit its ability to increase risk weighted assets and expand business.

On this crucial aspect of corporate governance, I would like to, therefore, discuss a little about the international best practices.

Corporate governance – international best practices for credit unions

As best practices guide, the World Council of Credit Unions has enunciated ideal governance principles for credit unions, which are financial cooperatives similar to our urban cooperative banks. These principles address the challenges of organizational power within credit unions at three separate levels viz. External Governance, Internal Governance and Individual Governance.

External governance

All financial institutions, regardless of type, are expected to comply with the following basic standards of transparency, auditing and financial reporting.

Transparency

- The board should commit to regular, honest communication of its activities with members, regulators and the general public in the spirit of full disclosure.
- Financial statements, compliant with generally accepted accounting principles and local regulatory standards, should be made available to members and the public.

Compliance

- The board is expected to comply in both the letter and spirit of regulation, to cooperate fully with its regulatory body and to comply with national laws.
- The board should ensure that the credit union meets or exceeds the International Credit Union Safety and Soundness Principles as well as any other relevant standards for financial institutions.
- The credit union should undergo annual external audits within 90 days of the end of each fiscal year.
- The audit relationship should be reexamined frequently and consideration be given to changing the auditor at least every 3-5 years in a competitive bidding process.

Public accountability

- The board of directors and management must be constantly cognizant of responsibilities to governmental structures, including but not limited to regulators, legislative bodies, the media, the community and the public.

Internal governance

Unlike for-profit entities, credit unions exist to serve their members. Thus, credit unions must address this additional layer of governance related to their democratic, member-driven nature. This includes a commitment to "one member, one vote," as well as adherence to the International Credit Union Operating Principles and the role of the general assembly as the highest governing body.

Structure

- The board of directors should be composed of an odd number, no less than five and no greater than nine.
- Consideration should be given to the rotation of directors.
- Interested general members who comply with the standards of individual governance can stand for nomination.
- The board should encourage dialogue with general members at the annual general meeting.
- The annual general meeting of the general assembly of members should be adequately promoted to ensure sufficient member participation.

Continuity

- The board should create strategies to maintain the competitiveness and sustainability of the credit union.
- The board should create succession plans for both directors and management that ensure the continued existence of the credit union.
- The board should approve a disaster management and recovery plan.

Balance

- The composition of the board should aim to adequately reflect the demographic make up of its members and balance the financial service demands of members.
- The board should seek to balance diversity and experience, but all directors must meet the standards of individual governance.

Accountability

- The board is formally accountable to the general assembly of members, which is the highest governing body.
- The roles and responsibilities of the board, committees and managers should be established clearly in the bye-laws or other policies.
- It is the duty of the board to establish strategic direction, approve policies and monitor management's implementation of these policies and achievement of targets.
- It is the duty of management to prepare the plan and budget, undertake operations, implement the policies approved by the board and achieve the targets set forth.

Individual governance

In order to perform their collective duties, the individual board members and managers have an obligation to maintain ethical conduct and professionalism and to speak with a single voice once board decisions have been made. Board members are also expected to possess the skills and technical capacity necessary to fulfill their duties.

Integrity

- The credit union should adopt a standardized code of conduct clearly explaining proper behavior.
- Directors or managers must not have criminal backgrounds, recent bankruptcies or penal backgrounds.
- Immediate family members should not serve on the board or in management at the same time.
- Board members must excuse themselves from participating in discussions and voting on matters from which they or their family have a potential conflict of interest.
- The board must approve loans to directors or management. All such insider loans must be made within the approved credit policy parameters and will be reported on a regular basis to the full board.
- Directors with delinquent loans more than three months will be removed from their position.

Competence

- All members of the board should have basic financial literacy, including the ability to interpret financial statements and standards, or commit to acquiring these skills through education or training within the first year of service.
- Individual members should have specialized financial or business skills and/or a member-focused viewpoint.

Commitment

- Directors should be willing and able to commit the necessary time to the credit union. Failure to attend board meetings may result in dismissal.
- Directors must respect the decisions of the board, adhering to all policies that have been adopted, regardless of personal opinion.

The board and managers, as a cohesive unit, would have to ensure the credit union's compliance with issues related to external and internal governance. In order to achieve this goal, each board member has a duty to adhere to the principles of individual governance.

Competence of directors

In the context of urban cooperative banks in India, the first issue of importance is whether there is collective expertise on the Board available to meet the competitive challenges before the bank to ensure growth while maintaining soundness? In today's context, some of the areas where expertise at the Board level is very useful is HR, IT and risk management. This enables the Board to get unbiased advice from such members on the Board on managerial decisions and on matters referred to the Board. Chairman and members of the Board should ensure that the Board has a broad based talent in the Board in the areas of accountancy and audit, IT, HR and other expertise and experience from industry, trade and agriculture. Domain knowledge of the Board members enormously increases the quality of governance and the Chairman should be able to tap this talent to the advantage of the bank.

The other aspect relating to the composition of the Board relates to 'fit and proper' criteria for directors. Internationally, the best principles of banking regulation require that regulators who give banks licenses ensure banks are owned, controlled and managed by 'fit and proper' shareholders, directors and senior managers. In most countries this is done through ensuring that all significant shareholders fulfill the fit and proper tests, all directors adhere to "fit and proper" criteria and appointments by the Board of CEOs of banks and key functionaries like CFO, COO and the auditors are approved by the regulator.

Role of bank directors

An important aspect of corporate governance is the role of directors. It would be interesting to note that the Bank for International Settlements (BIS) has spelt out the following principles that should guide the bank director:

- Understand their oversight role and their fiduciary "duty of loyalty" and "duty of care" to the bank and its shareholders;
- Avoid conflicts of interest, or the appearance of conflicts, in their activities with, and commitments to, other organisations;
- Recuse themselves from decisions when they have conflicts of interest that make them incapable of properly fulfilling their fiduciary duties;
- Are able to commit sufficient time and energy to fulfilling their responsibilities;
- Are of a size that allows for efficiency and real strategic discussion;
- Continue to develop and maintain an appropriate level of collective expertise as the bank grows in size and complexity;
- Periodically assess the effectiveness of their own governance practices, including nomination and election of board members, determine where weaknesses exist, and make changes as necessary;
- Select, monitor and, where necessary, replace key executives, while ensuring that the bank has an appropriate plan for executive succession, and determining that any intended successor(s) are qualified, fit and proper to manage the affairs of the bank;
- Serve as a checks and balances function vis-à-vis the senior management of the bank by exercising their duty and authority to question and insist upon straight forward explanations from management, and receive on a timely basis sufficient information to judge the performance of management;
- Meet regularly with senior management and internal audit to establish and approve policies, establish communication lines and monitor progress toward corporate objectives;
- Promote bank safety and soundness, understand the regulatory environment and ensure the bank maintains an effective relationship with supervisors;
- Provide sound and objective advice, and recommend sound practices gleaned from other situations;
- Contribute special expertise in overseeing a bank's activities which might not be available in the rest of the parent or group;

- Do not participate as the board of directors in day-to-day management of the bank;
- Exercise due diligence in the hiring and oversight of external auditors in jurisdictions where this is the responsibility of the board (in some jurisdictions, external auditors are hired directly by shareholders).

Policy initiatives of Reserve Bank of India

Now, let us now take a look at various initiatives taken by the Reserve Bank for stabilising and strengthening the Urban Cooperative Banks

Taking a view on the crisis faced by the sector time and again, the Reserve Bank, in the annual policy for the year 2004-05, announced its decision to stop granting fresh licenses for formation of new UCBs. This was followed up with a decision not to grant any fresh branch license as well. It was made clear that this was necessitated pending a comprehensive review of the legislative and regulatory framework governing the sector. It was in this background that a decision was taken to draft a vision document for the sector to outline a framework that would facilitate the strengthening of the sector and enable it play the assigned role of providing credit to the economically weaker sections.

Vision document for UCBs

The Reserve Bank eventually formulated a draft vision document, placed it in the public domain in March 2005 and finalised it thereafter, with the following objectives:

(i) To rationalize the existing regulatory and supervisory approach keeping in view the heterogeneous character of entities in the sector.

(ii) To facilitate a focused and continuous system of supervision through enhanced use of technology.

(iii) To enhance professionalism and improve the quality of governance in UCBs by providing training for skill up-gradation as also by including large depositors in the decision making process / management of banks.

(iv) To put in place a mechanism that addresses the problems of dual control, given the present legal framework, and the time consuming process in bringing requisite legislative changes.

(v) To put in place a consultative arrangement for identifying weak but potentially viable entities in the sector and provide a framework for their being nurtured back to health including, if necessary, through a process of consolidation.

(vi) To identify the unviable entities in the sector and provide an exit path for such entities.

MOU with state governments and constitution of TAFCUBs

In pursuance of the proposals in the draft vision document, state governments having a large number of UCBs were approached for signing memorandum of understanding (MOU). Some of these state governments have since signed MOUs. The memorandum, in fact, provides the basis for the constitution of Task Force for Urban Co-op. Banks (TAFCUB) in each State, which is the forum for the consultative decision making process. The TAFCUB has, apart from the representatives of the RBI and the State Government, those of the UCBs sector as well. The MOU also provides for professionalising the audit and the Reserve Bank's role in improving IT and HR levels in the UCBs.

The combined access to information from local and national level federations of the banks, as also from the regulators and supervisors, has made the TAFCUB effective instruments for consolidating the sector through quick and non-disruptive exit of unviable entities and revival of the viable ones. Recommendations of the TAFCUBs have the consent of all stakeholders including Reserve Bank of India and, therefore, can be implemented speedily by all concerned. In states where TAFCUBs have not yet been constituted, pending signing of MOU, the potentially viable and non-viable banks do not have the benefit of coordinated deliberations on their future set-up, by both regulators/supervisors. In such states, Reserve Bank directly initiates supervisory action as per a graded supervisory action framework, which suggests specific and objective course of action for the banks that are in different stages of weakness. In keeping with the consultative process initiated with the state governments, the

Reserve Bank has sought to extend the arrangement to the UCBs functioning in more than one state, through a MOU with the Central Registrar and enlarging the scope of the TAFCUBs to cover the Scheduled UCBs, which are systemically even more significant. Further, the consultative approach is sought to be extended to the liquidation stage to facilitate early lodging and settlement of insurance claims.

Arsing out of the comfort of coordinated supervision/regulation of banks in the states that have signed the MOU, certain facilities have been extended to the banks in such states. Requests from eligible banks in such states for additional business opportunities, like setting up currency Chests, selling mutual funds, providing forex services, opening of new ATMs etc. are also considered.

Strengthening of regulatory/supervisory framework

The RBI recognized that there is a need to mitigate the risk to which the system is exposed by providing a regulatory and supervisory framework that will appropriately address the problems of the sector as also the shortcomings of dual control. Significant features of the current regulatory/supervisory framework are outlined below.

Dispensing with the one-size-fits-all approach

In order to achieve the objectives set out in the Vision document, Reserve Bank of India is implementing a two-tiered regulatory and supervisory regime. Banks with deposits under Rs.100 crore and whose operations are limited to a single district, are considered to be more closely epitomizing the spirit of cooperative banking and as such are placed under simplified regulations to enable them to gradually gain in strength, such that, over a period of 3 years they can be brought at par with all other banks in term of performance, strength and regulatory prescriptions.

As a step in this direction, recently Reserve Bank of India has allowed the smaller banks to adopt 180 days delinquency norms for classification of assets as non-performing, instead of the 90 days norm which is applicable for the larger cooperative and all commercial banks in India. This is intended to provide a measure of relief to the small UCBs and improve their financial performance through lower Non Performing Advances requiring lower provisioning, which in turn would translate into higher profits that could be used to shore up the capital base of these banks. Incidentally, about a thousand UCBs stand to gain from such differential regulatory regime.

Further, in view of the market risks associated with investments made in Government securities, the smaller UCBs have been given exemption (upto 15 percent of their Net Demand and Time Liabilities) from the prescribed SLR of 25% required to be maintained in the form of government securities, to the extent of funds placed in interest bearing deposits with the public sector banks. Another, regulatory relaxation available to the small banks is in terms of provisioning requirement for 'standard advances' which has recently been enhanced for UCBs from 0.25% to 0.40%, but this enhancement has not been made applicable to banks having deposits below Rs.100 crore and whose operations are confined to a single district.

Supervision through enhanced use of technology

With regard to the mechanism for supervision, the smaller banks, which are limited by their size and type of operations, pose lower systemic risks and therefore it is envisaged that they would be supervised by a combination of simplified off-site surveillance system of the RBI and on-site audit by the state governments. The dependence on off-site surveillance and on-site supervision by state agencies in respect of small (unit) banks, in addition to lowering the supervisory burden of the small entities, would also provide increased flexibility to the RBI to deploy its supervisory resources to the larger and more risky banks.

Emphasis on corporate governance and professionalism

It is being increasingly highlighted that depositors are the most important stakeholders in a bank and therefore inclusion of depositors as shareholders, particularly the large depositors, is an agenda that is being actively pursued independently as also through coordination with state governments. In order to enhance professionalism, Reserve Bank insists on inclusion of at least two professional directors on the board of each bank, which otherwise is essentially an elected body comprising mainly of persons from the field of cooperation rather than banking. In this direction, 'Fit and Proper' criteria for CEOs is also being formulated for implementation through the state governments. Market discipline is gradually being increased through rigorous disclosure norms and initiatives like public disclosure of penal action taken against a bank by the RBI. Also in case of gross violation of RBI guidelines / directives where complicity of a director or of the Board is noticed, Reserve Bank of India approaches the Registrar of Cooperatives of the concerned state for removing the director or even for superceding the entire Board, depending upon the nature of violation. If necessary, RBI also files police complaints for taking criminal action against officials and directors of banks wherever criminal complicity is suspected by the supervisory departments of the RBI. State Governments through the MOU, agree to take immediate action on requisitions of RBI for super session of the Board of Directors or for winding up a bank.

In order to ensure that 'arms length distance' is maintained between the Board and the day-to-day operations of the bank, connected lending in terms of loans to directors, and relatives of directors and to firms in which any director may be 'interested', has been banned in India. Further, as the quality of audit is an important aspect of corporate governance, efforts have been made to ensure that statutory audit of banks is conducted by professionals. As per the MOU, the states agree to conduct statutory audit only through Chartered Accountants in respect of banks with deposits over Rs.25 crore, institute special audit by Chartered Accountants at the behest of RBI and enhance the quality of statutory audit by aligning their system of rating banks with that of Reserve Bank.

Consultative approach to regulation

In order to remain sensitive to developments in the marketplace as also for ensuring better coordination between the agencies entrusted with supervision and regulation of UCBs viz. Central and State Governments and Reserve Bank of India, certain processes and platforms for regular and structured consultation have been established by us. A Standing Advisory Committee comprising senior representatives of Central and state Governments and Federation of UCBs has been constituted, which meets the top and senior management of Reserve Bank once or twice a year and reviews past policies and also gives responses on important policy proposals and other issues of immediate concern. The committee also serves as a platform for the representative of the regulated entities to express their views in respect of any regulatory and supervisory issue. This also enables RBI to get a pulse on all emerging issues of the sector.

Non-disruptive exit route for non-viable banks

The Reserve Bank’s experience with the UCB sector clearly underscored the necessity for providing a non-disruptive exit route for non-viable banks. Accordingly, this aspect has been incorporated in the vision document. TAFCUBs constituted in the states that have signed MOU have been entrusted with the task of identifying potentially viable and non-viable UCBs and suggesting suitable revival path for the former and a non-disruptive exit route for the latter. The exit of non-viable banks would be ideally through merger / amalgamation with stronger banks or conversion into societies that would take deposits only from members without providing cheque facility or ultimately, through liquidation as a last resort.

Merger and consolidation

The consolidation of the sector through the process of merger of weak entities with stronger ones has been set into motion by providing transparent and objective guidelines for granting no-objection to merger proposals as a strategy for providing non-disruptive exit for the weak banks. It also set up a three member Expert Group of outsiders to vet the merger proposals, to provide a transparent mechanism to the process and impartial inputs on such requests. TAFCUBs have representatives of the sector who also provide local level inputs on banks that are on the lookout for taking over other weak banks for expansion of business. The merger process has gathered momentum over the last one year, partly because the stronger banks found this an inorganic growth route.. In all 44 merger proposals have been approved so far, of which no objection certificate has been issued for 23 proposals. Of these, 14 mergers have already materialized.

Liquidation and settlement of depositors' claims

Banks that are identified as non-viable and as having no scope whatsoever for revival by merger etc. are taken into liquidation keeping in view the interest of depositors. In liquidation cases, the Deposit Insurance and Credit Guarantee Corporation (DICGC) expeditiously settle the claims of depositors. However, in certain cases, there is a time lag in settlement of claims mainly on account of delay in submission of the claim list by the liquidators. Other factors which affect timely settlement of claims are audit of claim list by Chartered Accountants, court cases, delay in receipt of liquidation order from the RCS, deficiency in claim list prepared by the liquidators etc. DICGC has put in place follow-up and monitoring measures to mitigate the hardship faced by the depositors on account of such delays and facilitate settlement of claim list of failed banks at the earliest.

Recent initiatives

Apart from drawing up the vision document, signing of MOUs with certain states and constitution of TAFCUBs in those states, the Reserve Bank has initiated several other measures for strengthening Urban Cooperative Banks like exploring avenues for raising capital, upgrading technology and training initiatives, the progress in respect of which is outlined below.

Avenues for UCBs to raise capital

The scope for augmenting the capital of UCBs is limited. The Reserve Bank, therefore, constituted a group comprising representatives of the Bank, State Government and UCB, to study the avenues, methods and scope for increasing the capital of UCBs and imparting greater permanence to it. The group has submitted its report.

The Group has identified four new instruments to enable the UCBs to raise long-term capital/quasi capital funds. These are:

- Unsecured, subordinated, non-convertible redeemable debentures/ bonds,
- Special shares that are non-voting in nature (as opposed to shares with membership rights) which could be issued even at a premium,
- Redeemable cumulative preference shares, and
- Long term subordinated deposits with maturity in excess of 15 years.

The Group has recommended that the funds raised through the special shares which are non-voting in nature (as opposed to shares with membership rights) which could be issued even at a premium may be reckoned for Tier-I capital and the rest for Tier-II capital. None of these instruments would have a put option but could have a call option exercisable by the bank with the prior permission of the Reserve Bank. Exercise of call option/redemption in case of debentures/bonds and special shares would be subject to a lock-in clause of the bank meeting the prescribed Capital to Risk Weighted Assets Ratio at the relevant time.

Since UCBs come under the purview of the Co-operative Societies Act of the State in which they are registered or the Multi-state Co-operative Societies Act (2002), the provisions of which are not similar in certain respects, the Group has suggested necessary amendments to the Acts/Rules framed under them to facilitate issuance of some of the instruments proposed by it.

Technology initiatives

In order to enhance the access to technology for UCBs, Reserve Bank would consider facilitating acquisition of basic hardware and software for conducting routine operations. Further, software has also been developed to enable the UCBs to prepare and submit all returns to Reserve Bank, electronically. The software has been implemented free of cost in the banks and the officials of banks are also being provided adequate training in using the software, which enables banks to maintain a database of returns submitted to the supervisor which in turn acts as a MIS for the UCBs. The stronger UCBs also are members of clearing house and of the Real Time Gross Settlement System.

Skills development/training, including directors and auditors training

To the extent that it does not lead to any conflict of interest, the Reserve Bank of India, in addition to its regulatory and supervisory functions also seeks to play a developmental role for the urban cooperative banks. In this context, in order to improve the skill level of human resources and the technological infrastructure of UCBs, RBI in addition to subsidized programs also provides free of cost training on all important areas of banking operations to the staff and top managements of UCBs through its own training establishments as also through off-shore training programs at regional centers that have a large network of such banks. As mentioned earlier, a software has been developed for banks to help them prepare and submit all the returns to RBI, electronically and the software has been implemented free of cost by RBI, in the banks.

Recent developments

As envisaged in the Vision Document, Reserve Bank approached states having large network of UCBs for signing Memorandum of Understanding (MOU) to ensure greater coordination between RBI and State Government for supervision and regulation of the UCBs. Since June 2005, MOUs have been signed with 8 state governments viz. Andhra Pradesh (124 banks), Gujarat (296 banks), Karnataka (297 banks), Madhya Pradesh (61 banks), Uttranchal (7 banks), Rajasthan (39 banks), Chattisgarh (14 banks) and Goa (6 banks) which together constitute 844 UCBs i.e. over 45 percent of total number of UCBs and account for almost 23% of deposits of the sector.

As mentioned earlier, upon signing of MOU, as per the agreement, RBI constituted State Level Task Force for Urban Co-operative Banks (TAFCUB), which is a six-member body with two representatives each from State Government, UCB sector and Reserve Bank. The TAFCUBs are chaired by the respective Regional Directors of RBI and RCS is the Co-Chairperson. TAFCUBs also have representatives of the sector who provide local level inputs on banks that are on the lookout for taking over other weak banks for expansion of business. As such, the constitution of TAFCUBs and their role in the development of the UCBs in the state on sound lines constitutes a compelling attraction for the state governments to sign the MOU with RBI.

Regional flavour of TAFCUBS

In order to further instil transparency and improve inter regulatory coordination, the MoU signed between RBI and the state government also envisages signing of another MoU between the Registrar of Cooperative Societies of the State and respective Regional Directors of the Reserve Bank. This MOU stipulates the broad measures to be taken by the signatories for implementing the recommendations of the TAFCUB for each of the potentially viable/non-viable UCBs that are placed for consideration of TAFCUB. In the last one-year five TAFCUBs (other TAFCUBs constituted very recently) have deliberated upon and made recommendations on the financial position of about 250 weak UCBs. Based on TAFCUBs recommendations, supervisory actions that have been taken include exiting banks through merger with other UCBs, cancellation of license of unviable UCBs and issue of license to unlicensed cooperative societies.

Gains of 'MOU - TAFCUB' mechanism – empirical evidence

The impact of a consultative platform is reflected in the decline in the number of weak and sick banks in the states which were among the first to sign the MOU and therefore TAFCUBs were constituted the earliest (Table 6).

Table 6

Comparison of Grades as on March 31, 2005 and 2006 in 3 TAFCUB states

State	No. of Banks in Grade –I	No. of Banks in Grade -II	No. of Banks in Grade –III	No. of Banks in Grade –IV	TOTAL
Andhra Pradesh	48 (44)	43 (35)	18 (31)	15 (17)	124 (127)
Gujarat	136 (122)	50 (53)	67 (87)	43 (46)	296 (308)
Karnataka	90 (80)	76 (58)	85 (118)	46 (40)	297 (296)

Figures in parenthesis represent grades as on March 31, 2005

Conclusion

I have traced the evolution of UCBs, their unique structure, strengths and weakness. I have also indicated the multi-pronged approach adopted by RBI to arrest deterioration and strengthen the banks in this sector, including the recent developments. Our initiatives, we hope, would lead to the evolution of the urban cooperative banking system into a strong and vibrant sector with banks that conform to all prudential requirements in the medium term and become at par with the commercial banks in terms of competitiveness and performance. Looking at this large gathering of academics, bankers and other professionals, I am sure my address would have kindled your interest and involvement on the subject. I welcome your views on our approach towards strengthening this important sector of Indian banking.

Thank you.

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