Rationale for the Study of Urban Co-operative Banks in India

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ABSTRACT

This article examines the recent policy developments of UCBs as well as the major issues and challenges. In the last one and a half decade the UCBs have undergone historical transformation of unprecedented breadth and depth. This new stage has generated special concern amongst cooperative banks. At the same time, the economic meltdown impaired the financial institutions all over the world but cooperative banks in most markets have performed reasonably well in comparison with other financial institutions. This is due to relatively straightforward operations of most cooperative banks, their ability to focus on member service as opposed to short-term profit maximization and the conservative nature of its executives and their regulators. The current status and the operational features of UCBs are dealt with in order to describe the future trends and potential difficulties and opportunities of urban cooperative banking sector.

INTRODUCTION

The Indian cooperative credit movement is a complex system and the largest system in the world in terms of people served -267 to 390 million people. Urban Cooperative banks (UCBs) have long been a part of the Indian economic landscape. The first UCB was started at Kancheepuram in Tamil Nadu on October 8, 1904 with a handful of members. But today the number of UCBs in India is 1618 with nearly 20 million members and Rs.3033 billion in assets as on 31st March 2012.[1] UCBs are non-profit organizations, owned and controlled by the members. They are unit banks on the American model rather than the Branch banks of the British model.

Inspired by the success of the Cooperative Movement in Germany and Britain, the cooperative movement was started in India towards the close of the nineteenth

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[1] RBI (2011-2012) Trend and Progress of Banking in India.

century. The chief objective of the movement was to cater to the banking and credit needs of the urban middle class viz., small traders or businessmen, artisans, factory workers, salaried people and fixed income group in urban and semi-urban areas, besides protecting the middle classes and men of modest means from the clutches of the moneylenders. The urban cooperative movement is also expected to inculcate the habit of saving among the middle class. The cooperative movement was considered as the balancing force between the private sector and the public sector. The advantages of both private and public sectors could be very well achieved through the cooperative sector. In India, Cooperative Societies Act was passed in 1904 and since then cooperative movement has progressed by leaps and bounds. However, the Act of 1904 was found insufficient to meet the growing needs of the movement due to the following reasons:

1. It did not give legal protection to societies formed for purpose other than credit.
2. There was no provision for the formation of a central agency such as the Central Banks or unions for financing of primary societies.
3. The classification of societies into rural and urban was arbitrary and was found unsuitable.

The defects of the Act of 1904 were remedied in the Act of 1912. In 1942, the Multi-unit Cooperative Societies Act was passed by the Central Government to regulate the working of cooperatives covering more than one province. This was replaced by the Multi-State Cooperative Societies Act in 2002.

UCBs on account of their proximity to their members and their firm establishment locally, they are well placed to gather more comprehensive information on their customers and at a lower cost. This permits them to evaluate the needs and the solvency of their customer/ members more thoroughly than other banks. They actively involved at a local level.

The Indian Central Banking Enquiry Committee (1931), the Bhansali Mehta Committee (1939), Cooperative Planning Committee (1946) and the Rural Banking Enquiry Committee (1950) recommended the establishment of urban cooperative banks even in small towns.

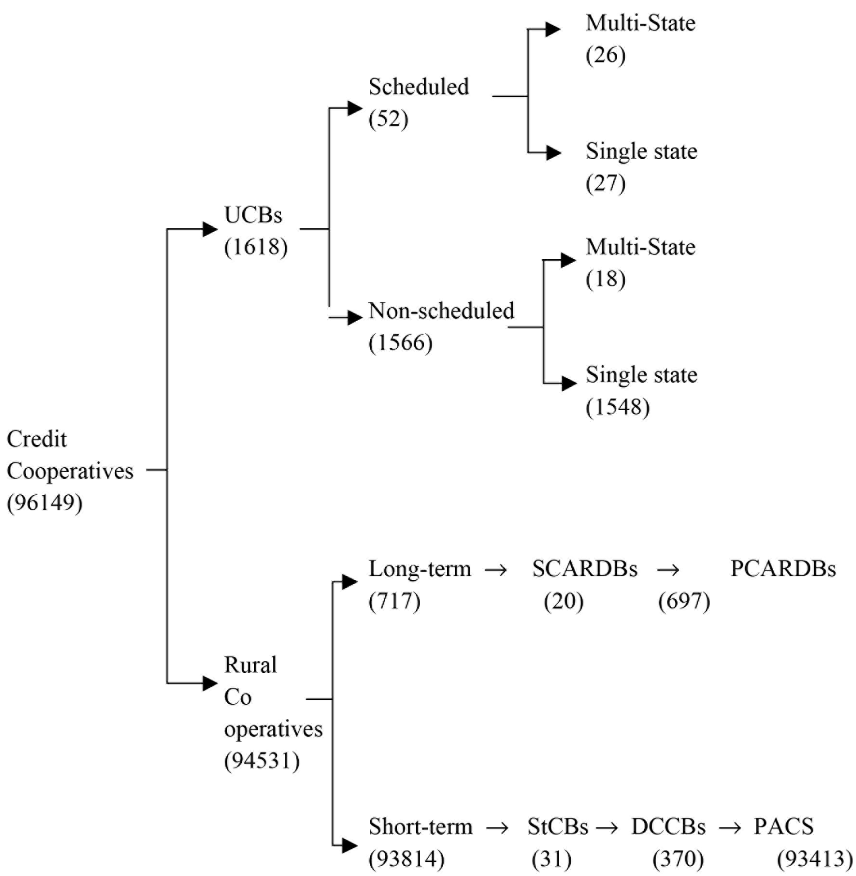
From the inception (in 1904), urban cooperative societies had been functioning only as societies, accepting deposit and granting loans. But on the first of March 1966, the urban cooperative societies were recognized as full-fledged banks and brought under the control of the Reserve Bank. This was done on the basis of the Banking Regulation

Act, 1949. Since then there has been an astronomical growth of the cooperative banks throughout India in terms of number of banks, volume of banking business (deposit plus loans and advances) and geographical outreach. In 1968 UCBs were extended the benefits of Deposit Insurance. The Marathe Committee (1992) ushered in the era of liberalization. The Madhavarao Committee (1999) focused on consolidation, control of sickness, and better professional standards in Urban Cooperative Banks.

The cooperative banking sector functions at two levels –
- Urban
- Rural

Chart – 1
Structure of cooperative credit institutions in India

Note:



Source: RBI (2011-2012), Trend and Progress of Banking in India.

(i) Figures in parentheses indicate the number of institutions as on 31st March 2012 for UCBs and as on 31st March 2011 for rural cooperatives.

(ii) For rural cooperatives, the number of cooperative refer to reporting cooperatives.

(iii) SCARDBS : State Cooperative Agriculture and Rural Development Banks.
PCARDBs : Primary Cooperative Agriculture and Rural Development Banks.
StCBs : State Cooperative Banks.
DCCBs : District Central Cooperative Banks
PACS – Primary Agricultural Credit Societies.

The rural cooperative societies are being financially supported and monitored by the state and central governments as per the provisions in the five year plans. On the contrary such provisions are not extended to UCBs. An amount of 98.5 billion (including 90 billion as Central Government's share and 8.5 billion as the State Government's share) was released upto 31st March 2012 to recapitalize 54728 short-term cooperatives (54715 PACs and 13 DCCBs) in 17 states to wipe out the accumulated losses prevailing as on 31st March 2004 and to enable them to reach a minimum CRAR of 7 per cent by 31st March 2004. The announcement of the reform package by the Central Government for long-term cooperative is, thus, awaited.[2] If it is justified that policy of both the Government and the regulator i.e. RBI is to protect the interest of the depositors and the credibility of the banking system, then the same policy should be applicable to those UCBs which are suffering from NPAs. The UCBs have lost even the existing exemptions from income tax (N. Ramu, 2009). Today, UCBs are facing a tough challenge in a fiercely competitive credit environment. Concern and skepticism are expressed on their credit worthiness and viability. Considering these facts, probing into the progress, problems and prospects of these institutions becomes significant.

RECENT POLICY DEVELOPMENTS FOR UCBs

The major policy initiatives in the UCB sector in the recent past include implementation of the Vision Documents 2005. In line with the recommendations of the documents, the Government of India and various state governments entered into a Memorandum of Understanding with the Reserve Bank. As a part of the arrangements under MoU, the Reserve Bank of India is committed to constitute State Level Task Force for

[2] RBI (2011-2012), Trend and Progress of Banking in India.

Cooperative Urban Bank (TAFCUB) comprising representatives of the Reserve Bank, State Government and the UCBs sector. The TAFCUB identifies potentially viable and non-viable UCBs in the state and suggests revival of the viable banks and closure of the non-viable ones.

Following the Vision Documents of 2005, 1234 UCBs were classified as Tier I and 384 as Tier II categories based on their deposit.[3] The UCBs sector has emerged financially stronger since 2005, when the Reserve Bank conceived a Vision Document for the revival of this sector. The RBI adopted a multilayered regulatory and supervisory approach for Tier I and Tier II aimed at the merger. This approach of viable UCBs and the exit of unviable UCBs. On account of this process of consolidation, there has been a continued reduction in the number of UCBs from 2005 to 2012. As a result of this trend the total number of UCBs stood at 1618 on 31st March 2012 as against 1645 as on 31st March 2011. Further, there was a steady rise in the number of financially stronger UCBs [defined as UCBs belonging to Grade I and II] and a decline in the number of financially weaker UCBs (defined UCBs belonging to Grade III and IV) between 2005 and 2011.[4]

TAFCUB is mainly concerned with the development of UCBs in the state on sound lines. At the same time, the state Government signed MoU with RBI, it minimized the role of the registrar of cooperative societies of the concerned state and RBI has become the sole regulator of UCBs. It is the best way of eliminating dual control regime.

On the other hand, the "not-one-size-fits-for-all" approach of RBI (Two tier approach) will be effective only when there are uniform laws governing the management and

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[3] Tier I UCBs were defined as UCBs with:

- Deposit base below 1 billion operating in a single district.
- Deposit base below 1 billion operating in more than one district provided the branches were in contiguous districts and deposit and advances of branches in one district separately constituted at least 95 per cent of the total deposits and advances, respectively, of the bank.
- Deposit base below 1 billion, whose branches were originally in a single district but subsequently because multi-district due to re-organisation of the district.

All other UCBs were defined as Tier II UCBs.

[4] The data on grade-wise distribution of UCBs are not available for 2012 as this classification has been discontinued and a new CAMELS rating-wise classification of UCBs has been introduced. The UCBs are classified into four Grades namely Grade I, II, III and IV instead of weak and sick with effect from May 12, 2003, on the basis of capital adequacy, asset quality, earnings, compliance with CRR/SLR requirements, and history of profit/loss.

operations of the cooperative institutions. In India, 'cooperation' is on the state list whereas 'banking' is on the central list. Another difficulty encountered by the RBI in exercising two-tier approach is lack of transparency and governance principles in the operations of the UCBs (N. Ramu, 2008).

The earlier studies related to urban banking sectors are based on differentiating between the performance of pre-reforms period (i.e. before, 1991) and that of the post-reforms period. But after the vision document by RBI, it is appropriate to examine the performance or operations of UCBs sector in India, before and after 2005, because it is the milestone in the history of UCBs in India.

SUPERVISION AND REGULATION OF UCBs BY RBI

In order to assess a bank's actual financial health in its balance sheet the Committee on Financial System under the chairmanship of M. Narasimham of the Reserve bank of India introduced prudential norms (1998) for the UCBs in a phased manner:

i) Income recognition, asset classification and provisioning for the advances portfolio; and

ii) Valuation of foreign exchange transactions to the UCBs in 1991.

In terms of these revised accounting standards, income from NPAs could not be taken to profit and loss account unless the income was realized. Earlier, an asset was considered as non-performing assets (NPAs) based on the concept of 'Past Due'. However, with effect from 31st March 2001, the concept of 'Past Due' has been dispensed with and 180 days overdues norms were introduced with a view to moving towards international best practices and ensuring greater transparency.

Jewel loans were traditionally advanced for the year. But Basel norms[5] insist on 90 days norm for all jewel loans and beyond that period the loans are classified as NPA. This came into force on 31st March 2006. The 90 days norms serve the interest of multi-national banks but this is a death blow to UCBs.

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5 Basel Committee, 1999. Best Practices for Credit Risk Disclosure.

The ratios used to judge the extent of NPA problem of the bank is Gross NPA / Gross Advances and Net NPA / Net Advances.[6] The gross non-performing assets of UCBs sector increased during the period 2010-2011. However, there was a decline in gross as well as net NPA ratios during 2011-2012.[7] Not only were the NPAs of UCBs on the decline, but also their provisions were on a steady rise. As a result, their Provisioning Coverage Ratio (PCR), defined as provisions as percent of gross NPAs, also showed a largely rising trend. The PCR coverage indicates the depth of the cushion of loan loss reserves relative to non-performing loans. A ratio of over 100 per cent is good, and 50 to 100 per cent generally satisfactory. Below 50 per cent PCR coverage raises warning signals (N.Ramu, 2009). It indicates that UCBs performance in recent years towards NPAs is good and it maintains asset quality. Most of the earlier studies relate to dimensions of NPAs in UCBs sector alone. But these studies are incomplete. But a comparison with state cooperative banks and district central cooperative banks will give a fruitful result for future researchers.

The Capital to Risk Assets Ratio (CRAR)[8] has been introduced in UCBs in a phased manner commencing on 31st March 2002 (John D. Silva, 2005). Based on the recommendations of Narasimham committee, the RBI appointed a high power committee on UCBs under the chairmanship of K. Madhava Rao.

The Principle of member participation has resulted in a unique system of linking share to borrowing in UCBs which to some extent takes care of capital adequacy to risk assets. For instance, every borrower (member) is required to contribute 2.5 to 5 per cent of the loan amount towards capital. Therefore, the concept of capital adequacy to risk assets is not new to UCBs. But the ability of UCBs to raise capital to meet CRAR norms is limited by certain features;

(i) The shares of Ucbs are neither quoted in the stock market nor are these banks allowed to raise capital in the market.

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6 Gross NAPs indicate account identified as NPA on application of the prudential norms on Income Recognition and asset classification specified. Net NPAs means the gross NPA minus balances in interest suspense account, claim received from deposit insurance and credit guarantee corporation (DICGC) and kept pending adjustment. Part payments received and kept in suspense account and total provisions held.

7 RBI (2011-2012). Trend and Progress of Banking in India.

8 The (peter) Cooke Committee was appointed in July 1988 by a group of 10 developed countries (G-10) for the evolution of common norms for capital requirements of banks of all the countries. As per Cooke Committee's recommendations, capital adequacy is to measure "The ratio of capital to risk weighted asset."

(ii) Member's share holdings are linked to the loan amounts and can be withdrawn once the loans are repaid.

(iii) Members can redeem their shares in the capital resulting in fluctuations in the size of the capital.

The capital can be enhanced only through accelerated earning and their retention. Managing this aspect is a challenge. The UCBs have been slack in relation to these aspects. The following are some of the reasons (R. Kannan, 2004).

a) High cost deposits
b) Lack of training of staff
c) Low level of IT implementation
d) High interest rates on advances
e) Denial of income from other sources
f) Non-adherence to the prescribed limits of loans

The majority of 1466 of UCBs reported capital to risk assets ratio as 9 per cent as on 31st March 2012.[9] There are still 152 UCBs which have CRAR below the prescribed limit of 9 per cent and of these 87 UCBs have negative networth (CRAR<3) as on 31st March 2012. However, the capital position of scheduled UCBs[10] was much weaker than that of non-scheduled UCBs. Moreover, most of the scheduled UCBs with CRAR below the regulatory minimum registered a negative CRAR. It is a topic for the researches to investigate into the issues and to find out, why large capital base scheduled UCBs are not in a position to achieve the prescribed limit of CRAR whereas many non-scheduled UCBs have achieved it.

The working group established by RBI under the chairmanship of N.S. Vishwanathan, has made the following suggestions for improving the capital base of the UCBs.[11]

a) The removal of the existing monetary ceiling on individual shareholding prescribed by state Governments, especially in respect of Ucbs which have capital adequacy below the prescribed limit or have a negative networth.

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[9] RBI (2011-212). Trend and Progress of Banking in India.

[10] Scheduled UCBs are banks included in the second schedule of the RBI Act, 1934 and include banks that have paid-up capital and reserves of not less than 0.5 million and carry out their business in the interest of depositors to the satisfactory of the reserve bank.

[11] RBI (2011). Report of the Expert Committee on licensing of new urban cooperative banks.

b) The issue of unsecured, subordinated, non-convertible, redeemable debentures / bonds which can qualify as tier II capital.

c) The issue of shares at a premium which will be non-voting.

d) The acceptance of deposits with maturity of 15 years and above.

A system of supervisory rating for UCBs on the basis of capital adequacy, asset quality, management, earnings, liquidity and system (CAMELS) has been introduced by RBI. The rating system is initially being implemented for scheduled UCBs commencing in the financial year 2003-04. A simplified rating system would be made applicable to non-scheduled UCBs with effect from 31st March 2004 (John D. Silva, 2005).

Under the CAMELS model two rating systems were adopted. One was component rating and the other was composite rating in accordance with their performance for regulatory and supervisory purpose. However with the introduction of the CAMELS rating model, this classification was discontinued and a newer dimension was introduced to judge the financial strength of UCBs, namely, the credit rating. Under the new CAMELS rating model, a composite rating of A/B/C/D (in decreasing order of performance). It is based on the weighted average rating of the individual components of CAMELS. The rating of A/B/C is suffixed with a '+' or '-' sign, wherever necessary, to reflect granularity in the components and composite rating of the bank. The rating of D represents the lowest rates.

As per this new classification, about 61 per cent of the UCBs had composite rating of A and B as on 31st March 2012. Further, 32 per cent of the UCBs had a composite rating of C. Only about 7 per cent of the UCBs had the lowest rating of D, representing the weakest financial health.[12]

Credit unions are financial cooperatives similar to urban cooperative banks. These are cooperative financial institutions owned and controlled by its members. Over 96 countries including the US and the UK have credit unions. These institutions largely adhere to the corporate Governance norms laid down by the World Council of Credit Unions (WOCCU). Its headquarters are in Madison, Wisconsin, in the United States. WOCCU has developed PEARLS monitoring system for credit unions since 1990. PEARLS refer to six areas of financial performance (N. Ramu, 2009).

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[12] RBI (2012). Trend and Progress of Banking in India.

(i) Protection (P)

(ii) Effective financial structure (E)

(iii) Asset quality (A)

(iv) Rates of return and costs (R)

(v) Liquidity (L)

(vi) Sign of growth (S)

In India, the RBI used to evaluate the financial performance of UCBs through 'CAMELS'. All over the world, the credit unions are evaluated through the 'PEARLS'. Both the systems have to evaluate more or less the same parameters. A new area of research to compare and contrast the financial performance of UCBs under these two systems definitely will offer scope for future researchers.

ISSUES AND CHALLENGES OF UCBS IN INDIA

The UCBs catering to the needs of the people of the weaker sections in the urban areas, are a powerful means of financial empowerment. A sound UCB has the following characteristics:[13]

i) A CRAR of nine per cent or more;

ii) Gross NPAs of less than 10 per cent of gross advances;

iii) Continuous record of profits in the last three years; and

iv) No defaults in maintenance of CRR and SLR

Measured by the above criteria, only 57.6 per cent of the total UCBs can be considered sound.[14] Both UCBs and the rural credit cooperatives were financially impaired, in terms of governance and management. The impairment of governance is due to political interference. The government appointed the Task Force Committee under the chairmanship of Vaidyanathan for reviving the rural credit cooperatives only. UCBs are self-dependent institutions which are not given any support by the Government. The government did not appoint a committee exclusively for the revival of UCBs (N. Ramu, 2009).

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[13] RBI (2011). Report of the Expert committee on licensing of New Urban Cooperative Banks.

[14] *Ibid*.

On the basis of findings of various committee reports and research studies, it clear that the following are the major financial constraints and managerial deficiencies of UCBs in India.

1. **High Cost Deposits**

   UCBs receive deposits at very high rates of interest which not only leads to the erosion of funds but also affects the financial condition of the banks. The average cost of deposits of UCBs is 8-10 per cent.

2. **Non-Appraisal / Lack of Proper Appraisal of Loans**

   Loans are granted as security-based and non-project-based. It has been found out that loans are issued without an assessment of the repaying capacity of the borrowers and are often more than the value of the property offered as collateral. UCBs concentrate mainly on unproductive lending such as advances for construction or repairing of buildings and consumer loans.

3. **Absence of Human Resource Management**

   A good number of misfits and unfits are found occupying the chairs of administration. Their inadequate knowledge and lack of training leads to inefficiency. External pressures such as political interference lead to appointments of unworthy persons. Employing and retaining skilled workers and specialists, re-training the existing workforce and promoting a culture of continuous learning are challenges for the UCBs.

4. **Absence of Professional Management**

   The RBI recommends the appointment of at least two directions with professional skills (such as Chartered Accountants, Lawyers and Specialist in Banking). But this is not in practice. As a result internal management and risk control are ineffective.

5. **Non-Use of Technology-Based Devices**

   Inspite of technological advancement, still manual work continued in some of the UCBs which causes delay and increases operational cost. Though computers have been installed in some banks trained staff are not available. E-banking may be introduced.

6. Reduction of High Interest Rates

It is observed that high interest rate on advances are charged by UCBs. For a defaulting borrower, it is found that the interest rate was charged even upto 25 per cent which has resulted in poor recovery of loans.

7. Denial of Income From Other Sources

Denial of income from other sources is also one of the reasons for low income of the bank. They should undertake non-funded business like issue of demand draft, credit and debit cards, letters of credit, bank guarantee, increasing safe deposit lockers, foreign exchange transactions, insurance agency, providing advisory and consultancy service to cottage and tiny industries, electronic transfer of money etc., in order to eke out their income.

8. Non-Adherence to Prescribed Limits of Loans

As per RBI guidelines, house mortgage loan should be granted within the limit of 15 per cent of the total deposits. It is noticed that the loans in this sector was more than 30 per cent in some banks.

9. Over Fulfillment of CRR and SLR Norms

A majority of UCBs have kept excess CRR and SLR. It can be understood that higher percentage of cash and bank balance with UCBs reflects poor management of funds, reasons being denial of direct access to the facility by RBI. In terms of CRAR guidelines provided, the deposit balances kept with the RBI alone will carry zero risk weight, whereas the deposits kept with other banks, will carry a risk weight of 20 per cent. The RBI is operating in state headquarters only. So the UCBs cannot have direct access to the service of RBI because the banks are situated in other parts of the country.

PROSPECTS OF UCBs

Despite these issues and challenges, the urban cooperative banks are still playing a key role in meeting the credit needs of the urban poor. The Canadian Cooperative Association has issued 12 reasons for cooperative enterprises to build a better world.[15]

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[15] http://www.coopscanada/coop/en/orphan/12-reasons. Retrieved on January 5, 2013

1. Cooperatives are **democratic** organizations owned and controlled by their members on the basis of one member, one vote.
2. Cooperatives are **value-Driven** enterprises that are guided by seven internationally-recognized principles.
3. Cooperatives have **social** as well as **economic** objectives and put **people** before profits.
4. Cooperatives are more **Durable** than other types of business; research has shown that new cooperatives are more likely to remain in business than other new enterprises and are more resilient in economic downturns.
5. Cooperatives are part of a dynamic **Global movement** with more than a billion individual members around the world.
6. Cooperative are rooted in their communities; the jobs and wealth they crate remain in the communities in which they are located.
7. Cooperatives **empower** people to take control of their own economic lives and futures.
8. Cooperatives respect the **environment** and are recognized as leaders in environmental sustainability.
9. Cooperatives are the business choice for **Millions of people.**
10. Cooperatives can be found **everywhere**; in small villages and big cities, in every region and most of the countries. They exist in virtually every sector of the economy, from retail and financial services to agriculture, housing and health care.
11. Cooperatives **cooperate** with each other, working together at the local, provincial, national and international levels.
12. By proclaiming 2012 the **international year of cooperatives**, the United Nations has recognized the important role cooperatives play in the social and economic development of communities worldwide.

The above points have been used in order to justify the rationale of this article.

CONCLUSION

The Indian economic reform process starts with banking industry along with urban cooperative banking sector. The major policy developments of UCBs have been effective from the year 1992-1993 i.e. post prudential norms era. The sudden changes in the policy environment of both state and central governments concerning the operations of urban banking system have direct and indirect implications on the performance of UCBs. The basic intention of this paper is to present a comprehensive picture of recent policy developments, issues and challenges of UCBs. The basic strength of UCBs is its dual capacity i.e. as a local grass-root initiative and as a local financial intermediary. The contemporary market conditions pose enormous difficulties in their future operational capacity. This leads to questions regarding the future of UCBs in India. Although the UCBs have shown significant progress in rendering financial services at local levels, there remains enormous practical and theoretical challenges that demand multidisciplinary approaches and new strategies by those engaged in the development of this sector as a whole.

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AUTHORS' BACKGROUND

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