R Gandhi: Whither the co-operative banking?

Speech by Mr R Gandhi, Deputy Governor of the Reserve Bank of India, at the Maharashtra Urban Co-operative Banks' Conference 2015, Nagpur, 24 October 2015.

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Dear Co-operators,

1. I am thankful to the Maharashtra State Urban Co-operative Banks' Federation for inviting me to this Seminar. The topic chosen for the Seminar is very contemporary. While I will certainly make a few points about it later, I would like to first discuss the current status of the urban co-operative banking in India, how it reached there, what recent initiatives the Reserve Bank has taken to strengthen the sector and what is the way forward.

2. The organisation of co-operative institutions in India dates back to 19th century when the first mutual aid society "Anyonya Sahakari Mandali" was formed in Gujarat at Baroda on February 05, 1889.

3. The Banking Regulation Act, 1949 was extended to co-operative societies on March 01, 1966 when there were about 1100 UCBs with deposits and advances of ₹ 1.67 billion and ₹ 1.53 billion respectively. As at the end of 1996, the number of UCBs increased to 1501 and their deposits and advances rose to ₹ 241.61 billion and ₹ 179.27 billion respectively. With the liberalisation of bank licensing policy, UCBs continued to grow at a fast pace till 2004 when their numbers increased to 1926 and their deposits and advances to ₹ 1020.74 billion and ₹ 649.74 billion respectively.

Madhavpura crisis

4. Very few regulated entities have the distinction of shaping an entire sector and generally it is in a positive sense; but sometimes in a negative sense. As destiny would have it, the Madhavpura Mercantile Co-operative Bank Ltd. has the dubious distinction in that regard.

5. The entire episode turned to be a watershed event in the history of urban Co-operative banking sector and the crisis led to decline in public confidence in the UCB sector as evident from the deceleration of the credit and deposit growth rate from 2003 to 2005 and the existence of large number of weak UCBs. As on March 31, 2004, 732 out of 1926 UCBs i.e. 38% were categorized in Grade III or IV signifying weakness and sickness. This forced the Reserve Bank to look at the sector differently and new regulations had to be prescribed.

6. Some of the major changes were compliance with CRAR prescription in phases, complete prohibition / ban on loans and advances to directors and their relatives, prescription of Interbank limits, imposition of restrictions on capital market exposure, increase in quantum of investment in G-Sec for SLR purpose and prescription of limit for single broker exposure.

7. It was also observed that nearly one third of the newly licensed UCBs became financially unsound within a short period. In view of this it was announced in the monetary policy statement for 2004–05 that no fresh proposals for setting up of new Urban Co-operative Bank (UCB) or for conversion of Co-operative Credit Societies into UCBs will be considered till a comprehensive policy on UCBs, including an appropriate legal and regulatory framework for the urban co-operative banking sector is put in place and a policy for improving the financial health of the urban co-operative banking sector is formulated. Further, embargo was also placed on issuance of new branch licenses for the UCBs.

Vision document

8. A vision document for the UCB sector was drawn up by RBI in 2005 which envisaged that state specific strategy would be adopted to deal with the UCBs.

Business growth

9. The UCB sector emerged financially stronger ever since RBI conceived the Vision document for the sector in 2005. The Vision Document envisaged a multi-layered regulatory and supervisory approach, revival of potentially viable UCBs and non-disruptive exit of non-viable ones. The sector witnessed a process of rehabilitation and consolidation. There has been a continued reduction in the number of UCBs from 1872 as at the end of March 2005 to 1579 as at the end of March 2015,inter alia, due to amalgamation of UCBs. The sector accounted for 3.9% of the deposits of the banking sector and 3.3% of the advances by the banking sector as on March 31, 2015.

10. During this period, while the number of UCBs were coming down, the business that all the UCBs recorded went on increasing. The number of UCBs declined in 2006 to 1853 with total deposits of ₹ 1122.37 billion and advances of ₹ 703.79 billion. The number of UCBs further declined to 1579 as on March 31, 2015 although there is absolute increase in deposits and advances at ₹ 3551.34 billion and ₹ 2243.08 billion respectively as at March 31, 2015.

11. Asset quality of the sector has steadily improved as reflected in the continuous decline in the gross NPAs ratio from 21% as on March 2003 to 6.02% as on March 2015. The gross NPAs are still very high as compared with commercial banks which have Gross NPAs at 4.62% as on March 31, 2015.

12. The profitability of the UCB sector, too, has shown remarkable improvement as net profit increased to ₹ 34.89 billion during the financial year 2014–15. Return on Assets (RoA) has increased to 0.84% in 2015 and Return on Equity (RoE) has increased to 9.85% in 2015. As regards capital adequacy, it is observed that 1503 UCBs i.e. 95.18% of the total UCBs have reported a CRAR of 9 per cent or more as on March 2015.

13. The sector, however, continues to be afflicted with the existence of 48 UCBs which are having negative net worth and 29 UCBs under All Inclusive Directions, as on date.

Expert Committee on licensing of new UCBs

14. Having satisfied with the stability achieved in the sector, an expert committee was set-up under the chairmanship of Shri Y. H. Malegam in 2010 for studying the advisability of granting licenses to new co-operative banks. The Committee recommended that new licenses may be given to UCBs having a good track record in relatively unbanked areas. It also recommended grant of licence to existing co-operative credit societies with proven track record. It observed that there is a need for clearly defined control system where co-operative character of a UCB is controlled by RCS / CRCS and the banking function by RBI for overcoming the problem of dual control and recommended the creation of a Board of Management (BoM) in addition to Board of Directors (BoD). It also recommended creation of Umbrella organization at both national and state level for the urban Co-operative banking sector.

15. RBI's main objective of regulation and supervision has been to maintain confidence in the financial system by enhancing its soundness and efficiency. I would now like to specifically highlight the steps taken by RBI for development of the sector and for strengthening the regulation and supervision in the recent past.

Recent developments

Steps taken for development of the sector and augmenting the fee based income

16. Introduction of Liquidity Adjustment Facility for scheduled UCBs, permission to offer internet (view only) facility to all UCBs, enhancement of limit under the scheme of bullet payment of gold loans from ₹ 1.00 lakh to ₹ 2.00 lakh, permission to offer Demat account trading facility and liberalization of opening of off-site ATM are some of the steps taken by RBI to strengthen the sector.

17. More avenues have been provided for UCBs to earn fee based income. Accordingly, UCBs are now allowed to undertake Point of Presence (PoP) Services under Pension Fund Regulatory and Development Authority (PFRDA), act as PAN Service Agent (PSA) for providing PAN Issuance Services to its Customers and issue "Semi-Closed Pre-paid Payment Instruments" permitting payment of utility bill / essential services up to a limit of ₹ 10,000/-

18. RBI has been conducting seminars / workshops / focused training sessions for directors / officers / staff of UCBs. This is an on-going exercise and our goal is to ensure that all Directors are covered under the training programme at the earliest.

19. It was decided to make it mandatory to conduct the statutory audit of UCBs with a deposit base of above ₹ 250 million by Statutory Auditors (SAs) who will be qualified Chartered Accountants. However, it was observed that there were large divergences between the audited financial parameters of UCBs and that assessed by Inspecting Officers. As statutory audit is one of the important inputs based on which on-site supervision is conducted, it is imperative to improve and strengthen the quality of reports of SAs. It has therefore been decided to hold workshops / seminars for SAs to sensitize them with IRAC norms issued by RBI. Institute of Chartered Accountants of India (ICAI) is also being advised to prescribe a standard format for statutory audit report of the UCBs.

Steps taken for strengthening the regulation and supervision of the sector

20. RBI moved to CAMELS pattern of rating of UCBs w.e.f. March 31, 2011 in lieu of earlier system of grading. With the switchover to rating system, there were 697 UCBs in C & D rating which constituted 42.47% of the total UCBs as on March 31, 2011. The number of C & D rated UCBs has declined to 339 constituting 21.50% of total number of UCBs as at the end of March 31, 2015. The number of UCBs in A & B rating increased from 948 in 2011 to 1240 as on March 31, 2015.

21. A new Supervisory Action Framework (SAF) was prescribed by RBI in March, 2012 which replaced the Graded Supervisory Action. As a part of the SAF, RBI specified regulatory trigger points in terms of five financial parameters viz. CRAR, Gross NPAs, concentration of deposits, profitability and CD ratio for initiating structured and discretionary action in respect of banks hitting such trigger points. A revised SAF has been implemented based on the findings of inspection conducted with reference to March 31, 2014. Under the revised framework, the individual UCB will be advised of the specific corrective action they need to take to improve the financial position. With the revision of SAF as above it is expected that the Board of Directors of UCBs will be proactive in identifying the shortcomings / deficiencies in the functioning of the bank and taking timely action to address them.

22. In view of the critical importance of CBS in the banking system, it has now been decided to include CBS implementation as an additional criterion for a UCB to be classified as an FSWM bank. With a view to imparting transparency and removing any unintended element of subjectivity the criterion of "regulatory comfort" has also been redefined.

Regulatory convergence

23. Pursuant to the amendment to the Banking Regulation Act through the Banking Laws (Amendment) Act, 2012, the percentage of CRR to be maintained by non-scheduled co-operative banks and the percentage of SLR to be maintained by co-operative banks were brought in line with that of commercial banks with effect from the fortnight beginning July 12, 2014. The assets eligible for being reckoned as part of SLR were also brought on par. To ensure that this is achieved in a non-disruptive manner, banks were allowed to reach the target in a phased manner. Similarly KYC guidelines for co-operative banks have also been brought at par with commercial banks.

Way forward

24. 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 finance banks.

25. The Discussion Paper noted that the Urban Co-operative Banks (UCBs) are organised based on the principles of co-operation. UCBs are perceived as banks for people of small means. They cater to the financial needs of local communities and serve the lower and middle strata of population in urban and semi-urban areas, within a limited geographical boundary.

Conversion of Multi State UCBs into commercial banks

26. As regards the Multi-state co-operative banks, the paper noted that there is a case for their conversion into commercial banks. As UCBs become larger and spread into more states, the familiarity and bonding amongst their members diminishes and commercial interests of the members overshadow the collective welfare objective of the organisation. The UCBs lose their co-operative character. In the process, some of them become "too big to be a co-operative". The collective ownership and democratic management no longer suit their size, and competition and complexities in the business force them to explore alternate form of ownership and governance structure to grow further. Corporatisation could be the best alternative for multi-State UCBs. UCBs enjoy arbitrage in terms of both statutory and prudential regulations. Only some provisions of Banking Regulation Act, 1949 are applicable to them. UCBs continue to be under Basel I capital framework. Though, these may not cause serious concerns when UCBs are small and their operations are limited, regulatory arbitrage may create incentives for large multi-State UCBs to have greater leverage. Their remaining under lighter regulation is a risk. Larger multi-State UCBs, having presence in more than one State, dealing in forex and participating in the money market and payment systems, could be systemically important. Their failure may have contagion effect and unsettle the UCB sector. The systemic risk could be minimized, by subjecting them to prudential regulations applied to commercial banks. Another supportive reason would be that larger multi-state UCBs having more restrictions in some respects in their functioning than commercial banks, may be at a competitive disadvantage and may lag behind their competitor commercial banks as they are unable to provide a wider range of facilities to their customers. Conversion into commercial banks would give more business opportunities to such UCBs.

27. The existing laws governing co-operatives do not specifically provide for conversion of UCBs into (banking) companies. Therefore, the Paper suggested that necessary amendments to the Co-operative Societies Acts/Multi-State Co-operative Societies Act and

Companies Act, 1956 may be required for facilitating conversion of UCBs into commercial banks.

28. On the whole, the Discussion Paper concluded that setting up stronger UCBs, with good net worth and strong corporate governance, would facilitate extension of banking services in the regions characterized by poor banking outreach. Some UCBs could convert into LABs/small finance banks if they meet the required prudential requirements. Such banks, freed from dual control and with better ability to raise capital, may be able to further extend the reach of banking services.

Licensing of new UCBs and conversion of UCBs into commercial banks

29. In pursuant of the conclusions of the Discussion Paper and in view of the high aspirations of UCBs to undertake the business akin to commercial banks despite lack of level playing field for regulation of UCBs vis-a-vis commercial banks and pursuant to the deliberations held in the 31st Standing Advisory Committee of UCBs, a High Powered Committee under my chairmanship was constituted to examine and recommend permissible business lines and appropriate size, and examine the issues with regard to conversion of UCBs into commercial banks besides determining whether the time is opportune to issue new licenses to UCBs as recommended by the Malegam Committee.

30. UCBs have high aspirations of competing with commercial banks despite their restricted ability to raise capital and they expect RBI to provide relaxation in various regulatory restrictions. However due to weak resolution regime and non-availability of powers to RBI to regulate and supervise UCBs at par with commercial banks, RBI faces constraints in making such relaxations. No powers are available with RBI for constituting Boards of UCBs, removal of directors, supersession of Board of Directors, auditing of UCBs, winding up and liquidation. The resolution regime for UCBs exists in a rudimentary form. The growth of the sector, therefore, has to be in a carefully calibrated manner, consistent with legal framework and regulatory parameters and their limitations. It is in the above background that the High Powered Committee had as one of its terms of reference to determine whether unbridled growth of UCBs can be allowed and if so, in what form it should take keeping in view the restricted ability to raise capital, lack of level playing field in regulation and supervision and the absence of a resolution mechanism at least on par with commercial banks.

31. The important recommendations of the HPC *inter alia* include UCBs having a business size of ₹ 200.00 billion or more may be expected to convert itself into a commercial bank. The conversion need not be de jure compulsory. Smaller UCBs can apply for conversion to Small Finance Banks provided they fulfil the eligibility criteria for such conversion and the licensing window is open.

32. Licenses to set up new UCBs may be issued to financially sound and well-managed co-operative credit societies having a minimum track record of 5 years which satisfy the regulatory prescriptions set by RBI as licensing conditions and putting in place a BoM in addition to BoD as suggested by Malegam Committee has to be one of the mandatory licensing conditions for licensing of new UCBs and expansion of existing ones. The report has also suggested amendment of Section 56 of the B.R. Act, 1949 so as to empower RBI to bring in regulation of UCBs at par with commercial banks.

33. The report is already placed on the website of RBI for soliciting public comments; I am glad that this Seminar today also has been arranged to discuss the recommendations of the Committee. Debate, in any case, is always welcome and differing or different views will certainly augment final decision which will be taken by RBI after duly considering the views of all the stakeholders.

Co-operative character in co-operative banking

34. While the likely loss of co-operative character of the large Multi-State Co-operative Banks was vividly deliberated in the Discussion Paper as mentioned above, and so have become “too big to be co-operatives”, it is unfortunate that the co-operative character is increasingly being undermined even in the uni-state co-operative banks. A study conducted a couple of years ago by the College of Agricultural Banking 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 co-operative character.

35. We need to reflect on certain soul searching questions. It may cause certain shock to several of you, the veterans of co-operative movement, to undertake this search. Because, you need to find answers to some inconvenient questions. They are as follows:

a. Has the co-operative movement retained its relevance after its 130 years existence in India?

b. Has the Indian psyche grown beyond the need for “one person one vote for mutual benefit” idiom?

c. Has the co-operative movement captured the imagination of younger generation?

d. Has it produced enough qualified and energetic young leaders to carry forward the movement?

e. How the movement can insulate itself from the trends that as the CAB study pointed out reduce the cooperativeness of co-operatives?

36. I would strongly urge the sector, if not in this Seminar, to find answers to these questions.

37. Another area where the cooperativeness of co-operatives is missing relates to the Federations’ role. Several Committees have suggested that the co-operative banking sector need umbrella organisations to facilitate, among others, funds management, IT services, capacity building and strategic guidance. I hear about only one serious attempt has been made by the Gujarat Federation so far in that direction. It is a matter of regret that Federations could not so far come forward to activise such umbrella organisations. I look forward to the Federations moving ahead on this very useful, self-helping initiative.

Conclusion

38. To conclude, let me say that we do recognize that co-operative banks are unique in terms of their structure, clientele and credit delivery. The resilience shown by these banks during their long existence can be leveraged. Despite their inherent weaknesses in terms of low capital, poor management and intrusive policies of State, co-operative 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 been continuously taking policy measures to strengthen the co-operative banking sector. It is heartening to see that supportive regulatory environment, adoption of technology and re-orientation of business strategy can act as enablers for co-operative banks to contribute more meaningfully. Yet, looking into the future, some hard questions relating to maintaining the cooperativeness in co-operatives need to be answered. And Federations have to deliver on Umbrella Organisations.

39. Thanking you all for your patient attention.