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CO-OPERATIVE BANKS: IS DUAL REGULATION THE PROBLEM?

Relevant for: Developmental Issues | Topic: Role of NGOs, SHGs, Donors & Charities, and Institutional & other Stakeholders in Development Process

In late September, the Reserve Bank of India (RBI) imposed restrictions on withdrawals from the Punjab and Maharashtra Cooperative (PMC) Bank, one of the largest urban cooperative lenders. Over the past week, bank customers have been in a state of panic and the central bank has sought to assuage concerns about the banking sector's health. Usha Thorat, former RBI Deputy Governor, and S. Mahendra Dev, Director, Indira Gandhi Institute for Development Research, discuss the measures needed to restore confidence among customers in a conversation moderated by ***Vikas Dhoot****. Edited excerpts:*

Usha Thorat: One needs to go back to history. Cooperative banks came directly under the RBI's radar in 1966 but faced the problem of dual regulation. The Registrar of Cooperative Societies (RCS) is in control of management elections and many administrative issues as well as auditing. And the RBI brought them under the Banking Regulation Act as applicable to cooperative societies, which included all the regulatory aspects, namely, the granting of the licence, maintaining cash reserve, statutory liquidity and capital adequacy ratios, and inspection of these banks. So, in a sense, urban cooperative banks have been under the radar of the RBI, but because of dual regulation, one always had a feeling that one did not have as much control over these banks in terms of supercession of boards or removal of directors, as the RBI has over private sector banks.

The Madhavpura Mercantile Cooperative Bank issue turned out to be huge because it had a significant percentage of its assets as loans to Ketan Parekh, not unlike the case we are seeing now. And because it was an active bank in liquidity and money markets, Madhavpura used to provide liquidity to many other banks, so a huge number of cooperative banks had deposits with Madhavpura. So, a closure of that bank would have meant the closure of several other banks too. There was a lot of talk between the RBI, and the Central and Gujarat governments and a package was put together for Madhavpura. It was challenged, but finally it did go through with a staggered repayment of deposits and infusion of funds from the Deposit Insurance and Credit Guarantee Corporation (DICGC). I don't recall whether the legal challenge was finally disposed of.

Why I am talking of Madhavpura is that maybe some parts of its resolution can be examined today. After this episode, RBI decided to squarely deal with the problems of cooperative banks. It issued a vision document in 2004-05 and stopped all licences of new branches and new bank entities. There was a proliferation of licences issued between 1991 and 1998. Under the vision document, a Memorandum of Agreement was entered into by the RBI with each of the States, where the State accepted an audit by professional auditors, and constituted a Task Force for urban cooperative banks. The TAFCUB was co-chaired by the RCS and the RBI Regional Director and was required to provide a bank-by-bank solution to those banks that were not maintaining minimum capital ratios. Not giving any new licences or new branches also pushed existing cooperative banks to come forth to take over the weak ones. This worked very well and a number of cooperative banks were delicensed, merged or liquidated. By 2017-18, as stated in the RBI Financial Stability Report, there were only four urban cooperative banks with capital adequacy ratios below the regulated threshold.

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UT: I don't think so. As I said, there was a forum for the RBI and the RCS to work together. Moreover, since 2004, a number of banks have been brought under all-inclusive directions where there have been significant weaknesses. So, the RBI has been taking action when it is clear that a bank is not able to carry on its operations in a manner that protects the interests of the depositors. But in PMC's case, it is a fraud, total hiding [of the problem] — a huge exposure to a single entity in the real estate sector was camouflaged under a whole lot of dummy accounts. Reporting to RBI and probably the auditors too was false. So, primarily, the CEO and the Board are responsible. It is not due to dual regulation.

How could this happen? Does this throw up fresh challenges on the kind of information the RBI should be looking for? Should it be doing a forensic audit? Is it possible to do this for more than 1,400 urban cooperative banks? How do you realise there is a problem brewing? I think there is a serious need to understand how the exposure was camouflaged, how did this not get reflected in other returns filed, etc.

S. Mahendra Dev: Cooperative institutions play a significant role in credit delivery to unbanked segments and financial inclusion. But their role has declined with the expansion of scheduled commercial banks and adoption of technology. Even urban cooperative lenders are facing competition from payment banks, small finance banks, and NBFCs (non-banking finance companies). We have about 1,500 urban cooperatives, but there are nearly 96,000 rural banks, including primary agriculture credit societies. Long-term credit extended by them is declining, but there is still a role in agriculture for rural cooperative societies. On the urban front, however, there is a need for change partly because of some of these scams that Ms. Thorat mentioned.

In the case of PMC Bank, as per RBI, there are three problems — major financial irregularities, failure of internal control and systems, and underreporting of exposures. It is well known that PMC Bank has extended 73% of its assets to HDIL, which has created a panicky situation for depositors. The RBI has had to clarify that Indian banking is safe. The problem is, of course, dual control by the RBI and the RCS, with the State government also playing a role and politics sometimes entering the space. The management, Board and auditors are responsible. It's a governance and transparency issue that also affects public sector banks, private banks, and NBFCs.

So, what should be done? I am in favour of merging and converting some of the cooperative banks to small finance banks. The RBI has announced a scheme for voluntary transition of urban cooperative banks into small finance banks, in line with the recommendations of a high-powered committee chaired by former Deputy Governor of the RBI, R. Gandhi. This would enable them to have most of the products available with commercial banks, and help get a pan-India presence. But there are many conditions on share capital, loan sizes and loans to priority sector. So, you can't convert all of them but there can be a gradual move towards that.

UT: Let's again look at the things the RBI has tried to do in the last four-five years. First, there was a committee under H. Malegam which recommended a board of management of fit and proper persons, other than the board of directors. Directors are elected by members and very often the borrowers get to nominate their own persons, while depositors are not really represented as these banks accept deposits from non-members. So, the idea was to have a board of management in actual control of operations as opposed to elected directors. I think this must be done immediately as an incentive for those who want to continue to grow. We should perhaps tell these banks, you must put this in place, otherwise there will be no more branch licences and we can impose restrictions on your loan book. There must be a push for a fit and proper management, otherwise the elected director can get away with fraud. Then all we can do is cope with the aftermath of his or her actions.

Having said that, you will find that a majority of the cooperative banks have been doing a good job — meeting the needs of small businesses and even rural credit — very much what we call inclusive finance. Just about 50 or 60 of these 1,500 banks are large. So the RBI's supervisory resources have to be really focused on these larger banks mostly operating across the country like commercial banks.

Second, the RBI has given the choice to urban cooperative banks to convert to small finance banks. That option is there for those players with more than 50 crore capital and 15% capital adequacy. This is an incentive as they will then be able to grow their capital by issuing shares at a premium. Today, the biggest hurdle for an urban cooperative bank is to raise capital. For them, the RBI might like to incentivise conversion into small finance banks. It can say that for further growth the larger urban cooperative banks should either appoint a board of management that meets the RBI's norms for fit and proper or become small finance banks. The challenge in banking supervision and regulation lies in knowing the quality and engagement of the Board, the key personnel and their conflicts of interest and connections.

Third, RBI has also said that for urban cooperative banks there could be an umbrella organisation promoted by the banks themselves to raise capital as a joint stock company can from the markets.

This incident poses a challenge for supervision. It comes back to how exposures can be hidden, which can be done in any bank or NBFC, not just a cooperative. The supervision system should be able to catch much more underreporting or false reporting and ensure accountability of the Board and the auditors. Criminal action has been initiated against the managing director, but what about all the directors? Is it possible that the directors or the Board were not aware of the exposure? In any case they are liable.

I think we should also look at the extent of deposits of other cooperative banks in such large urban co-operative banks. Perhaps it is time to review whether an urban cooperative bank should accept deposits of other urban cooperative banks. Because this means depositors of smaller banks may also suffer.

The frequency and intensity of supervision has to be clearly based on the size of the bank and the assessment made of the governance standards in the banks. All banks — small finance banks, cooperative banks and leveraged institutions like NBFCs — are open to the risk of poor governance. There is no option but to look at the fit and proper character of the directors.

MD: Many depositors opt for cooperative banks because they give a higher interest rate. Even the RBI's staff cooperative has deposits parked with PMC. The confidence comes from governance and regulation. RBI has been urging cooperative lenders to act professionally. We need confidence-building for all banks, not just for cooperatives, but even NBFCs. A recent study showed that small cooperatives are doing better in terms of non-performing assets and other aspects, while large urban cooperatives are not doing well. So, we have to look at how to supervise large cooperatives better.

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