

Draft Vision Document for Urban Co-operative Banks

Urban Co-operative Banks (UCBs) are an important part of the financial system in India. It is, therefore, necessary that the UCBs emerge as a sound and healthy network of jointly owned, democratically controlled, and ethically managed banking institutions providing need based quality banking services, essentially to the middle and lower middle classes and marginalized sections of the society.

This document sets out the broad approach and strategies that need to be adopted to actualize this vision.

1. Background

1.1 The urban cooperative banking system has witnessed phenomenal growth during the last one and a half decades. From 1307 urban cooperative banks (UCBs) in 1991, the number of UCBs has risen to 2105 in the year 2004. Deposits have increased by over 1100 percent from Rs. 8600 crore to over Rs.100, 000 crore, while advances have risen from Rs. 7800 crore to over Rs.65,000 i.e. by 733 percent during the above 15-year period. This growth path has been possible mainly on account of the enabling policy environment in the Post 1991 period, which encouraged setting up of new urban cooperative banks. Further, the deregulation of interest rates, as available to commercial banks, enabled the UCBs to mobilize vast deposits, which, together with the liberal licensing policy propelled the growth of UCBs in terms of numbers as also in size. This significant growth in business, which has come about in a competitive environment was largely due to the efforts and the ability of the sector to harness resources from the small depositors.

1.2. Thus, while the sector has shown spectacular growth during the last decade exhibiting substantial potential for sustained growth, there are certain infirmities in the sector that have manifested in the form of weakness of some of the entities resulting in erosion of public confidence and causing concern to the regulators as also to the sector at large. There is, thus, a need to harness the benefit of rapid growth and mitigate the risk to which individual banks and the system are exposed by providing a regulatory and supervisory framework that will address the problems of the sector as also the shortcomings of dual control.

2. Objective

2.1. In the light of above, the broad objectives of the document can be set out as under: -

- i. To rationalize the existing regulatory and supervisory approach keeping in view the heterogeneous character of entities in the sector
- ii. To facilitate a focused and continuous system of supervision through enhanced use of technology.
- iii. To enhance professionalism and improve the quality of governance in UCBs by providing training for skill up-gradation as also by including large depositors in the decision making process / management of banks.
- iv. To put in place a mechanism that addresses the problems of dual control, given the present legal framework, and the time consuming process in bringing requisite legislative changes
- v. To put in place a consultative arrangement for identifying weak but potentially viable entities in the sector and provide a framework for their being nurtured back to health including, if necessary, through a process of consolidation
- vi. To identify the unviable entities in the sector and provide an exit path for such entities.

3. The Operating Environment

3.1. Urban cooperative banks form a heterogeneous group in terms of geographical spread, area of operation, size or even in terms of individual performance. As such, development of the urban cooperative banking institutions into safe and vibrant entities requires the small banks in the group to be insulated from systemic shocks by emphasizing their cooperative character. Further, the weak banks may have to be strengthened as a group, through a process of consolidation that may entail mergers/ amalgamations of viable entities and exit of the unviable ones, if there are no other options available. It is also felt that it is necessary to set up a supervisory system that is based on an in-depth analysis of the heterogeneous character of the urban cooperative banks and one that is in tandem with the policy of strengthening the sector.

4. Structures and Spread of UCBs

4.1. In terms of geographical spread, UCBs are unevenly distributed across the states. Five states viz., Maharashtra, Gujarat, Karnataka, Andhra Pradesh and Tamil Nadu account for 1523 out of 1924 banks that presently comprise the sector. Further, the UCBs in these states account for approximately 82% of the deposits and advances of the sector as may be seen from the table below:

Name of the State	No of banks in operation	% to total no. of banks	Deposits (Rupees in lakhs)	% of deposits to total deposits	Advances (Rupees in lakhs)	% of advances to total advances
Maharashtra	639	26.68	60,72,498	55.08	37,42,401.2	55.09
Gujarat	321	15.24	16,27,946	14.77	9,70,287.03	14.28
Karnataka	300	14.25	8,35,274	7.58	5,37,186.7	7.91
Tamil Nadu	132	6.27	3,10,521	2.82	2,12,113.28	3.12
Andhra Pradesh	131	6.22	2,11,324	1.92	1,37,888.23	2.03
Total	1,523	2,106	90,57,563	82.15	55,99,876.5	82.44

For all UCBs in the country, the total Deposits are Rs. 1,10,25,642 lakhs and total Advances are Rs. 67,93,017 lakhs.

5. Regulatory Environment

The urban co-operative banks are regulated and supervised by State Registrars of Co-operative Societies, Central Registrar of Co-operative Societies in case of Multi-state co-operative banks and by Reserve Bank. The Registrars of Co-operative Societies of the States exercise powers under the respective Co-operative Societies Act of the States in regard to incorporation, registration, management, amalgamation, reconstruction or liquidation. In case of the urban co-operative banks having multi-state presence, the Central Registrar of Co-operative Societies, New Delhi, exercises such powers. The banking related functions, such as issue of license to start new banks / branches, matters relating to interest rates, loan policies, investments, prudential exposure norms etc. are regulated and supervised by the Reserve Bank of India under the provisions of the Banking Regulation Act, 1949(AACS). Various Committees in the past, which went into working of the UCBs, have found that the multiplicity of command centers and the absence of clear-cut demarcation between the functions of State Governments and the Reserve Bank have been the most vexatious problems of urban cooperative banking movement. This duality of command is largely responsible for

most of the difficulties in implementing regulatory measures with the required speed and urgency and impedes effective supervision.

6. Strategy

6.1 State Specific Approach

6.1.1. The strategy to deal with the UCBs may need to be state specific, one that involves the concerned State Government, RBI and the UCBs operating in the state. A State level Task Force on Co-operative Urban Banks (TAFUCB) comprising the Regional Director (RD) of the RBI for the concerned state, Registrar of Cooperative Societies, an official from Central Office of Urban Banks Department (UBD), in-charge of UBD of the concerned Regional Office of RBI and a representative each from NAFCUB and the State Federation of the UCBs, could be set up, in each of the 5 states with high concentration of UCBs and in a few other states having, say, more than 50 banks to explore viable state specific solutions, including, on the future set up of the existing unlicensed banks whose license applications are pending with the RBI. Similar approaches may be considered for other states in a second phase after assessing the working of the state specific approach in the five states and in states with more than 50 UCBs. However, if any state prefers to adopt the approach in the first phase itself, RBI could consider the proposal appropriately.

6.1.2 The Regional Director (RD) of the RBI and RCS of the concerned state could be the Chairman and co-chairman of TAFUCB, respectively. Each TAFUCB could identify the weak but viable (non-scheduled) UCBs in the respective states and frame a time bound programme for revival of such entities. It would identify the nature and extent of funds required to be infused, the changes in management where necessary and suggest periodical milestones to be achieved. The RBI would closely monitor the progress made by the bank vis-à-vis the revival plan and initiate appropriate action, in case of non-achievement of the targets, as per the plan. Further, UCBs which are not found viable by the TAFUCB, could be required to exit from banking business either through merger with strong banks, if such merger makes economic sense to the acquiring bank, or through voluntary conversion into a cooperative society by paying off the non-member deposits and withdrawing from the payment system and if there is not other viable option they could even be taken into liquidation by the Registrar at the behest of the RBI. The proposed terms of reference of TAFUCB is given in Appendix.

6.1.3. The guidelines on merger and amalgamations (M&A) of UCBs have been issued vide our circular UBD.No.(PCB)Cir.36/09.169.00/2004-05 dated February 2, 2005. These guidelines provide that Reserve Bank of India may consider proposals for merger and amalgamation in the following circumstances:

(i) When the networth of the acquired bank is positive and the acquirer bank assures to protect entire deposits of all the depositors of the acquired bank.

(ii) When the networth of acquired bank is negative and the acquirer bank on its own assures to protect deposits of all the depositors of the acquired bank.

(iii) When the networth of the acquired bank is negative and the acquirer bank assures to protect the deposits of all the depositors of the acquired bank with financial support from the State Government extended upfront as part of the process of merger.

In all cases of merger/ amalgamation the financial parameters of the acquirer bank, post merger, should conform to the prescribed minimum prudential and regulatory requirement for urban co-operative banks and the realizable value of assets has to be assessed through a process of due diligence. TAFUCB shall make suitable recommendations on M&A based on the above guidelines

6.2 Memorandum of Understanding with State Governments

As per provisions of the State Cooperative Societies Act as also the BR Act 1949 (AACS), the Reserve Bank is not empowered to take action against the management of an urban cooperative bank, in case of need, as in respect of commercial banks. It may be useful to have a working arrangement in the form of Memorandum of Understanding (MOU) between the RBI and the State Government/CRCS to ensure that the difficulties caused by dual control are suitably addressed through such MOU/s. The State Governments may, through the MOU, agree to take immediate action on requisitions of RBI for supersession of the Board of Directors, appointment of liquidators, initiating action for removal of CEO/Chairman of a bank, enhancing quality of HR and IT resources in the banks on the lines required by RBI, work to raise the standards of corporate Governance by putting in place certain minimum fit and proper criteria for members to be eligible for seeking election for the post of director, institute special audit by Chartered Accountants, the cost of which may be borne by the RBI, and furnish reports of the findings within a given time frame, introduce long form audit reports for conducting statutory audit, modify its audit rating models to bring it on par with the gradation system of RBI, conduct statutory audit only through external Chartered Accountants in respect of banks with deposits over a specified minimum level etc. The draft MOU is given in Annexure –I. The TAFUCBs would be set up in states that sign the MOUs with the RBI. In respect of the states that sign the MOU but do not fulfill the commitments therein, the TAFUCB would cease to function and RBI would be at liberty to initiate appropriate corrective action

7. Proposed Operating Framework

7.1. The entities in the sector display a high degree of heterogeneity in terms of their deposit/ asset base, area of operations and nature of business. A system of differentiated regulatory and supervisory regime as opposed to a 'one size fits all' approach may be more appropriate, keeping in view the vastly differentiated entities comprising the sector. The broad principles governing RBI regulation over UCBs could largely follow the principles as under:

A. Unit Banks (Simplified regulatory regime)

7.2. Unit banks, in particular, the smaller among them, essentially capture the basic concept and spirit of cooperative banking since they function from a single office/ branch and cater to the clientele in and around their place of business. As such, they have a natural ability to relate to the customer, have the local feel and flavour and consequently modulate their business strategy to meet the local aspirations. Since small unit banks with deposits below, say, Rs.50 crore epitomise the basic tenets of cooperative banking, less stringent regulations could be considered for such banks. For example, CRAR could be replaced by the simpler form of minimum capital requirement viz. Net Owned Funds to NDTL ratio which is easier to compute for the small banks while serving the purpose adequately. At the same time, keeping in view their ability to assess and absorb risks, appropriate limitations like a lower level of single and group exposure limit could be prescribed for these banks to contain their concentration risk. Similarly, the exposure by such banks to sensitive sector should be checked, as these banks lack the wherewithal, in terms of expertise, technology and financial strength to sustain exposure to capital market / real estate etc. As such, keeping in view the nature and size of their operations, appropriate relaxations like a lower prescribed minimum investment in G-Sec (in view of their inability to access market) and restrictions necessary to insulate them from systemic shocks may be introduced for such banks. Ideally the unit banks should work within a small geographical area and accordingly the Unit banks to be eligible for the simplified regulatory regime shall conform to this requirement by rolling back their business in far off locations. The suggested simplified regulatory prescriptions are given in Annexure - II.

B. All Banks (other than unit banks with deposits less than Rs. 50 crore)

7.3. Regulatory prescriptions, as applicable to commercial banks should be applicable in all respects to banks falling in this category. However, for these banks the extant relaxations for UCBs could remain in force for the period already prescribed. Further, it is suggested that as a matter of principle, there should not be any unscheduled Multi State Bank. This could be operationalised through the

Central Registrar of Cooperative Societies, which could ensure that a bank is scheduled before it is granted registration under the Multi State Co-operative Societies Act. In order to ensure that all scheduled banks are also, as far as possible, strong enough to support themselves and a few smaller UCBs around them, the RBI could prescribe appropriate norms for scheduling of cooperative banks. Further, banks in this category which comply with the prescribed regulatory requirements can be extended facilities and privileges as are presently available to the commercial banks of comparable size.

7.4. The existing scheduled banks, both under Multi State and State Cooperative Societies Act, which do not meet the prescribed criteria and do not comply with the prudential and regulatory regimen akin to that of commercial banks, could be excluded from the second schedule to the RBI Act through a time bound corrective action framework. As a corollary, the existing non-scheduled Multi State Banks could also be required to close their branches/withdraw from any business outside the principal State of their activity.

8. Supervision

The number of unit banks with deposits under Rs. 50 crore constitute 33 percent of UCBs and account for less than 6 percent of deposits of the sector. These banks, limited by their size / type of operations, pose lower systemic risks and could be supervised by a combination of simplified off-site surveillance system of the RBI and on-site audit by the state governments. Based on these reports, Reserve Bank of India, at its discretion, could conduct inspection of such banks, which, however would not be normally covered under its regular schedule of inspection. The increased dependence on off-site surveillance of RBI and on-site supervision by RCS in respect of the small unit banks would provide increased flexibility to the RBI to deploy its supervisory resources to the larger and more risky banks.

9. Developmental Role of RBI

9.1 The Reserve Bank may have to provide assistance to the UCBs, more particularly the smaller ones, in improving their skill levels. Since the College of Agricultural Banking is already providing training facilities to the UCBs, this institution could be used as the forum for doing so. Keeping in view the financial implications for banks, for providing quality training, the cost of training programmes could be largely subsidised by the Reserve Bank for the Unit banks falling under Tier I.

9.2 The Reserve Bank has been encouraging the UCBs to invest in government securities by stipulating that a portion of the SLR investments are held in the form of these securities. There is an inherent advantage in holding a part of the SLR investments in G-Secs as otherwise the banks are

required to keep their entire SLR in higher tier co-operative banks, the financial position of which may itself be uncertain. At the same time it would be necessary to ensure that the UCBs are not put to any difficulty in buying and selling the securities. To address this issue Reserve Bank may, through its Regional Directors, liaise with the network of Primary Dealers to put in place an appropriate arrangement in this regard.

10. Conclusion

Every authority concerned with Co-operative sector will have to play its part in ensuring that the aspirations of the Urban Co-operative Banking sector are nurtured in a manner that depositor interest and the public interest at large is protected. The role of RBI could, thus, be to frame a regulatory and supervisory regime that is multi-layered to capture the heterogeneity of the sector and implement policies that would provide adequate elbowroom for the sector to grow in a non-disruptive manner. The State and Central Governments could recognize that the UCBs are not just co-operative societies but they are essentially banking entities whose management structure is that of a co-operative. They should recognize the systemic impact that inefficient functioning of the entities in the sector could have. Consequently, it would be in the interest of the sector if they support, facilitate and empower the RBI to put in place mechanisms and systems that would enable these UCBs to perform their banking functions in a manner that is in the overall interest of the depositor and the public at large.

Appendix**Draft terms of reference of the TAFUCB**

1. To categorise the UCBs in the state under the two tiers of regulatory regime.
2. To identify banks, which are viable, potentially viable and unviable.
3. To recommend the various conditions, including the nature and extent of funds required to be infused, in each UCB identified as potentially viable, the source thereof, changes in management where necessary and the time frame for achieving viability. In doing so, the TAFUCB may assign responsibility to different agencies for facilitating the turn-around.
4. To set up milestones for evaluation of progress made under the rehabilitation plan.
5. To recommend the future set up of the existing unlicensed banks whose applications are pending with Reserve Bank of India.
6. To recommend the manner and time frame for exit of the un-viable banks, which could be in the form of merger / amalgamation, conversion into a credit society and liquidation. The proposals for merger / amalgamation recommended by the TAFUCB shall conform to the guidelines issued in this regard.
7. To arrive at a threshold limit of deposits that would make a depositor automatically eligible to become a member.
8. To recommend on the management aspects of a bank which is placed under the revival plan.
9. Any other issues as may be referred to it by the Reserve Bank of India.

Annexure-I

This Memorandum of Understanding dated between the Government of the State ofrepresented byhaving office at (hereinafter referred to as 'the State') and the Reserve Bank of India having its Central Office at Shahid Bhagat Singh Marg, Post Box No. 406, Mumbai – 400 001 (hereinafter referred to as 'Reserve Bank').

Whereas the State administers theCo-operative Societies Act, and the Reserve Bank is the regulator of co-operative banks under the Banking Regulation Act,1949(as applicable to co-operative banks), the State and the Reserve bank exercise regulatory powers over co-operative banks concurrently;

And whereas it is considered essential to have coordination between the State and the Reserve Bank for ensuring proper regulation of co-operative banks;

It has, therefore, been decided to enter into a Memorandum of Understanding between the State and the Reserve Bank as under:

1. On requisition of the Reserve Bank under Section of theCo-operative Societies Act, for supercession of the Board of a co-operative bank and appointment of Administrator therefor, the State shall comply with the requisition forthwith.
2. On requisition of the Reserve Bank for winding up of a co-operative bank and appointment of a Liquidator therefor under Section of theCo-operative Societies Act, the State shall comply with the requisition forthwith.
3. The Board of the a Co-operative bank shall not be superceded by the Registrar without the prior approval of the Reserve Bank
4. The election to the Board of a co-operative bank shall not be postponed nor the tenure of the Board extended without concurrence of the Reserve Bank.
5. The State shall introduce long form audit report for conducting statutory audit of all urban cooperative banks. For banks with a deposit base of over Rs. 25 crore the State shall provide for the statutory audit to be mandatorily conducted by qualified Chartered Accountants to be appointed in consultation with the Reserve Bank of India.
6. The State shall modify the audit rating models such that the same is brought in alignment with the gradation system adopted by the Reserve Bank of India.
7. The State shall work to raise the standards of corporate Governance by putting in place certain minimum fit and proper criteria for members to be eligible for seeking election for the post of director or for being appointed as CEO, based on guidelines provided by Reserve Bank.

- 8. The State shall provide for upgradation of HR and IT in co-operative banks in consultation with the Reserve Bank.
- 9. The State shall provide for conduct of special audit of a co-operative bank if requested by the Reserve Bank and for submitting of report to the Reserve Bank within the time stipulated by it.

The State government hereby notes that the Reserve Bank would be constituting a State level Task Force on Urban co-operative banks (T AFCUB) for identification of potentially viable UCBs and that in the event of any of the above terms being not observed, the Reserve Bank, at its discretion, would wind up the T AFCUB and it would be at liberty to initiate such corrective action in terms of the provisions of the B.R. Act, 1949 (AACS) as it considers appropriate with respect to the urban cooperative banks in the state, notwithstanding any recommendations that might have been made by the T AFCUB.

In witness whereof the parties hereto have signed this Memorandum of Understanding aton thisday of2005.

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 For the State

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 For the Reserve Bank of India.

Witnesses

- 1.
- 2.

Proposed 2 - Tiered Regulatory Regime

UCBs may be classified into the following two tiers of regulatory regime:

- a) **Tier I:**
Unit Banks with deposits upto Rs. 50 crore
- b) **Tier II**
All other Banks

To determine the deposit base, the fortnightly average of the NDTL reported in the statutory returns in the preceding accounting year may be reckoned so that a stable and reliable basis is adopted.

The prudential norms recommended for banks falling under different Tiers are as under:

(I) Tier I Banks i.e. Unit Banks with deposits less than Rs.50 crore**(i) Asset classification norms:**

To identify NPAs on the basis of 180 day delinquency norm for three more years commencing March 31 2005 but build up adequate provisions in the BDDR over the next three years such that they would be able to transit to 90 day NPA norm by March 31 2008. Since the 90 day norm for asset classification came into force effective March 31 2004, revised asset classification norm should not result in any write back of provisions and the new norm would be applicable for identification of NPAs in 2005 and onwards.

Note: Extant instructions would apply for agricultural loans.

(ii) Provisioning norms:

The provisioning norms will be as under for another three years:

- Sub standard : 10%
- Doubtful (up to one year) : 100% of unsecured portion plus 20% of secured portion
- Doubtful (one to three years) : 100% of unsecured portion plus 30% of secured portion
- Doubtful for more than 3 years: 100% of unsecured portion plus 50% of secured portion
- Loss : 100%.

Note: i) A Sub standard account will be classified as doubtful after 18 months.

ii) All the above provisioning norms will apply for another 3 years. Consequently implementation of the instructions requiring classification of substandard account into doubtful category after 12 months instead of 18 months and 100 % provisioning for doubtful assets of over 3 years would be deferred by another three years. As such the banks should build up adequate provisions over this period to facilitate smooth transition.

(iii) Norms for Investment:

(iii.i) SLR: The minimum SLR holding in Government and other approved securities as a percentage of NDTL for non scheduled UCBs is presently 15 % for banks with NDTL of over Rs. 25 crores and 10% for the remaining non scheduled UCBs. It is observed that the smaller banks, particularly those operating in rural, semi-urban centers, find it difficult to make investments in G-Sec due to lack of access to the markets. In order to meet SLR requirements, these banks often have to purchase G-Sec at a price that is higher than prevailing market rates, as they do not have the wherewithal to obtain information on current market price of these securities, like access to PDO-NDS platform etc.

While efforts will be made to enable access to securities' market through Primary Dealers, in the interregnum, these banks could be exempted from compulsory investment in G-Sec to the extent of the deposits kept by them in SBI, Associates and Nationalised banks.

(iii.ii) Non-SLR: Present limit of 10% of total investments would continue.

(iv) Borrowings: Not to exceed 2% of deposits

(v) Capital Adequacy:

At present all UCBs are required to comply with 9% CRAR akin to commercial banks. For easier understanding and simplification, it is suggested that CRAR in respect of Tier I banks may be replaced with a Net Owned funds to NDTL ratio. It is proposed that a NDTL to NOF ratio of 15 could be prescribed.

(vi) Exposure Norms:

10% of capital funds or Rs.40 lakhs, whichever is lower for individual borrower and 20% or Rs.80 lakhs, whichever is lower, for group, would be applicable in order to contain concentration risk for the Tier I banks.

Off-Balance sheet exposure not to exceed 2 percent of NDTL.

(vii) Sensitive Sector Exposure:

Tier I banks should not be allowed to take any direct exposure to real estate, builders or to the capital market. However, loan for individual housing may still be extended by these banks upto the present limit of Rs.15 lakh per individual borrower.

(viii) Audit:

Concurrent audit should be compulsory for all banks. Statutory audit should be done using Long Form Audit Report. Statutory audit of banks with deposit base of over Rs 25 crore should be entrusted to chartered accountants.

TIER - II (All other banks) :

For all banks, other than unit banks with deposits upto Rs.50 crore, all regulations as applicable to commercial banks should be applied, However, for these banks the extant relaxations for UCBs could remain in force for the period already prescribed. Further, facilities and opportunities available to commercial banks should, as far as possible, be also made available to such banks to enable them to grow and compete with commercial banks. Banks that do not comply with the regulations should either reduce their operations to qualify for the relaxed regulations applicable for unit banks with deposits less than Rs.50 crore or may be required to convert into cooperative societies.