Urban Cooperative Banks : At Crossroads

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URBAN COOPERATIVE BANKS AT CROSSROADS

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Abstract

Urban Cooperative Bank in India, with their long history of over 100 years, play an important role in financial inclusion. The mainstay of these banks was rooted in their captive clientele the forms of shareholders, and also in some cases specific community or location. This shielded them from the competition from large commercial banks. Recently, Indian banking industry has witnessed failure of a large number of Urban Cooperative banks. What are the reasons for these failures and what lays ahead for cooperative banks in India? This paper analyze the causes of concern and brings out some of the measures such as giving preferential treatment which would help urban cooperative banks to co-exist in the present competitive environment.

The urban Cooperative Banks (UCBs) are a unique form of organization. They are registered under the Cooperative Societies Act of the concerned state, which empowers the registrar of cooperative societies to register and liquidate the societies. At the same time, these banks were converted into full-fledged banking system only after the extension of Banking Regulation Act 1949 with effect from 01.03.1966 which ensures regulatory powers to the Reserve Bank of India (RBI) like issue of licence and controlling banking business. This creates a situation of dual control of UCBs by both state and central governments. In India, 'cooperation' is a state subject whereas 'banking' is with the union government. Laws governing the management and operations of the cooperative institutions are not uniform and this is another cause of concern.

The Indian urban cooperative credit movement is almost a hundred years old. During this long journey, the movement has passed through various phases of development. The various committees appointed by the RBI and Government of India gave lot of recommendations in order to tune up balanced growth of UCBs in the country. These recommendations could not be successfully implemented because of dual control. Moreover, these banks have entered into every sphere of the economic activity. The UCBs had a network of 1,859 banks with a membership of 20 million and more than 200 million clients as on 31st March 2005.[1] The UCBs have the reputation of serving all their members, including those on the lower rungs of the economic ladder. They have committed themselves to promoting the economic interest of their members, who are simultaneously their owners and customers. The Banking Regulation Act refers to UCBs as primary cooperative banks. The word ‘primary’ is used to denote that the UCBs perform the role of a primary unit in a 3-tier cooperative credit structure.

But the economic reforms that have been introduced in India since 1991 have given new dimensions to the practice and performance of UCBs. Certain privileges (higher interest rate on deposits), concessions like maintenance of lower percentage of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR), special treatment (refinance facility from RBI and tax exemption), and monopoly power (issue of micro-credit) enjoyed by the UCBs are being taken away one-by-one. However, these institutions have not been able to take the fullest advantage of the economic reforms, as they have not been provided level playing field. Liberalisation, privatization and globalization (LPG) have given functional autonomy and operational freedom to commercial banks but even in this era UCBs do not enjoy the fruits of directed polices of RBI and state governments. Huge non-performing assets (NPAs) are the major problem contributing to failure of UCBs in India. Continued weakness or failure of a significant number of UCBs reflects adversely on the financial system as a whole. Gross non-performing advances have been ranging between 2 percent and 18.3 percent of total advances as on 31st March 2001 in the case of most public sector banks (PSBs).[2] The government had to provide huge amounts to some of the banks to bail them out in successive years from their problem of non-performing advances. The government invested INR 20,446 crores on recapitalization of banks[3] and an additional of INR 2,550 crores were earmarked during 2002-03 for investments towards restructuring of some of the weak banks.[4] 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. Contradictory to this, the RBI imposed restrictions on their activities through the announcement of monetary and credit policy in April 2001. Both, the commercial banks and UCBs accept deposits from the public. The government released huge funds to write-off NPAs of PSBs only. But at the same time UCBs got punishment for their default. In what way will this attitude help the balanced growth of financial system as a whole? Actually in the real interest of depositors of weak UCBs, the regulators should have taken two steps; one to provide financial help for restructuring weak banks and closely monitoring their operations and the other to review their progress. If the regulator is not satisfied with the performance of weak UCBs certain restrictions may be imposed.

Major Issues of UCBs in India

UCBs are pioneers in acknowledging the common man as their client who has to be serviced and have managed to create a niche among the lower and middle-income groups. This institutional network has indeed succeeded in facilitating banking service in a more user-friendly environment. The major policy developments of UCBs have been effective from the year 1992-93 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 following are some of the major issues of UCBs in India.

Competition

Nationalisation of major commercial banks in 1969 with the introduction of social control created a competitive environment for the UCBs, breaking its monopoly in the sphere of micro-credit. Subsequently, the introduction of financial sector reforms in 1991 and the opening up of the economy exposed the inherent adversities in the functioning of the UCBs. The UCBs operate in a highly competitive market, on a level playing field with commercial banks. They do so, by successfully applying the cooperative principle underlying their business model. Owned by its members, their primary mission is to offer them the best services, as opposed to maximizing profit for shareholders[5].

Mismanagement and failure of UCBs

UCBs also have certain weaknesses. For instance, the weakness and instances of mismanagement of the cooperative banking sector were highlighted when the Ahmedabad-based Madhavpura Mercantile Cooperative Bank, with deposits of INR 1,200 crores went into liquidation in March 2001[6]. This bank was one of the scheduled UCBs in the country. Out of total deposits of around INR 1,200 crores in the Madhavpura bank, almost INR 600 crores or more were from over 165 urban banks[7]. This has brought about a situation whereby wrong doings of one bank affected other banks too.

Another significant incident which took place in the history of UCBs sector in India has seriously jeopardized the financial interest of millions of small investors during the year 2002-03. Thirty-nine UCBs in the country were deregistered on account of their non-payment of deposit insurance premium to Deposit Insurance and Credit Guarantee Corporation (DICGO), Mumbai for more than three consecutive periods[8].

The major crisis in UCBs can also be judged from the outflow of funds from DICGC. The DICGC paid INR 104.4 million to depositors of failed banks in the year 2004. The amount rose to INR 148.4 million in the subsequent two year; all the outflows of DICGC have been to cooperative banks only[9].

Political interference

There are instances of gross misuse of cooperative finds for political ends, which has landed a good number of institutions in dire straits. Very often, elected boards and managements are superseded not for reasons of mismanagement or violation of law but on political considerations[10]. These observations confirm that political interference in the cooperative sector always exists. The tendency of politicians to misuse the UCBs for their personal gains has many times landed the UCBs in trouble.

Poor credit management

The gross NPAs of reporting UCBs (1853) in India have increased from INR 3,306 crores in 1999 to INR 13,871 crores in 2006, registering 4.2 times increase. The percentage of gross NPAs to total advances of UCBs, which was 11.07 percent in 1999 rose to 23.40 percent in 2005 and slightly fell to 19.70 percent in 2006. However percentage of NPAs to total advances of UCBs at 19.70 percent as on 31st March 2006 was quite high compared to the percentage as on 31st March 1999 and also in comparison to that of commercial banks (3.3 percent)[11]. The high level of gross NPAs of UCBs was on account of burdensome procedure of write-off of loans as also their inadequate profits to absorb such losses due to write-offs. High level of NPAs is an indication of poor credit management. This is a major cause of failure of UCBs in India.

Supervision and regulation of UCBs by RBI

The RBI introduced income recognition and asset classification norms for UCBs in 1993. In terms of these revised accounting standards, income from NPAs could not be taken to profit and loss account unless the income was realized. These norms prompted banks to pay attention to the quality of their assets. Two aspects of prudential regulation, which have assumed greater importance in the recent period relate to capital adequacy and provisioning. The UCBs have been slack in relation to both these aspects[12]. The following are some of the reasons[13]. (a) High cost deposits (b) Lack of training for staff (d) Low level of IT implementation (e) High interest rates on advances (f) Denial of income from other sources (g) Non-adherence to the prescribed limits of loans.

The norms for the ratio of capital to risk weighted assets (CRAR) have been introduced in UCBs in a phased manner commencing from 31st March 2002[14]. The ability of UCBs to raise capital to meet CRAR Norms is limited by certain peculiar features. The shares of UCBs are neither quoted in the stock market not are these banks allowed to raise capital in the market. Members' shareholdings are linked to the loan amounts and can be withdrawn once the loans are repaid. Members can redeem their shares in the capital resulting in fluctuations in the size of the capital. Managing this aspect is a challenge.

The norms of grading UCBs as weak and sick were modified in the year 2003. The UCBs are classified into four grades namely Grades I, II, III and IV instead of weak and sick with effect from 12.05.2003[15], on the basis of capital adequacy, asset quality, earnings, compliance with CRR/SLR requirements and adherence to RBI guidelines and directives. Grade I banks are only permitted by RBI to declare dividend to their members. This restriction will adversely affect the efforts of the UCBs for augmenting their capital.

A system of supervisory rating for UCBs, under the capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems (CAMELS) model has been introduced by the RBI. The rating system was initially being implemented for scheduled UCBs commencing from the year ended 31st March 2003. A simplified rating system was made applicable to non-scheduled UCBs with effect from 31st March 2004[16].

In order to ensure adherence to the prudential standards by UCBs, the regulator's frequency of intervention increased, thereby affecting the cooperative character. In this regard, RBI intervention has indirectly infringed upon the functional autonomy covering areas like share-linkage, credit, investment, deposit and so on.

Absence of professional management and governance

Professional management is essential for any banking system and hence the RBI insists on it. But on many occasions, the state governments dissolve the elected boards of UCBs and depute government officials to mange the affairs of these banks. As the government officials do not possess adequate expertise in banking, the efficiency of the UCBs suffers.

Absence of human resource management

Human resource management (HRM) is one of the key factors defining the characteristics of a successful banking institution. Improving managerial skills within this sector is now a permanent challenge. Many UCBs are also seeking new ways to allow the involvement in the provision and governance of personal services. Employing and retaining skilled workers and specialists, re-training the existing workforce and promoting a culture of continuous learning are challenges for the UCBs.

Lack of technology based products

The number of customers unhappy with banking service in India is on the rise. This is brought out by the fact that the number of complaints received by banking ombudsman shot up from 5,399 in 2002-03 to 8,246 in 2003-04, marking an increase of 52 percent[17]. The process of globalization requires banks to move towards global standards of customer service so as to effectively meet the growing demands by their customers. E-banking services offered by many banking institutions can be a strategic weapon against UCBs, threatening their very existence.

Recent developments for UCBs

Considering very high rate of failures of UCBs in the recent years, the government and the RBI have together initiated many steps, a few of which are enumerated in the following.

Vision document

The RBI formulated a draft vision document and placed it in the public domain in March 2005 with the objectives of (1) rationalizing the existing regulatory and supervisory approach keeping in view the heterogeneous character of entities in the sector, (2) enhancing professionalism and improving the quality of governance, (3) identifying weak but potentially viable entities in the sector for strengthening through a process of consolidation, (4) identifying the unviable entities and providing exit path for such entities.

MoU with state governments and constitution of TAFCUBs

In pursuance of the proposals in the draft vision document, state governments having a large number of UCBs were approached for signing a memorandum of understanding (MoU). Since June 2005, MoUs have been signed with eight state governments viz Andhra Pradesh, Gujarat, Karnataka, Madhya Pradesh, Uttranchal, Rajasthan, Chhattisgarh and Goa, which together constitute 844 UCBs i.e. over 45 percent of total number of UCBs and account for almost 23 percent of deposits of the sector[18]. After signing of MoU, as per agreement, RBI constituted state level task force for cooperative Urban Banks (TAFCUB) which is a six-member body with two representatives each from state government, UCB sector and the RBI. The constitution of TAFCUB is mainly concerned with the development of UCBs in the state on sound lines.

At the same time, some states have reservation on signing the MoU with the RBI. It is generally believed that if the state governments signed MoU with RBI, then that will minimize the role of the registrar of cooperative societies of the concerned state and thereafter RBI will become the sole regulator of UCBs. It is the best way of eliminating dual control regime.

In order to achieve the objectives set our in the vision document, the RBI is bringing in a two-tiered regulatory and supervisory regime. Banks with deposits under INR 100 crores and whose operations are limited to a district are considered to be more closely optimizing the spirit of cooperative banking and as such are placed under simplified regulations to enable them to gain in strength. Gradually, over a period of three years they can be brought at par with all other banks in terms of performance, strength and regulatory prescriptions.

The 'not-one-size-fits-for-all' approach of RBI will be effective only when there are uniform laws governing the management and operations of the cooperative institutions. Another difficulty encountered by the RBI in exercising two-tier approach is lack of transparency and governance principles in the operations of the UCBs. The RBI and the national and state level federations of UCBs are struggling to gather information about the performance of UCBs. The information provided has discrepancies and only 70 to 75 percent of UCBs have reported their performance. As a result, it is very difficult to practice a two-tier approach by the RBI.

Merger and consolidation

The merger process in UCBs sector has gathered momentum over the last one year. The proposal of consolidation through the process of merger of weak entities with stronger ones in the cooperative sector may not be a healthy process. Merger and consolidation process of a weak and a strong bank is not practicable because the financial burden of weak bank may adversely affect the financially strong one. It may also create conflict among the boards of directors of the merged entities.

Need for strategic transformation

The following measures are suggested for the development and improvement of UCBs in future.

Augmenting capital

The capital base of UCBs can be strengthened in the following three ways:

a) Enhancing membership and motivating depositors to become ‘A’ class members, because they are contributing money to the bank for doing the business.
b) Raising upper statutory limit of shares linked to borrowings.
c) Increasing the face value of each share of the UCBs to INR 100.

Shuttling of portfolios

As per the RBI direction, every UCB has to invest up to 10 to 15 percent of their net demand and time liabilities (NDTL) in government securities for maintenance of their SLR. A bank can go for investment in government securities rather than parking funds in district central cooperative banks (DCCBs), scheduled commercial banks (SCBs) and increase their CRAR. The bank balance in DCCBs/SCBs will have 20 percent risk weight whereas the government securities have only 2.5 percent of risk weight. Thus, a prudent banker can park funds in government securities and maintain the low risk assets and higher CRAR.

Reduction of high cost deposits

The share of fixed deposits in UCBs is more than three-fourth of their total deposits. Such a swing towards fixed deposits in the deposit-mix of the banks cannot be reckoned as a healthy sign because it leads not only to the erosion of profits but also affects the financial condition of the banks. Special attention should, therefore, be paid by UCBs to mobilize savings and current deposits with a view to reducing the cost of funds. Due to high cost of deposits, the banks are unable to lend to the borrowers at a competitive rate, as they would incur loss and in turn not being able to capture good borrowers.

End of dual control

The earlier committees like Madhava Das Committee (1978), Maratha Committee (1992) and quite recently Narasimham Committee (1998) and High power committee (1999) have all suggested that there is a need to address the issue of duality of control on UCBs by carrying out necessary statutory amendments. It has also become a real challenge for the UCBs to maintain the cooperative character and at the same time to do commercially viable banking business. So it is time to put an end to the dual control of UCBs.

Removal of political interference

The autonomy and efficiency of UCBs have been eroded over a period of time due to undue political interference. Political influence in the management of UCBs has an adverse impact on small traders. In order to avoid political interference, there is a need to have suitable legal provisions prohibiting the office bearers of political parties from holding office of directors of UCBs. RBI or National Bank for Agriculture and Rural Development (NABARD) should prevail upon the government of India/State governments to bring suitable amendments in this regard to State Cooperative Societies Act/Banking Regulation Act 1949.

Similarly, guidelines should be issued in respect of situations when state governments would be justified in announcing waiver of interest and principal loans granted by UCBs. This will avoid instances of such announcements for political gains by the ruling parties, which affects the profitability of UCBs.

Increasing income from other sources

The UCBs should undertake non-funded business like issue of demand draft, bank guarantee, increasing safe deposits lockers, foreign exchange transactions (if RBI permits), providing advisory and consultancy services to cottage and tiny industries, collecting electricity bills, telephone bills, income tax, sales tax, custom duties in order to improve their income. Handing of government business would automatically increase the trustworthiness of UCBs.

System of human resource management

In order to meet the global standards and to remain competitive, UCBs will have to recruit specialists in various fields such as treasury management, credit and risk management, IT related services, HRM, etc., in keeping with the segmentation and product innovation. As a complementary measure, fast track merit and performance-based promotion from within would have to be institutionalized to inject dynamism in the workforce. Another important ingredient of HRM is reward and compensation, which at present does not have any linkage to skills and performance. There is an urgent need to have the system of reward and compensation in place that will attract, recognize and retain the talent in UCBs on the lines comparable with other banks, particularly banks in private sector and the foreign banks.

Continued existence of cooperatives

Apprehensions have been expressed that the cooperatives will not be able to face competition from the private sector. This fear is largely unfounded. First, cooperatives already have a head start in terms of their reach and infrastructure. Secondly, their area of business is such that, in most cases, private entrepreneurs/companies shy away from. For instance, one cannot imagine a multinational bank to open a branch in a remote place, however profitable the proposition may be. The main difference between a cooperative and a well-run private company is management. To bridge this gap, executives in UCBs must be suitably trained.

Need for autonomy

The interference of state government in the organization and day-to-day functions of UCBs is a disturbing feature. Many times, this causes impairment to UCBs in governance and in management. The impairment in governance is deep due to various reasons: (1) Stay on elections in cooperatives in some states since May 2001 (2) Interference in the form of superseding of board of directions and (3) Departmental interference in financial matters in various forms like directions on interest rates, interference in loan decisions, announcement of waivers. The functional freedom to UCBs is the need of the hour.

Awareness programmes for employees

A proper training to the employees in bank management enhances their knowledge, which is necessary for the smooth functioning of the business of the banks. The role of employees for the success of banks is very important. Some employees do not have proficiency in their work. At the same time some employees are not only worthy but also honest and dedicated to their work. There has to be a commitment and involvement of every employee in the functioning of UCBs. They should appreciate the fact that their livelihood is based on the survival of their employer and collapse of the system would render them jobless. The political elements can switch over to other organizations and shareholders also have alternatives for getting banking services in case of failure of a UCB whereas the employees generally are left to fend for themselves. Hence it is the basic duty of every employee of the cooperative sector to appreciate the above facts and work in the larger interest of cooperative banks.

Conclusion

In the last one and a half decade the UCBs have undergone historical transformations of unprecedented breadth and depth. This new stage has generated special concern amongst cooperative banks. UCBs are increasingly operating in highly competitive market environment. The severe competition they face from nationalized banks, private sector banks, and foreign banks poses a threat to the survival of UCBs in small towns. The ever-increasing incidence of overdues and consequent NPAs occasioned by poor recoveries of loans disbursed by the banks and inadequate human resources development have crippled their financial solvency, economic viability and profitability.[19] As such, the problems faced by the UCBs need to be addressed urgently, not only to ensure future growth of these institutions, but also to secure orderly progress of the entire financial system of the country. In India, demand for quality service has been met with some degree of efficiency and equity; but in few cases the customers' basic expectations are not satisfied. Although the UCBs have shown significant progress in attaining more just and inclusive financial services at local levels, there remains enormous practical and theoretical challenges that demand multidisciplinary approaches and new strategies by those engaged in development.

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