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IMPROVING FUNCTION OF CO-OPERATIVE BANKS IN INDIA THROUGH REGULATIONS AND RISK BASED PRICING

Issue No. 52, FY20
Date: 05 November 2019

The Indian financial system's regulatory architecture has its complexity - both in terms of the sheer number of regulating bodies and also because of their overlapping spheres of concern and influence. An example of this is the regulation of cooperative banks in India with their regulation largely left to the registrar of cooperatives. Though RBI has the expertise, it does not have the regulatory power to regulate these institutions, and the registrar of cooperatives though not having the expertise regulates such entities. The result, creation of PMC type behemoths! **We need to change this!**

First, we believe that UCB/ Urban Cooperative Banks registered under the Multi-state Co-operative Societies Act, 2002 may be immediately considered for conversion to SFB/ Small Finance Banks/ CB/ Commercial Banks. Currently, UCBs has more relaxation in regulation compared to SFBs, and hence they don't convert and hence there is an urgent need to cap the business size of UCBs (say Rs 20,000 crore). There after the UCBs has to mandatorily convert into a CBs/SFBs. RBI may come out with a detailed scheme in this regard.

Second, at present, no powers are available with RBI for constituting boards of UCBs, removal of directors, supersession of BoDs, auditing of UCBs and winding up and liquidation of UCBs. **Government should amend the desired laws and empower RBI for supervision and regulation of UCBs by RBI at par with commercial banks.**

Third, in line with the recommendations of several committees, RBI should now form an Umbrella Organization (UO) for UCBs in India to make them more financially resilient and to enhance depositor's confidence. As prevalent in many countries, the UO will extend liquidity & capital support to the member UCBs, setup IT infrastructure for shared use and enable them widen their range of services at a lower cost. The UO can also offer fund management and other consultancy services.

Simultaneously, apart from increasing the limits of deposit insurance and given that banks in India are already being monitored by RBI under Risk Based Supervision (RBS) it would be prudent and sound to introduce a risk based pricing model for deposit insurance in India. Our hypothetical example suggests that **If the DGCIC were to introduce an differential risk based premium the Banking Industry can add at least Rs 3641 crores to their bottom-line!**

CO-OPERATIVE BANKING IN INDIA

- Co-operative institutions play a significant role in credit delivery to unbanked segments of the population and financial inclusion within the multi-agency approach adopted in India in this context. The genesis of cooperatives can be traced to the formation of the Fenwick Society on March 14, 1761 in Scotland. Credit cooperatives in India have a long history of over 110 years and the first credit cooperative was setup in 1903 with the support of Government of Bengal.
- The cooperative structure in India can broadly be divided into two segments. While the urban areas are served by Urban Cooperative Banks (UCBs), rural cooperatives operate in the rural parts of the country. As per the latest data available, there are 1551 UCBs (54 scheduled and 1497 non-scheduled) and 96,612 rural cooperatives are working in India. RBI pursued a liberalizing policy during 1993-2004 and based on the recommendations of the Marathe Committee, the number of UCBs increased from 1311 in 1993 to 1926 by Mar'04. However, due to weak financial conditions of the newly UCBs, with the help of State/Central Government, RBI introduced appropriate regulatory and supervisory policies in 2005 and merged weak but viable UCBs and closure of unviable ones. As a result, the number of UCBs declined significantly but there was consistent growth in deposits and advances from Rs 1398 billion and Rs 904 billion in 2008 to Rs 4565 billion and Rs 2805 billion respectively in 2017, recording a CAGR of 14.1% and 13.4% respectively. The UCBs accounted for 31.3% of the total asset size of all co-operatives taken together.
- Among the rural cooperatives, there are 33 State co-operative banks (StCBs), 370 district central co-operative banks (DCCBs), 95,595 primary agricultural credit societies (PACS), 13 State Cooperative Agriculture and Rural Development Banks (SCARDBs) and 601 Primary Cooperative Agriculture and Rural Development Banks (PCARDBs). Regional Rural Banks (RRBs) have also been created to bring together the positive features of credit cooperatives and commercial banks and specifically address credit needs of backward sections in rural areas. As per 31 Mar'19, there are 51 RRBs, consolidated from 196 RRBs that were originally set up.

Co-operative Banks in India

	Number	Deposits (Rs Bn)	Advances (Rs Bn)
1. All Co-operatives (2+3)	98163	10290	8974
2. Urban Co-operatives (UCBs)	1551	4565	2805
2.1 Scheduled UCBs	54	2120	1369
2.1 Non-Scheduled UCBs	1497	2445	1436
3. Rural Co-operatives	96612	5725	6169
3.1 StCBs	33	1220	1270
3.2 DCCBs	370	3309	2527
3.3 PACS	95595	1159	2009
3.4 SCARDBs	13	24	212
3.5 PCARDBs	601	13	151

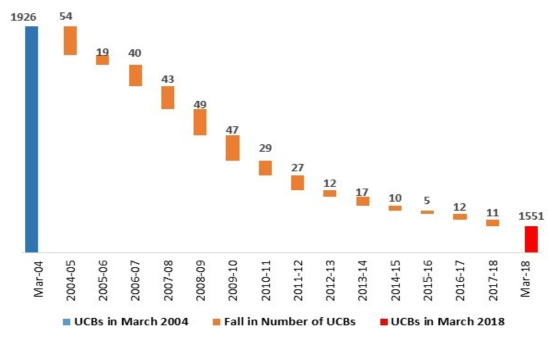
Source: RBI; SBI Research; Rural Co-operatives: Mar'17

PSL Lending by USBs

	2014	2015	2016	2017	2018
PSL % Gross Advances	48.9	49.4	50.8	45.6	46.6

Source: RBI, SBI Research

Closure of Urban Cooperative Banks Since 2005



Source: SBI Research, RBI

- PACS primarily provides crop loans and working capital loans to farmers and rural artisans. They also provide medium-term loans for investments in agriculture and the rural sector, with refinance support from the NABARD. Long-term co-operatives such as SCARDBs and PCARDBs dispense medium and long-term loans like land development, farm mechanisation, minor irrigation, rural industries and lately, housing. Short-term credit co-operatives account for 94.3% of the total assets of rural co-operatives, while the share of long term co-operatives has diminished over the years.

THE REGULATORY MYRIAD IN INDIA

- The Indian financial system's regulatory architecture has its complexity - both in terms of the sheer number of regulatory, quasi-regulatory, non-regulatory – but still regulating bodies, and also because of their overlapping, ambiguously defined respective spheres of concern and influence. An important implication of this architecture is the regulatory arbitrage emerging from it, because there are spaces in the financial system that are either regulated by multiple entities with little clarity on division of responsibilities, or are regulated by agencies that do not have the competence to regulate them effectively.
- An example of this is the regulation of cooperative banks in India. which, except in terms of their ownership structure, are very much like other banks – they take deposits and give loans. Still, their regulation is largely left to the registrar of cooperatives but supervised by RBI. Though RBI has the expertise, it does not have the regulatory power to regulate these institutions, and the registrar of cooperatives have a more direct role in their regulation, but they typically don't have the expertise to regulate such deposit-taking entities. Additionally, the UCBs are currently regulated under the less stringent Basel I norms as opposed to Basel II and III norms applicable to commercial banks.
- The Madhavpura Mercantile Cooperative Bank failure of 2001 caused severe damage to the sector. Nevertheless, the bank had to be kept alive for a decade before cancellation of its licence on June 4, 2012, as RBI does not have full powers for resolution of issues that deal with UCBs. It has no powers for moratorium, amalgamation, supersession and liquidation and in the absence of resolution powers at par with commercial banks, RBI faces constraints when these banks grow.
- There have been several Committees, which have attempted to streamline the functions and working of cooperative banks in India, e.g., Satish Marathe Committee (1991), Madhav Rao Committee (1999), N.H. Vishwanathan Working Group on augmenting capital of urban cooperative banks (2005), R Gandhi Working Group on information technology systems in urban cooperative banks (2007-08), V S Das Group on an umbrella organisation for the urban cooperative banking sector (2009), Y H Malegam Committee on licensing of new urban cooperative banks (2011), R Gandhi Committee (2015). The Gandhi Committee (2015) recommended, inter-alia, an accelerated winding up/ merger process, effective regulation of such banks and meeting the capital needs of urban cooperative banks in a greater measure.

Regulation Comparision: UCBs, SFBs, CBs

Indicators	UCBs	SFBs	SCBs
CRR	4%		
SLR	18.50%		
CRAR	9%	15%	9%*
Capital Accord	Basel I	Basel III	
PSL Target	75%	75%	40%
Min Paid up capital (in Rs crore)	25	200	500
Shareholding of Promoter	26%	40%	51%
Regulated by	State Cooperative Societies & RBI	RBI	RBI

Source: RBI, SBI Research *Tier I & II

- Further, on 27 Sep'18 the RBI has announced a scheme for "voluntary transition of eligible UCBs into small finance banks (SFBs) inline with the recommendations of Gandhi Committee (2015). However, not a single UCBs converted itself to SFBs. This may be due to the higher capital requirements and stricter regulations (like CRAR 15%, 75% of ANBC to PSL, net worth Rs 1 billion and promoter should hold at least 26% of the paid-up equity capital) applicable to SFBs.

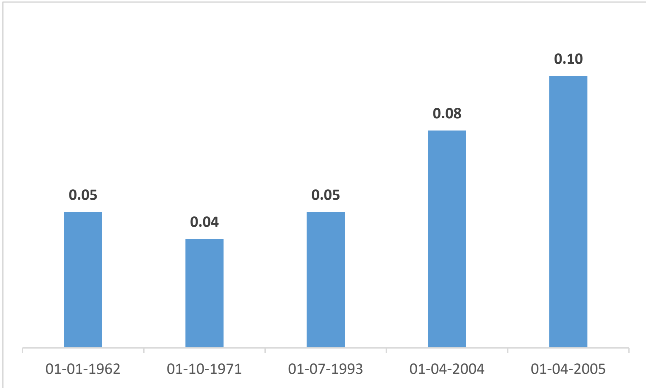
SUGGESTIONS TO IMPROVES COOPERATIVE BANKS IN INDIA

- We believe that conversion of cooperative banks into commercial banks requires requisite amendments in the provisions of the Co-operative Societies Acts of all states which is a long drawn out process. So, only the UCBs which are registered under the Multi-state Co-operative Societies Act, 2002 may be immediately considered for conversion to SFBs/CBs.
- As UCBs has more relaxation in regulation compared to SFBs, there is a need to cap the business size of UCBs (say Rs 20,000 crore). There after the UCBs has to convert into a CBs/SFBs. RBI may come out with a detailed scheme in this regard.
- At present, no powers are available with RBI for constituting boards of UCBs, removal of directors, supersession of BoDs, auditing of UCBs and winding up and liquidation of UCBs. However, such powers for commercial banks are vested with RBI. Government should amend the desired laws and empower RBI for supervision and regulation of UCBs at par with commercial banks.
- In line with the recommendations of the Vishwanathan (2006), Malegam (2011) and Gandhi (2015) Committees, RBI should now form an Umbrella Organization (UO) for UCBs in India to make them more financially resilient and to enhance depositor's confidence. As prevalent in many countries, the UO will extend liquidity & capital support to the member UCBs, setup IT infrastructure for shared use , to enable them widen their range of services at a lower cost. The UO can also offer fund management and other consultancy services.

PRICING OF DEPOSIT INSURANCE IN INDIA

- Even as India is currently grappling with the issue of deposit insurance, the issue of correct pricing of deposit insurance in the Indian context is of vital importance. Worldwide the issue of pricing deposit insurance has evolved over time through reforms adopted by various jurisdictions based on experience and international developments. Deposit insurance systems in India like an ex-ante flat-rate premium system / one size fit all approach for all banks are invariant to the level of risk that banks pose to the deposit insurance system. Flat-rate premium systems are also unfair in practice as "low-risk" banks are required to pay the same premium as "higher-risk" banks. Thus, with no incentive for "higher risk" banks to improve their risk profile it introduces an element of moral hazard in the system and perpetuates the same.
- **In the Indian context we have a flat premium rate (Rs 0.10 per deposit of Rs 100 since April 2005)** with a static insurance cover of Rs 1 lakh per depositor (since May 1993).
- It may be noted that most countries in the world including South Asian countries now adopt a risk based premium for deposit insurance. For example, Federal Deposit Insurance Corporation (FDIC) in USA adopts a risk based pricing model that is determined by (1) capital ratios based on financials and (2) CAMELS ratings derived from on-site examinations. Given that banks in India are already being monitored by RBI under Risk Based Supervision (RBS) it would be prudent and sound to introduce a risk based pricing model for deposit insurance in India with premium tied to risk rating of the bank.
- Further, with hardly any claims, there is room for the premium rate itself to be reduced. The insurance expense being significant, this is yet another area where profitability of Banks is adversely impacted without adding commensurate value to customers.
- **We constructed a scenario of risk based premium for deposit insurance and found that banking industry can save a significant amount (in comparison to flat premium) with better risk management. Our assumptions based on market experience suggest that nearly 70% of bank customers can be low risk, while 25% carries medium risk and 5% might be high risk. If the DGCIC were to introduce an differential risk based premium by bifurcating the customers into High, Medium and Low, the Banking Industry can add at least Rs 3641 crores to their bottom-line!**

Premium Rates per Deposits of Rs 100



Source: SBI Research

Risk based premium for deposit insurance

	in Rs	Share (%)	Rs Crore
1. Total Assessable Deposits (Sep'18)		-	11202000
2. Flat premium (per Rs 100)	0.10	100	**11202**
3. Risk Based Premium (per Rs 100)		-	**7561**
High Risk	0.15	5	840
Medium Risk	0.10	25	2801
Low Risk	0.05	70	3921
4. Net Savings due to Risk based pricing (2-3)	**-**	**-**	**3641**

Source: SBI Research

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