R Gandhi: Future and new thoughts on co-operative banks

Speech by Mr R Gandhi, Deputy Governor of the Reserve Bank of India, at the Silver Jubilee celebrations of the National Institute for Rural Banking (NIRB), Bengaluru, 19 June 2015.

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Assistance provided by Mr P K Arora is gratefully acknowledged.

The co-operative movement in India is more than a century old; regulation thereof is also more than a century old with the first major impetus provided by the passage of the Co-operative Society Act in 1904. The co-operatives have come a long way and have seen many ups and downs since then; they have played the original role in financial inclusion and taking care of banking and credit needs of the lower and middle strata of society, in the length and breadth of India, more specifically even in the remote villages.

I. Looking back

2. Traditionally, the co-operative structure is divided into two parts viz. rural and urban. The three tier Short Term Cooperative Credit Structure (STCCS) consists of more than 90,000 Primary Agricultural Credit Societies (PACS), 367 District Central Cooperative Banks (DCCBs) and 33 State Cooperative Banks (StCBs) whereas the urban side is dotted with 1579 Urban Cooperative Banks (UCBs). Even with such a large number of co-operative banks, considering the total asset size, their share in the Indian banking sector is not more than 5%. Thus, it may be observed that the true potential has not been achieved by co-operative banks. Let me elaborate some important recent reasons for this.

Reluctance for technology adoption

3. In today's technology driven world, one cannot ignore the role of technology in providing competitive banking services. However, reluctance of co-operatives to adopt new technology and implement CBS system has proved to be a major impediment to their growth.

4. UCBs were prescribed a staggered timeline for the implementation of CBS with December 2014 as the final deadline. However, only 913 UCBs are fully CBS compliant and 330 UCBs are in the process of implementing CBS. Further, 336 UCBs are yet to start the process of implementation. Based on the requests received from UCBs, RBI has also taken up the matter with IDRBT to prescribe some uniform minimum benchmarks for the CBS and some cloud-based solution could be worked out which is cost effective yet reliable to smaller UCBs.

5. As regards rural co-operatives, NABARD, as part of its mandate of institutional development, launched an ambitious yet much needed attempt to bring the RCBs on CBS platform. In all, 201 banks (DCCBs / StCBs) joined the project with as many as 6953 branches already on CBS platform. Outside NABARD project, 177 banks out of 178 licenced cooperative banks have completed implementation of CBS. But much more is definitely needed to be accomplished.

Decline in co-operative character

6. The co-operative character of co-operative banks is on the wane as was evident from a recent study conducted by CAB, Pune. The study pointed to low attendance in AGMs, restrictive practices in admitting new members, low voting turnout for election of new management, re-election of the same management or their family members, unanimous elections, lack of meaningful discussions in AGMs, etc. Thus, it was observed that the co-operatives especially UCBs are losing their cooperative character. In the process, some of them have become 'too big to be a cooperative'. To keep the spirit of democracy alive, urgent steps need to be taken by the institutions themselves to keep co-operatives relevant to their members.

Lack of professionalism and corporate governance

7. Weak corporate governance has been one of the major factors that is plaguing the sector and has led to bank failures / unsatisfactory growth of the sector. Co-operation being a State subject, RBI does not have adequate control on the management of these banks. The provisions of Section 10A of the B. R. Act, 1949 are not applicable to them. The criteria for CEO / Board members as envisaged in Section 10B of the Act are also not prescribed.

8. To address this problem, Malegam Committee had suggested a new organizational structure for UCBs consisting of a Board of Management, in addition to the Board of Directors. The idea was segregation of the ownership of a UCB as a co-operative society from its functioning as a bank. While the Registrar of Co-operative Societies would continue to exercise control and regulation of the UCB as a co-operative society, RBI would exercise control and regulation on its function as a bank. The Committee recommended that it should be made as a licensing condition for a UCB.

9. Pursuant to the recommendations of the High Power Committee on Urban Co-operative Banks constituted by the RBI in 2001, presence of atleast two professional directors on the board of UCBs was made mandatory. It is also made one of the enabling conditions for co-operatives to be termed as Financially Sound and Well Managed (FSWM). However, it is observed that 111 UCBs are still not having professional directors on their Board which has a negative bearing on their overall performance. The Constitution (97th Amendment) Act 2011 has tried to impart some professionalization to the Board of co-operative banks but professional management on the lines of commercial banks remains a far cry in the current set-up.

II. Current issues

Transition to niche or universal commercial banks

10. RBI had come out with a discussion paper on "Banking Structure in India – The Way Forward" in August 2013. The paper envisaged four tier banking structure consisting of International Banks at Tier I, National Banks at Tier II, Regional Banks at Tier III and Local Banks at Tier IV. The paper has brought to the fore a case for re-orienting the existing banking structure to make it more dynamic and amenable to meet the needs of the economy and had suggested basic building blocks of the re-orientation exercise which inter alia included setting up of specialized / differentiated banks and conversion of Urban Co-operative Banks which meet the necessary criteria into commercial banks or Local Area Banks / small banks. Thus, the paper identifies the need of co-operative banks in the lowest tier in serving the needs of the community.

11. RBI has already come out with the guidelines for Small Finance Banks and Payments Banks. As per the guidelines, Small Finance Banks (SFBs) shall primarily undertake basic banking activities of acceptance of deposits and lending to unserved and underserved sections including small business units, small and marginal farmers, micro and small industries and unorganised sector entities, distribution of mutual fund units, insurance products, pension products, become an AD Category II dealer, etc. The annual branch expansion plans should be in compliance with the requirement of opening at least 25 per cent of its branches in unbanked rural centres and the area of operation of small finance banks would be the whole Union of India.

12. UCBs in contrast have a limited area of operation and can extend their area of operation with the prior approval of RBI and open branches anywhere in their area of operation without any limit on the number of branches to be opened in a particular area. UCBs in addition to the services permitted for SFBs are also permitted to open specialized branches, undertake intra-day short selling in secondary market transactions in government securities, undertake ready forward contracts in corporate debt securities, open currency chests, access Liquidity Adjustment Facility (LAF), membership to NDS-OM, engage the services of Business

Correspondents (BC) / Business Facilitators (BF), act as PAN service agents and issuer of Pre-paid payment instruments, trading facility to demat account holders, mobile banking, access to centralized payment systems like RTGS, NEFT, etc. Thus, it may be observed that co-operatives provide universal banking services in a niche geographical area whereas small banks are mandated to provide niche services throughout India.

13. It will be interesting to see as to how UCBs react to the opportunity provided to them. Whether they would continue as existing banks or convert themselves to universal banks with ability to offer every possible product to customers albeit at a cost of tighter supervision and compliance to more stringent Basel II and III norms or give up their universal character and offer only niche products by converting to SFBs.

14. Rural cooperative banks are differentiated entities in terms of their structure, capital funding and mandate to cater to the credit needs of small and marginal farmers and rural artisans. These banks have access to refinance facilities from NABARD and interest subvention for agricultural loans from the respective State Governments in order to increase / maintain flow of agricultural credit. In pursuit of public policy, several social welfare schemes of State Governments are channelized through these institutions. It can be said that rural cooperatives are also functioning as ‘niche’ banks with limited area of operation catering to the local clientele.

Increased competition from SFBs and payment banks

15. The mandate of SFBs to serve the unserved and underserved sections make them natural direct competitors of the co-operative banks. The major advantage that the co-operatives currently have is their deep-rooted connections with specific communities and people of lower strata which keeps them in good stead compared to SFBs for mobilization of low cost deposits which are a prerequisite for profitable business. Being local in nature and intricately interwoven with the local community, the co-operatives have a clear advantage over the proposed SFBs. It is easier for them to create trust among its target community and bring customers within their fold. Even though cooperative banks’ share in total agricultural and urban credit has come down over the years in terms of amount, they are the leaders in terms of the number of small-ticket loans which commercial banks hesitate to take up on account of high cost of servicing small value accounts.

16. However, SFBs and payments banks with reliance on high-end technology can pose significant challenges to cooperative banks. Payments banks sponsored by telecom companies can easily capture the remittance business from these banks. Co-operative banks have to substantially alter their approach to protect their turf from this competition onslaught.

Relevance of co-operative banks

17. With still a sizable population remaining without access to formal institutional finance, the issue of financial inclusion has taken a whole new meaning in this 21st century. Financial inclusion is not only about credit, but involves providing a wide range of financial services, including saving accounts, insurance, and remittance products. Co-operative banks with their peculiar character of local feel and democratic set-up are automatically placed at the centre of any meaningful financial inclusion drive. Ensuring the last mile connectivity will only help these banks to sustain their business. However, for these to happen, co-operative banks need to focus on corporate governance and imbibe the current distributive technology to offer low cost products and turn the tide in their favour against the likely onslaught of competition from small finance and payments banks.

Position of unlicensed DCCBs

18. As there were many unlicensed cooperative banks operating in the country, the Committee on Financial Sector Assessment (CFSA) (Chairman: Dr. Rakesh Mohan) had recommended

that no unlicensed cooperative bank may be allowed to operate in cooperative space beyond 31 March 2012.

19. As on March 31, 2009, there were 31 State Cooperative Banks (StCBs) and 371 District Central Cooperative Banks (DCCBs) functioning as part of short-term cooperative credit structure. Out of these, 313 banks (StCBs-17 and DCCBs-296) were unlicensed. The Reserve Bank of India in pursuit of its commitment to allow only licensed cooperative banks to do banking business in India relaxed the licensing parameters that enabled 290 cooperative banks (StCBs / DCCBs) to get banking license from RBI. Only 23 banks remained unlicensed as on date in four States viz. (Uttar Pradesh –16, Jammu & Kashmir – 3, Maharashtra – 3, and West Bengal – 1).

20. Regulatory action was initiated by RBI against unlicensed banks by issuing directions to them prohibiting from acceptance of fresh deposits in May 2012, and show-cause notices were issued for rejection of their applications for grant of license in March 2013. Further, Speaking orders were issued to four banks in May 2014 rejecting their license applications and requisitions were made to the RCS for appointment of Liquidators.

21. Present Status of revival of 23 unlicensed banks – Financial Package by PMO

i. The Union Cabinet in its meeting held on November 5, 2014 approved a financial package for the revival of the 23 unlicensed DCCBs. Total capital infusion required was estimated at ₹ 2375.42 crore, comprising GOI Share – ₹ 673.29 crore, State Government's share – ₹ 1464.59 crore and NABARD's share – ₹ 237.54 crore.

ii. For the purpose of implementation of the Scheme, a tripartite agreement in the form of Memorandum of Understanding (MoU), stipulating the conditionalities and deliverables was to be signed by Government of India, concerned State Governments and NABARD. The MOU has been finalized in consultations with RBI. Government of India and all the four State Governments and NABARD had signed the MoU.

iii. GOI had released its share of funds to three States viz. Uttar Pradesh (₹ 401.17 crore), Maharashtra (₹ 129.70 crore) and West Bengal (₹ 31.20 crore). While, the State Governments of Maharashtra and West Bengal have released their share to the DCCBs fully, the Uttar Pradesh Government has released its share partially. As against the total amount of ₹ 1074.57 crore to be released for 16 DCCBs, Uttar Pradesh Government has released ₹ 610.00 crore to 11 DCCBs (10 DCCBs fully and one DCCB partially), because of budgetary constraints for the financial year 2014–15. The Jammu & Kashmir Government had signed the MoU on March 31, 2015 and the Central Government is yet to release the funds.

22. After getting NABARD's recommendations that the bank has attained the licensing norms, RBI would consider issuing of license to the banks and Directions would be withdrawn, subject to final order of the court.

Status of negative net-worth DCCBs

23. As per the latest data made available by NABARD, besides 23 unlicensed DCCBs, two licensed DCCBs in Karnataka viz. (i) Kolar-Chikballarpur DCCB [(-) ₹ 2.60 crore] and Shimoga DCCB [(-) ₹ 10.43 crore] were having negative networth as on March 31, 2014. We have advised NABARD to take up the matter with the State Government / RCS to take suitable measures for recapitalisation of the banks so as to ensure that the banks achieve a minimum CRAR of at least 7% by March 31, 2015. We have also taken up with the Chief Secretary, Karnataka State Government and RCS of the State to initiate steps for recapitalization of these banks.

III. Way forward

24. Considering the inherent challenges in the sector, it is required to put in place measures for the long term health of the sector. Earlier, RBI was not able to take coordinated action as it could have destabilized the sector. The sector has shown considerable improvement today and time, is perhaps, ripe to strengthen the framework to a level of regulatory comfort. It is possible of getting co-operative banks to move towards regulatory capital requirements over a period of time by nudging capital compliance towards industry standards based on a practical timeline. Further, in the context of changing landscape, a view needs to be taken whether a fresh round of co-operative bank licensing is due and put in place a definite migration path for FSWM co-operatives to make the transition to SFBs / commercial banks and at the same time continue efforts relating to governance reforms.

25. It is pertinent to examine the merit and possibility of amending Cooperative Acts in states to the effect the provisions requiring every borrower having a voting share do not weaken the UCBs; you all will recall that such provisions have led to an anomalous situation where borrowers, who create the risk, control the bank and the depositors who bear the risk don’t.

26. The possibility of acquiring shares by members at the book value at the time of entry and divest the shares at the book value at time of exit also needs to be examined, the purpose of the exercise would be to create appropriate incentives so that members get the benefit or otherwise of the reserves that are built during their membership.

IV. Conclusion

27. Cooperative banks are unique in terms of their structure, clientele and credit delivery. The resilience and stability shown by these banks during the recent global financial crisis has underscored their importance in the financial system of both developed and emerging market economies. Despite their inherent weaknesses in terms of low capital, poor management and intrusive policies of State, cooperative banks in India have successfully weathered several challenges during their century old existence and continued to grow in the competitive environment which emerged following the Economic and Financial Sector Reforms initiated in 1991. RBI has initiated several policy measures to strengthen the cooperative banking sector by gradually introducing the prudential norms and regulatory prescriptions on par with commercial banks. It is heartening to see that cooperative banks are showing keen interest in diversifying their business and broad-basing their clientele. One can hope that changes in the existing legal framework, supportive regulatory environment, adoption of technology and re-orientation of business strategy can act as enablers for cooperative banks to contribute more meaningfully in the equitable economic growth across regions through their delivery model.

28. Thank you all for your patient listening.