ABHINAV
NATIONAL MONTHLY REFEREED JOURNAL OF RESEARCH IN COMMERCE & MANAGEMENT
www.abhinavjournal.com

URBAN CO-OPERATIVE BANKS: PROBLEMS AND PROSPECTS

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ABSTRACT

One of the major areas of the macro economy that has received renewed focus in recent times has been the financial sector. The financial sector acts as the 'brain' of the economy: it acts as a bridge for channeling resources from final savers to final investors. As a result, the greater the ease of resource intermediation, the lower the cost at which these resources can be available to final investors, enhancing investment and growth. Urban Cooperative Banks were set up with the objective of promoting sustainable banking practices amongst a relatively specific target clientele viz., the middle income strata of the urban population. They were brought under the regulatory ambit of the Reserve bank by extending certain provisions of the Banking Regulation Act, 1949, effective from March 1, 1966.

INTRODUCTION

It might be useful to briefly recount the basic structure of the cooperative banking sector and locate Urban Cooperative Banks as a group within that framework. The cooperative banking sector may be viewed as consisting of Rural Cooperative Banks and Primary (Urban) Cooperative Banks. Leaving aside the structure of Rural Cooperative Banks, Primary Cooperative Banks, numbering 1,936, have a network of over 6,300 branches catering to the banking requirements of the lower and middle income groups in urban and semi-urban areas.

The performance of the cooperative banking sector as a whole has attracted considerable attention in the recent years especially in the context of the ongoing phase of financial sector reforms. Compared to their rural counterparts, the Primary Cooperative Banks (PCBs), which operate in the urban areas, have posted better performance. Not surprisingly however, there is significant heterogeneity in the performance of PCBs which number more than 1,900 at present. While a large number of these banks have shown creditable performance, a fair number of them, on the other hand, have shown discernible signs of weakness.

Problems and Findings of High Power Committee on Urban Cooperative Banks

The second phase of financial sector reforms have brought about vast changes in the structure and operation of the Indian financial sector. However, the reform measures are yet to fully impact the system. Financial and managerial weaknesses of a good number of cooperatives have been a matter of concern for quite some time. State Governments and cooperatives have been demanding capital infusion for wiping out past losses. Unless the inherent weaknesses are adequately addressed, funds infusion alone may not solve the problem. In this respect, the areas that need careful examination include: (i) the pattern of resources of cooperatives (owned funds, deposits, and borrowings), (ii) the deployment of resources, (iii) the management and supervision, (iv) the role of cooperative banks in the financial system and (v) the regulatory framework for cooperatives.

The essential spirit of the regulatory and reform measures adopted for the commercial banks need to be extended to the cooperatives as well with necessary adaptations to suit the circumstances in which cooperative banks operate. This would imply that areas such as (i) strengthening of regulatory and supervisory framework, (ii) enhancing capital adequacy standards (iii) introducing stringent licensing norms for new entrants into the sector (iv) enabling legal amendments and (v) corporate governance measures need to be given very close attention.

Narasimham Committee recommendations (High Powered Committee)

As a starting point, it would be useful to look at the Narasimham Committee recommendations. The Committee suggested that the RBI should review the entry norms in respect of UCBs and prescribe revised prudent minimum capital norms for them. To achieve an integrated system of supervision over the financial system, the Committee recommended that UCBs should also be brought within the ambit of the Board of Financial Supervision. In response to these recommendations of the Committee, the Reserve Bank set up a High Powered Committee on Urban Cooperative Banks under the chairmanship of Shri K.Madhava Rao, former Chief Secretary to Government of Andhra Pradesh, to review the performance of UCBs and suggest measures to strengthen them. The committee gives its views on important areas such as

Licensing Policy: In the new liberalized regime, licensing policy for new UCBs is expected to be not only transparent, but also precise and objective, based on established standards and procedures. Moreover, the procedures governing these licensing norms have to be simple and minimal.

Dual Control: One of the problem areas in the supervision of UCBs is the duality in control by the State Government and the Reserve Bank. Since UCBs are primarily credit institutions meant to be run on commercial lines, the responsibility for their supervision devolves on the Reserve Bank. Therefore, while the banking operations pertaining to branch licensing, expansion of areas of operations, interest fixation on deposits and advances, audit and investments are under the jurisdiction of the RBI, the managerial aspects of these banks relating to registration, constitution of management, administration and recruitment, are controlled by the State Governments under the provisions of the respective State Cooperative Societies Act. The Narasimham Committee (1998) recommended that this duality of control be done away with and the responsibility of regulation of UCBs be placed on the Board for Financial Supervision. This will require amendment of the Multi-State Cooperative Societies Act, 1984; State Cooperative Societies Act, and the Banking Regulation Act.

Corporate Governance: Good corporate governance is essential for the effective functioning of any financial entity. To this end, the Madhava Rao Committee suggested that at least two directors with suitable professional qualification and experience should be present on the Boards of UCBs and that the promoters should not be defaulters to any financial institutions or banks and should not be associated with chit funds/ NBFCs/ coopertaive banks/commercial banks as Director on the Board of Directors. These recommendations would need to be examined intensively before formulating policy actions in this regard.

Capital Adequacy: The Narasimham Committee (1998) had raised the issue of extending capital adequacy prescription for cooperative banks. Accordingly, the Committee recommended that the cooperative banks should reach a minimum 8 per cent CRAR over a period of five years. The findings of the Madhava Rao Committee on UCBs also reiterated that a majority of the UCBs was in favour of extending the CRAR discipline to UCBs. However, the ability of the UCBs to raise additional capital for the purpose has been limited by certain features viz., inability to make public issue of capital and that, they can raise capital only from members, subject to an overall ceiling and restrictions imposed by the various Acts (State Cooperative Societies Act and Multi- State Cooperative Societies Act, 1984) which constrains the number of shares that an individual can hold.

Legislative Reforms: The Narasimham Committee in its Report had rightly observed that a legal framework that clearly defines the rights and liabilities of the parties to contracts and provides for speedy resolution of disputes is essential bedrock of the process of financial intermediation and UCBs are no exceptions. Accordingly, the Government had appointed an Expert Group under the Chairmanship of Shri T.R. Andhyarujina, former Solicitor General of India, to suggest appropriate amendments in the legal framework affecting the banking sector. The Committee would address amendments in the various external Acts affecting banking sector such as, the Transfer of Property Act, foreclosure laws, Stamp Act, Indian Contract Act, DRT Act, etc. The Committee, in its Report submitted in April, 2000, recommended inclusion of a new law for granting statutory powers directly to banks (and financial institutions) for possession and sale of securities backing a loan, an enabling framework for securitization of receivables and strengthening the recovery mechanism.

Unlicensed and Weak banks: The existence of a large number of unlicensed banks has become a serious cause for concern to regulators. The main reason for proliferation of such banks has been a mild screening process in the past. In view of the regulatory discomfiture that such banks impose on the system as a whole, it has been suggested that these banks be licensed provided they satisfy the quadruple criteria of (a) minimum prescribed CRAR, (b) net NPA ratio not exceeding 10 per cent, (c) have made profits continually for the last three years, and (d) have complied with the RBI regulatory directions.

One issue of serious concern regarding UCBs is the delay/ non-submission of returns within the stipulated time frame. In particular, PCBs are required to submit two types of returns (statutory returns and control returns) to the Reserve Bank with a view to exercise adequate supervision over them. Unfortunately, there is often a serious delay in the submission of these returns by individual banks. Non-availability of adequate and timely data would no doubt have serious effect on timely policy action. In this context, PCBs have to improve their statistical reporting system and bridge the wide gap in data availability as compared to that of commercial banks.

Agenda of Future Reforms and Progress

The urban co-operative banking sector being an integral part of financial system, the Reserve Bank has brought in a series of reforms for it. The recent Madhava Rao Committee which is also called High Power Committee (HPC) on UCBs, has dwelt extensively on certain regulatory issues related to UCBs' licensing policy, future set up of weak and unlicensed banks, application of capital adequacy norms, resolution of conflicts arising of dual control over UCBs, etc. The Reserve Bank has accepted these recommendations and implemented them. However, issues related to dual control necessitate legislative changes to State and Central Acts and there is hardly any progress in this area. In the backdrop of the present scenario, future agenda for reforms in urban co-operative banking sector are, as follows:

Aligning UCB Sector with Rest of Financial System

Unlike the other segments of cooperative credit sector, UCBs today undertake multifarious banking activities. Some of them have also been permitted to undertake forex and merchant banking activities. There is a view emerging in the recent past that UCBs, being members of payment system, beneficiaries of deposit insurance scheme and enjoying unlimited access to public deposits, it is an imperative necessity to apply exactly the same regulatory rigors to UCBs as applicable to commercial banks.

Interest rates Today, main risk exposure of UCBs' is not the credit risk but interest rate risk. Most of the UCBs' interest rates particularly on deposits are out of sync with the rest of the banking sector. In this backdrop, observance of Risk and Asset Liability Management guidelines assumes importance. The Reserve Bank has recently constituted a Working Group to evolve guidelines keeping in view the specifics of UCB sector. The Group is expected to submit its recommendations very soon.

Timely disclosure of returns as market discipline is an important supervisory tool in approach to new capital adequacy framework, prescription of disclosure standards for UCBs, perhaps is of imminent necessity. UCBs, therefore, should be able to disclose their level of owned funds, unimpaired net worth, CRAR, Gross/Net NPAs, operating results, ROA, compliance with reserve requirements, per employee productivity, etc. with balance sheet figures. This issue is engaging the attention of the Reserve Bank.

Audit System Strengthening the audit systems is of paramount concern for the Reserve Bank as it is an important tool in its supervisory kit. It had taken a lead in appointing an expert panel in 1995 for reforming the audit systems in vogue in UCBs. The panel suggested Professionalisation of audit, mandatory concurrent audit for larger banks, redesigning audit format, etc. The Reserve Bank had accepted these recommendations and advised States to initiate measures. Unfortunately, many State Governments have yet to respond positively despite five years of persistent persuasion by the Reserve Bank.

Future set-up of weak Banks The sheer number of weak banks which is well over 200 is a cause of concern. In a large number of cases, licenses have already been cancelled and the banks have been closed down. This process is taken up very cautiously so as not to create panic in the society. Closure is decided only after all other options are exhausted. Level of capital, history of losses and size of NPAs are some of the factors which weigh with us in taking a decision on closure. Possibilities of rehabilitation are invariably explored before such a decision is arrived at. Rehabilitation may involve the following strategies:

Registrars should direct the cooperative courts for speedy recovery process and execution of decrees, Unviable branches should either be relocated or closed down, Avenues should be explored for the bank getting additional capital Merger with a well-managed bank. However, a forcible merger should be strictly avoided.

Improving Governance It is extremely important that there is a mechanism to ensure that an effective system of internal governance is in place. Chief Executive should be a person of clean image and display a professional attitude. Board should consist of knowledgeable persons who are aware of their responsibilities as board members. There should be a board level committee which should focus attention on the findings of audit and inspection teams and ensure compliance thereof. The committee should also ensure compliance with various regulatory instructions issued by the Reserve Bank as also State Governments. It is ultimately the Board's responsibility that all prudential norms of governance are observed by the bank.

Dual control dilemma Duality of command over UCBs perhaps has become an intense issue of debate in co-operative circles. Academics, co-operators and bankers made vociferous representations to the Madhava Rao Committee that dual control over UCBs must end as that was instrumental in stifling their growth. Narsimham Committee II had also unequivocally recommended for ending dual control regime over UCBs. Most of the issues emanating out of dual control regime are due to overlapping jurisdiction of the Reserve Bank and State Governments. Duality in command does come in the way of effective supervision. In the case of commercial banks, the Reserve Bank has the wherewithal under the Banking Regulation Act for dealing with crucial aspects of functioning of commercial banks. In the case of co-operative banks, however, many areas which directly relate to supervision over them have been kept beyond the Reserve Bank's authority. Situation gets somewhat messy as may be indicated by a few illustrations as follows:

The Reserve Bank has no authority to deal with delinquent management in a co-operative bank. This requires intervention of the Registrar of Co-operative Societies.

Making investments out of surplus resources being clearly a banking function should be entirely within the decision making powers of cooperative banks subject to the Reserve Bank guidelines but this needs approval of the Registrar.

Similarly, writing off an unrealizable debt also requires permission of the Registrar.

There was an instance where on request made by the Reserve Bank, the Registrar superseded the board of a co-operative bank. But subsequently the State Government in its wisdom annulled Registrar's orders and restored the Board. It is strange but true.

It is open for a bank whose licence has been cancelled to appeal to the Government. The Reserve Bank is required to appear before the Appellate Authority. Often, the Reserve Bank is advised to review its decision. It is a matter of satisfaction; however, that the Reserve Bank's decisions have been supported by Government and in no case the Reserve Bank's decision has been struck down. Nevertheless, the exercise has to be gone through.

CONCLUSION

Urban co-operative banking sector has come to occupy a formidable place in the Indian financial system. However, sustenance of its growth is attendant to Professionalisation of its management, inculcating good corporate governance, technology absorption and scrupulous adherence to regulatory framework. I hope the sector will learn from its past experiences and adjust to new realities since banking is risky business.

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