

## R Gandhi: New-gen urban cooperative banks – some musings

Address by Mr R Gandhi, Deputy Governor of the Reserve Bank of India, at the Conference of Urban Co-operative Banks in Gujarat, Ahmedabad, 8 June 2014.

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*Assistance by Shri Sushanta Kumar Kar, General Manager is gratefully acknowledged*

1. Dear Shri Jyotindra Mehta, Chairman, Gujarat Urban Cooperative Banks Federation, Shri V S Das, Director, Centre for Banking Research, Development & Excellence, other dignitaries and delegates. I feel specially privileged to address this Conference of urban co-operative banks, which is very aptly titled “Sahakar Setu-2014” focusing on the theme of “Next-Gen Co-operative Banks”. I am also happy to note that a Centre for Banking Research, Development & Excellence is being set up here as a hub for training and capacity building in the urban banking sector and also to promote research relevant to the functioning of co-operative banks.
2. Talking to all of you in Gujarat is also of very special significance, not only because of the origin and proliferation of cooperative banks here but also it is the birth place of M.K. Gandhi, father of the nation, who propounded the Theory of Trusteeship. Putting it in Gandhiji’s words “Supposing I have come by a fair amount of wealth – either by way of legacy, or by means of trade and industry – I must know that all that wealth does not belong to me; what belongs to me is the right to an honourable livelihood, no better than that enjoyed by millions of others. The rest of my wealth belongs to the community and must be used for the welfare of the community.”
3. If you notice, cooperatives are also based on the same principles of community camaraderie, – mutual help, democratic decision making and open membership. Cooperatives represent a new and alternative approach to organisation as against proprietary firms, partnership firms and joint stock companies, which represent the dominant form of commercial organisation. As you may be aware, cooperatives around the world generally operate according to the seven core principles and values, adopted by the International Co-operative Alliance (ICA) in 1995. Cooperatives trace the roots of these principles to the first modern cooperative founded in Rochdale, England in 1844. The principles cover various aspects of cooperatives beginning from its membership to concern on community.

### Evolution of the urban bank sector

4. Urban Cooperative Banks (UCBs) started in India back in 1889<sup>1</sup> exactly a century and quarter ago here in Gujarat and India has one of the oldest community-banking movements in the world. However, the real growth and proliferation began after this sector was brought under the purview of Banking Regulation Act in 1966. The evolution thereafter may be broadly divided into three phases, Growth phase, crisis phase and Consolidation phase.

### Growth phase (1966–2003)

5. In 1966, there were about 1100 UCBs with deposits and advances of ₹1.67 billion and ₹1.53 billion respectively. Since then there has been phenomenal growth in terms of their numbers, size and scale of operations. The Reserve Bank pursued a liberal licensing policy especially pursuant to the recommendations of the Marathe Committee, which had suggested dispensing the “one-district, one-bank” approach and to shift the stance of the

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<sup>1</sup> Anyonya Sahkari Mandali in Gujarat 1889.

policy to assess the “need and potential” in an area for mobilizing deposits and purveying of credit for a new UCB. In the year 1993, before the liberalisation of bank licensing policy, there were 1311 UCBs having deposits and advances amounting to ₹111.08 billion and ₹87.13 billion, respectively, which increased to 1926 UCBs with deposits and advances of ₹1020.74 billion and ₹649.74 billion, respectively<sup>2</sup> by end-March, 2004. This is because after the liberalisation of licensing norms in May 1993, up to June 2001, 823 bank licences were issued.

### **Crisis phase (2003–2008)**

6. However, it was observed that nearly one-third of these newly licensed UCBs became financially unsound within a short period. RBI, therefore, constituted a screening committee consisting of outside experts in June 2001 to examine the applications for licences. The Committee recommended that it should be made mandatory for all newly proposed UCBs to come through a process of graduation from a co-operative credit society on the strength of demonstrated and verifiable track record.

7. However, in the light of the experience and the prevailing financial health of the UCB sector after the Madhavpura Mercantile Cooperative Bank episode, it was announced in the Annual Policy Statement for the year 2004–05 that the Reserve Bank would consider issuance of fresh licences only after a comprehensive policy on UCBs, including an appropriate legal and regulatory framework for the sector, is put in place and no fresh licences have been issued thereafter for organizing new UCBs.

8. The number of UCBs declined from 1926 as at end-March 2004 to 1770 by end-March 2008. The deposits and advances of urban banks increased only marginally during the same period from ₹1020.74 billion and ₹649.74 billion to ₹1398.71 billion and ₹904.44 billion,<sup>3</sup> respectively, posting an average annual growth of 9% in deposits and 10% in advances.<sup>4</sup>

9. Reserve Bank took several steps to strengthen the sector during this period. Most important among them is the Memoranda of Understanding (MoU) with all State Governments and the Central Government. In order to improve the financial soundness of the UCB sector, Reserve Bank of India entered into Memoranda of Understanding (MoU) with all State Governments and the Central Government since 2005. The MOUs facilitated coordination of regulatory policies and actions through the mechanism of TAFCUBs, a comprehensive set of capacity building initiatives and measures to bring in efficiency through adoption of technology. This phase also ushered in voluntary consolidation in the sector by merger of non-viable UCBs with financially sound and well-managed UCBs.

### **Consolidation phase (2008 onwards)**

10. As a result of the new initiatives and sustained efforts by RBI, the number of financially weak banks in the UCB sector declined and consequently the total number of UCBs declined from 1770 as end-March 2008 to 1606 by end-March 2013. However, the deposits and advances of urban banks increased from ₹1398.71 billion and ₹904.44 billion to ₹2769.41 billion and ₹1809.60 billion, respectively, during the same period.<sup>5</sup> Thus, there was an

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<sup>2</sup> ₹15785 billion and ₹8643 billion, respectively, for scheduled commercial banks.

<sup>3</sup> In 2008 deposits and advances were ₹33201 billion and ₹24770 billion, respectively, for scheduled commercial banks.

<sup>4</sup> The average annual growth in deposits and advances of scheduled commercial banks during the period was 28% and 47% respectively.

<sup>5</sup> In 2013 deposits and advances were ₹74295 billion and ₹58797 billion, respectively, for scheduled commercial banks.

average annual growth of 20 percent<sup>6</sup> in deposits and in advances, which is more than double of the previous phase growth. Further, the number of financially sound<sup>7</sup> banks also increased from 248 as on March 31, 2010 to 684 as on March 31, 2013. Incidentally, mergers of as many as 116 UCBs have been effected till date after 2005.

11. Against this backdrop, with a view to increasing the coverage of banking services amongst local communities, the Malegam Committee was set up in 2010 for studying the advisability of granting new urban co-operative banking licences. After elaborate deliberations, the Committee recommended that UCBs play a useful role and there is need for a greater presence of UCBs in unbanked districts and in centers having population of less than 5 lakh. It is necessary to encourage new entrants to open banks and branches in States and Districts which are unbanked or inadequately banked. It is equally necessary to discourage new entrants from opening branches in Districts and population centers which are already adequately banked. Further, the Committee suggested that the existing well-managed co-operative credit societies meeting certain financial criteria should be given priority for granting licenses. The Committee's recommendations are under examination by RBI.

### **Issues for discussion**

12. As we have observed from the trend and pattern of growth in this sector so far, we have left Madhavpura long behind and moved ahead by fostering organic and inorganic growth. With higher degree of CRAR<sup>8</sup> and less NPAs,<sup>9</sup> the system has more or less stabilized, while the process of consolidation is still on. The first question that rises now is what next. Where do we go from here? Have we reached a plateau where we need to maintain and strengthen the healthy consolidation achieved or should we allow further growth? Given the fact that UCBs are an important segment of the banking system, play a vital role in mobilizing deposits and purveying credit to the people of small means thereby enhancing financial inclusion and facilitate payment and settlement, it will only be appropriate to support their growth and proliferation further.

13. That brings us to the second question. If we allow further growth, in what form should that be? It again can be addressed in two ways. We either allow them to grow in the existing set up or UCBs above a certain threshold may assume a new corporate identity.

14. As an implication of this, for large UCBs who have reached certain threshold in the size and complexity of business, enabling their graduation into commercial banks can be thought of, so that their further growth is facilitated. It is important to mention here that once cooperative banks reach a certain threshold level, they are also expected to follow a regimen like large banks and standardized global practices, which may not be possible within the existing legal structure of cooperative banks. Thus, before we move forward, the existing legal and regulatory framework need to be revisited to enable smooth transition. Specifically, we need to debate the needed legal framework that will facilitate conversion of cooperatives into joint stock companies, conversion of deposit holders into shareholders etc.

15. The other alternative could be to allow the UCBs to grow and sustain themselves in the existing set-up. In that event, the obvious question that comes to mind is what are the existing restrictions that can be liberalised and what further measures can be envisaged for

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<sup>6</sup> Around 25% average annual growth in deposits and advances for the scheduled commercial banks.

<sup>7</sup> Broadly defined at CRAR of 10%, net profit for last three years, Gross NPA<7% and Net NPA≤3%.

<sup>8</sup> 88.2 per cent of the total UCBs have reported a CRAR of 9 per cent or more as on March 31, 2013.

<sup>9</sup> The gross and net NPA ratios as on March 31, 2013 stood at 6.0 per cent and 1.4 per cent respectively.

the smooth non – disruptive growth of the sector? I hope the delegates will deliberate on these issues and suggest possible measures.

### **The next phase – next generation cooperative banks**

16. Since the theme of the Seminar is “Next-Gen Co-operative Banks” let me now briefly dwell on the subject. To begin with let us analyse some of the best global practices in cooperative banking and their implications for next-gen cooperative banks in India, before moving forward to what is our expectation from these banks.

#### ***European co-operative business model***

17. As you may be aware, the co-operative banking sector contributes significantly to the growth, stability and competitiveness of the European banking industry at a local and regional level. Ordinary citizens can become members / owners of co-operative banks with relatively small investments. As a result, they have a direct say in the business and are involved in the governance, strategy and risk management processes. The core business of co-operative banks is value creation for their members and a long term relationship of trust, opposed to the profit maximization approach of mainstream banks.

18. It is worth mentioning that their performance is a result of their central focus on retail banking, solid capitalisation and their high-quality credit portfolios. In fact, in Italy, France, Germany and Netherlands where co-operative banks’ market share in loans range between 25% and 45%, SMEs represent between 20% and 50% of the total client portfolio of co-operative banks. They are able to face the challenges of the new post crisis environment because their business model responds to the present needs and expectations.

19. Further, across Europe, Cooperative banks exceed the minimum legal capital ratio requirement of 8%, with an average ratio of about 9%. Credit ratings reflect this very well, ranging between AA and AAA for the largest co-operative banking groups in Western Europe.

20. With their roots in the Europe, the Rabobank Group, DZ Bank Group, Credit Agricole Group, etc have grown in recent decades into an international financial services provider that has activities in the field of banking, asset management, leasing, insurance and real estate. The strong points of the cooperative structure became evident during the financial crises of recent years. They did not have to ask for state aid and were able to keep financial results well up to standard. Measured according to Tier 1 capital, these Groups are the world’s largest financial institutions. All rating agencies continue to give them high ratings.

21. Their cooperative identity stems back to the early twentieth century. The local member cooperatives continue to be the collective owner of these groups to this day. The groups support the member cooperatives and oversee the subsidiaries and affiliated companies. The members not only benefit from banking and non-banking advantages, they also have the opportunity to join in the discussion and co-decide on the bank’s course. Local member banks serve millions of retail and wholesale customers with a comprehensive range of financial services. The groups are leaders in nearly all customer and product segments, from youth to start-ups and from mortgages to corporate enterprises.

22. I feel Indian cooperative banks can gain from the business matrix of their European counterparts to cope up with the competition and pressure from bigger commercial banks and maximize value creation while not undermining the importance of solid capitalization and high-quality credit portfolio.

#### ***Asian cooperative business models***

23. If we look eastward, we observe a considerably large presence of co-operatives in Asia Pacific also. In Asia-Pacific alone there were 22,212 credit unions in 2012 which were more than double of the 10,051 figure of North America and Europe put together. In terms of the

underlining focus also, it is observed that the co-operatives in Asia were basically formed to bring about socio-economic development, particularly with respect to agriculture and rural development.

24. In Asia itself, there have been many success stories to emulate. An exemplary initiative which the Co-operative Development Authority (CDA) of the Philippines has taken is the launch of the Co-operative Information System. The CDA in association with the US Agency for International Development and another technology partner developed this web-based database of co-operatives, to be accessed in real-time at any of the CDA's extension counters. The information on each cooperative's annual organizational and financial status through the Co-operative Annual Performance Report is also integrated with this database, thereby providing a platform for the co-operatives to exchange information readily. Further and more importantly, the main aim of the system is to help the Government in creating performance standards, policies, regulations and development programmes for the overall benefit of the sector. Perhaps, the creation of such technology information system will also help our cooperative sector by providing a platform to them to exchange information readily for performance oriented and integrated development.

### ***Cooperativeness among cooperative banks***

25. Cooperatives also need cooperation among themselves to support and promote their growth and expansion. As you might be aware, the V.S. Das Working Group constituted by RBI to study these umbrella organization of cooperative banks internationally found that there are two broad approaches in this regard.

26. In European countries, the Umbrella Organization is generally in the form of a strong apex level entity. All the local cooperative banks are generally members of the apex entity. Each member exercises its voting rights under the "one member one vote" principle. The apex entity supports and advises the individual member banks in areas such as customer services, ALM, IT, Mutual Funds, product development, etc.

27. In the case of Australia, USA and, Canada, the Umbrella Organization is not part of any group, but is a distinct entity where the credit unions are its members. In US there is an "Umbrella" of Umbrella Organizations. The Umbrella Organization in US provides extensive investment, liquidity, and cash-management products and services; risk-management and analytic capabilities; settlement, funds transfer and payment services; and safekeeping and custody services. However, in Australia the emphasis has been on payment clearing services and emergency liquidity support.

28. These organizations are serving the sector well and have not only resulted in greater efficiency of operations of their members at the grassroots, but have also contributed significantly in augmenting financial stability and safeguarding depositors' interests. This has given comfort to the regulators. Notably, in Australia all credit unions adhere to the Basle II norms and their average CRAR is 16 percent.

29. It is in this context I will like to touch upon the need for an umbrella organization for the UCB sector in India that will be the beginning of the next part of my address, viz., our expectation from the next-gen UCB sector in India.

### **Expectation from next-gen UCBs**

#### ***Umbrella organisation for UCBs in India***

30. UCB sector in India needs to have the benefit of an Umbrella Organization of its own customized to the legal framework in India and the challenges of the sector. In India only scheduled UCBs have direct access to liquidity support from RBI in the form of refinance. Other UCBs are dependent on District Cooperative Banks / State Cooperative Banks for their liquidity needs. Some District Cooperative Banks / State Cooperative Banks are themselves

financially not well. There is also a need to provide the management, IT and training and other services which the UCB sector needs.

31. For our UCB sector, the V S Das Group had recommended the requirements of the provision of payment and settlement services; the provision of other services, which are mainly in the region of management or outsourced services; the provision of liquidity support through state level schemes; and the provision of solvency support through state level schemes. The Group further recommended that there should be two separate Umbrella Organizations. First one is a national level organization which provides payment and settlement services and other services as also liquidity support to its members. The second could be state level organizations or outside agencies, which provide the management, IT and training and other services.

32. The proposals are being examined by RBI in consultation with urban bank federations and other stake holders. In this context, I feel that the Centre for Banking Research, Development & Excellence that is being set up here as a hub for training and capacity building in the UCB sector is a good initiative in that direction.

### ***Technology-savvy UCBs***

33. It is heartening to note that leveraging on technology is being taken up for discussion in this Conference. In today's technology driven world, one cannot ignore the role of technology in providing competitive banking services and all UCBs must exhibit the keenness to adopt technology in a time-bound framework. Presently, only 32% (510 out of 1589 as on March, 2014) of UCBs have adopted Core Banking Solution (CBS). Delay in adopting technology has resulted in UCBs losing their customers to commercial banks. They also become vulnerable to frauds due to use of applications that are outdated or lacking security features, etc. Also manual book-keeping system has led to arrears in reconciliation of accounts and made them vulnerable to frauds.

34. RBI has advised UCBs to adopt CBS in a graduated framework: large UCBs by Dec 31, 2013, tier I banks by June 30, 2014 and unit banks by Dec 31, 2014. In future, Reserve Bank will definitely look forward to more technology-savvy UCBs competing with commercial banks for customer spaces.

### ***Cooperative character of UCBs***

35. Apart from the cooperativeness among cooperative banks, the next issue to ponder over is the cooperativeness inside a cooperative bank. We observe that over the years, many UCBs have lost their cooperative character and have been reduced to almost family run institutions. To ensure cooperative membership, RBI has prescribed that the proportion of borrowing nominal members should be limited to 20% of regular members. Some large multi-state UCBs have aligned their business models and goals with those of commercial banks while availing the concessions to the sector.

36. In this context, a study was undertaken by the RBI on cooperativeness of cooperative banks. The study found that the cooperative business model has withstood the test of times in several countries in the world and also weathered the recent financial crisis in the most non-disruptive manner while commercial entities have struggled to stay afloat. What has seen them through is the cooperativeness in their character, which is somehow getting diluted in the Indian UCBs. The assessment of the study establishes that "Cooperativeness of Cooperative banks" in India is on the decline.

37. RBI, therefore, conducted a Seminar on this subject in September last year to sensitize the cooperative banks on this crucial issue. Some of the steps to enhance the cooperativeness in UCBs in India could be increasing member awareness to strengthen the democratic character, focus on member education and rekindle members' interest in the principles of cooperation. Steps can be also taken to increase in the quorum requirement for

Annual General Body meetings, make provision of electronic and secure remote voting facility and cap the tenure/term of the Directors of UCBs in the Board.

### **Strengthening capital standards**

38. In today's globalised world it is difficult to insulate our institutions from the best global regulatory practices.

39. In India UCBs can raise capital only from their members. Recognising this limitation, RBI has prescribed share-linking to borrowing. The matter was further examined by a Working Group appointed by RBI and based on their recommendations. UCBs were permitted in 2008 to raise capital through innovative instruments like Perpetual Non-Cumulative/Cumulative and Redeemable Preference Shares as also Long Term (Subordinated) Deposits. RBI has issued several guidelines for financial restructuring of less capitalised UCBs such as conversion of deposits into equity, guidelines for merger including that with DICGC support, guidelines for transfer of asset & liabilities of weak UCBs to commercial Banks with DICGC support, etc.

40. Reserve Bank of India has adopted a calibrated and gradual approach towards application of Basel standards for various regulated entities keeping in view their systemic importance and availability of skill sets. As of now, UCBs have been subjected to Basel I requirements for computation of capital. Certain elements of market risk management have been made applicable for bigger UCBs conducting forex transactions.

41. However, it may be worth mentioning in this context that keeping in view the risk management structure of cooperative banks, internationally Basel II norms are applicable for Co-operative banks in many of the advanced countries. Although in view of the heterogeneity in size and sophistication of Indian UCBs RBI has taken a considered view, the next-gen banks must gear up for adopting global best practices in prudential regulations.

### **Role of financial inclusion by UCBs**

42. Our next issue for deliberation could be the important expectation from Government, RBI and people in general from the banks, i.e. promoting financial inclusion. I am happy to note that this issue is also included for discussion in this Conference. The organizational structure, local clientele and easy access are UCBs' strengths in this regard. RBI has taken a number of measures in this direction for UCBs by prescribing introduction of No-frills account with nil or low minimum balance, relaxation of Know Your Customer (KYC) requirements for small accounts, liberalising norms for opening of new branches and off-site ATMs and permitting use of Business Correspondents (BCs) and Business Facilitators (BFs), etc.

43. UCBs are, to some extent, already into financial inclusion as their client profile mainly consists of priority sector segments viz. small business establishments, SSI, retail traders, self-employed etc., who do not get easy access to commercial banks. There still remains, however, a huge hidden potential to be tapped, given the large number of small urban co-operative banks.<sup>10</sup> UCBs need to capitalise on their advantage and reap the business opportunity. In semi-urban and rural areas, there are a number of unbanked and under-banked districts inhabited by people like artisans, migrant labour, small businessmen and retailers, etc. These people find it difficult to join the formal financial sector. UCBs can take a lead in bringing these people into the ambit of banking.

44. UCBs should re-design their business model in this regard and integrate their financial inclusion plan into their annual business plans. UCBs should give wide publicity to their

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<sup>10</sup> Out of total 1589 banks as on date 1167 are Tier 1 banks, i.e., deposits below ₹100 crore.

services to connect with large population segments. It is also important that the service provided should be at an affordable cost and here technology will play a big role.

### **Corporate governance and management structure**

45. Before I conclude let me touch on the final issue of importance in the next-gen UCBs that is corporate governance. The concept of corporate governance is not much different than the internationally accepted principles of co-operation. One of the cardinal principles of co-operation as accepted by International Co-operative Alliance (ICA) is “member economic participation” indicating contributing equitably to, and controlling democratically, the capital of co-operative by the members.

46. Many of the problems faced by the UCBs are due to governance issues and lack of professionalism.

47. RBI has also prescribed that at least two directors with suitable banking experience or with relevant professional qualification in the fields of law, accountancy or finance are co-opted on the Board. The Malegam Committee has even recommended creation of a professional Board of Management structure in between the Board of Directors and the CEO as a pre-condition for licensing of new urban co-operative banks. However, there are still many governance gaps that need to be addressed for the UCBs of future. There can hardly be a debate on the desirability of a higher degree of professionalism in the governance structure of co-operative institutions. We will like to look forward to having a highly efficient and professional management structure in next-gen cooperative banks.

48. Another issue with regard to governance is that today it is typical of our cooperative banks where the creditors have a big say in the governance; depositors have very little stake and they need to be empowered appropriately. This will ensure that they have a direct bearing on how well their moneys are managed.

### **Conclusion**

49. I am sure all these issues are being addressed by the distinguished panelists and participants during this two-day conference which has technical sessions in the form of panel discussions on important topics relevant to this theme and other important issues. I sincerely thank the Conference organizers for their efforts and wish this Conference all success.

50. I thank all of you for your patient attention.

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