Chapter-3
Conceptual Framework of Co-Operative Banks and Urban Co-operative Banks
3.1 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

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.
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

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**

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**

   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:

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**Table 3.1 Deposits & Advances**

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

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**

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 (TAFCUB) 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.

The Regional Director (RD) of the RBI and RCS of the concerned state could be the Chairman and co-chairman of TAFCUB, respectively. Each TAFCUB 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 TAFCUB, 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 TAFCUB is given in Appendix.

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. TAFCUB 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 TAFCUBs 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 TAFCUB would cease to function and RBI would be at liberty to initiate appropriate corrective action.

7. **Proposed Operating Framework**

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)**

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)

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.

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

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.

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.

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.

3.2 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, which ever is lower for individual borrower and 20% or Rs.80 lakhs, which ever 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 up to 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 up to 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.
FINANCIAL REGULATION AND SUPERVISION

The blurring of the distinction between financial intermediaries under the combined effect of domestic and cross-border integration, innovations in instruments and processes, advances in technology and the massive volumes of capital intermediated by the financial system has necessitated a pro-active strengthening of the regulatory and supervisory framework. Recent international experience has highlighted the critical role played by the regulatory and supervisory system in ensuring the stability of the financial system. This has made the upgradation and refinement of the regulatory and supervisory function of the Reserve Bank a concurrent priority. The approach of the Reserve Bank in this context has been to pursue a progressive upgrading of prudential norms and benchmarking of these norms against international best practices, although there has been a strong emphasis on adapting these standards to the country-specific situation.

This Section presents an overview of the regulatory and supervisory policy initiatives undertaken in 2003-04 to intensify and broaden the ongoing process of financial sector reforms. It reviews the measures initiated during the year to strengthen the financial sector with a view to calibrating the approach to a new supervisory regime compatible with the Basel II process. An overview of various measures initiated to enhance the co-ordination with other regulatory agencies, to strengthen the transparency and corporate governance practices and to improve customer service is also presented. The performance of various intermediaries - commercial banks, co-operative banks, financial
institutions and non-bank financial companies - is evaluated in terms of key financial and prudential indicators.

REGULATORY FRAMEWORK FOR THE INDIAN FINANCIAL SYSTEM
The Reserve Bank regulates commercial and urban co-operative banks, development finance institutions (DFIs) and non-banking financial companies (NBFCs). There are 293 commercial banks (289 scheduled and 4 non-scheduled), 1,926 urban co-operative banks (UCBs), 9 DFIs and 13,671 NBFCs (of which 584 NBFCs are permitted to accept/hold public deposits). In addition, the Reserve Bank is also the regulator in respect of State and district central co-operative banks [(the supervision is vested with the National Bank for Agriculture and Rural Development (NABARD)]. Life insurance companies and mutual funds are regulated by the Insurance Regulatory and Development Authority (IRDA) and the Securities and Exchange Board of India (SEBI), respectively.

The main objective of regulation and supervision has been to maintain confidence in the financial system by enhancing its soundness and efficiency. For this purpose, the Reserve Bank evaluates system-wide risks and promotes sound business and financial practices. It also conducts analyses of institution-wise risks to detect deficiencies in their operations, if any, in a timely manner and ensures that institution-specific problems do not spread to the system as a whole. The Board for Financial Supervision (BFS), constituted as a Committee of the Central Board of the Reserve Bank in November 1994 and headed by the Governor with a Deputy Governor as Vice Chairperson and other Deputy Governors and
four Directors of the Central Board as members, held 12 meetings during the period July 2003 to June 2004. During this period, it examined 105 inspection reports. While State and district co-operative banks are supervised by the NABARD, certain problem cases are reviewed by the BFS. The Reserve Bank closely monitors these banks to enforce regulatory provisions and takes corrective action in respect of problem banks.

REGULATORY AND SUPERVISORY INITIATIVES

As the financial sector matures and becomes more complex, the process of deregulation must continue, but in such a manner that all types of financial institutions are strengthened and financial stability of the overall system is safeguarded. As deregulation gathers momentum, the emphasis of regulatory practice has to shift towards effective monitoring and implementation of regulations. To ensure this shift in regulatory practice, corporate governance within financial institutions must be strengthened and internal systems must be developed. Furthermore, as financial institutions expand and grow more complex, it is also necessary to ensure that the quality of service to customers is focused upon and improved.

Various issues which received regulatory attention during the year included ownership and governance in banks, further progress towards international best practices in prudential norms with country-specific adaptation, greater deregulation and rationalisation of banking policies, compliance with Know Your Customer (KYC) norms, strengthening the financial system for global integration in the light of the ongoing liberalisation of the capital account, greater inter-regulatory co-ordination
and the drive for improving the quality of public services rendered by banks. In the evolution and implementation of policy, a consultative approach continues to be followed through formal institutional structures such as the BFS, the newly-formed Standing Committee on Financial Regulation, the Technical Committee on Money and Government Securities Markets and also through specific working groups and committees as well as formal and informal consultations with the regulated entities, external experts and professionals.

Scheduled Commercial Banks

Ownership and Governance of Banks

Corporate governance has assumed crucial significance for ensuring the stability and soundness of the financial system in recent years. The ongoing debate is focused on shareholders’ rights and shareholder influence on corporate behaviour in respect of banks. Furthermore, in order to protect the interests of depositors and integrity of the financial system, it is necessary that owners and managers of banks are persons of sound integrity. Keeping these considerations in view, the Reserve Bank initiated several measures to enhance transparency and strengthen corporate governance practices in the financial sector in India.

The Reserve Bank provided guidelines for acknowledgment for transfer of shares of private sector banks in February 2004. The guidelines set out the factors that would be taken into account by the Reserve Bank for permitting acquisition of 5 per cent or more of the paid-up capital of banks. Due diligence would be intensified at higher threshold levels, keeping in view the desirability of diversified ownership and public interest. It was also decided that an independent advisory committee will
make appropriate recommendations to the Reserve Bank for dealing with such applications.

In pursuance of the discussions held at the BFS for ensuring that suitable persons are appointed as directors in private sector banks, the Reserve Bank advised banks in June 2004 that they should undertake due diligence to ensure that persons appointed as directors satisfy ‘fit and proper’ criteria upfront. Also, such persons should be required to sign a deed of covenant undertaking to follow good governance principles.

The BFS formulated a draft comprehensive policy framework with regard to ownership of and governance in private sector banks and placed it in the public domain on July 2, 2004 for wider consultation and feedback before it is finalised. The draft policy framework envisages diversified ownership and restrictions on cross holding by banks.

In terms of the existing legal framework, mergers between banking companies and non-banking companies do not require specific approval by the Reserve Bank. As such mergers could involve significant changes in ownership and control of banks with implications for depositor interest, the Reserve Bank advised banks in June 2004 that banks should obtain prior approval of the Reserve Bank for any merger with a non-banking financial company.

In order to minimise cross holding of equity and other instruments eligible for capital status within the financial system, banks/DFIs were advised in July 2004 to restrict their investments in these instruments issued by other entities in the financial system to 10 per cent of the investing bank’s capital funds. Furthermore, the equity holding in any other bank / DFI is required to be restricted to 5 per cent of the capital of
the investee bank. Banks/DFIs are required to indicate to the Reserve Bank the time frame for reducing the equity holding where such holding exceeds 5 per cent.

**Strengthening Prudential Norms**

Banks were advised to ensure that the building up of the Investment Fluctuation Reserve (IFR) to 5 per cent of their investments in ‘Held for Trading’ (HFT) and ‘Available for Sale’ (AFS) categories is achieved earlier, though they have time up to March 2006. In order to ensure that the internationally accepted norms for capital charge for market risk under Basel I are adopted, banks were also advised in June 2004 to maintain an explicit capital charge for market risks on the lines of the standardised duration method prescribed under the 1996 Amendment to the Capital Accord issued by the Basel Committee on Banking Supervision (BCBS). This would apply to the trading portfolio by March 2005 and to the AFS category by March 2006.

**Ownership and Governance in Private Sector Banks - Draft Guidelines**

The objective of the draft guidelines issued by the Reserve Bank in July 2004 is to have a regulatory road map for ownership and governance in private sector banks in the interests of the depositors and financial stability. The underlying thread of the draft guidelines is to ensure that the ultimate ownership and control of banks is well diversified, banks are owned and managed by 'fit and proper' persons/entities and well capitalised and that the processes are transparent and fair. Several countries, both developed and developing, have regulatory stipulations and clearance for significant shareholding and control. The threshold
level may vary from country to country and can also involve more stringent conditions for higher thresholds.

The draft guidelines allow for a level of shareholding of a single entity or a group of related entities beyond 10 per cent with the prior approval of the Reserve Bank. Such approval will be governed by the principles enunciated in the February 2004 guidelines. Apart from more intensive due diligence at higher levels of shareholding, the February 2004 guidelines require public interest objectives to be served for shareholding beyond 30 per cent. Where the ownership of a bank is by a corporate entity, diversified ownership of that corporate entity will be considered among other factors. The draft guidelines do not cover foreign bank investment in Indian banks, which will be released separately, consistent with the policy in the Government press note of March 2004 to allow only one form of operational presence for foreign banks in India.

In order to minimise vulnerability due to small size, the guidelines provide for increasing the net owned funds to Rs.300 crore for all private sector banks within a reasonable period. Cross holding beyond 5 per cent is sought to be discouraged and where such holding exceeds five per cent, the objective is to reduce it to 5 per cent. Promoters with existing shareholding beyond 10 per cent will be required to indicate the time table for reduction - the requests would be considered on the basis of the underlying principles of 'fit and proper' governance and public interest. As a matter of desirable practice, not more than one member of a family or close relative or associate should be on the board. Based on the feedback received, a second draft of the guidelines would be prepared and put in the public domain.
Banks were advised to examine the soundness of their risk management systems and draw up a road map by end-December 2004 for migration to Basel II. They were also advised to review the progress made there under at quarterly intervals. The Reserve Bank is closely monitoring the progress made by banks in this direction.

In terms of the earlier guidelines, all eligible direct agricultural advances would become NPA when interest and/or instalment of principal remains unpaid, after it has become due for two harvest seasons, not exceeding two half years. In the case of long duration crops, the prescription of “not exceeding two half-years” was considered to be inadequate. In order to align the repayment dates with crop seasons, with effect from September 30, 2004 a loan granted for a short duration crop (i.e., with a crop season less than one year) would be treated as a non-performing asset (NPA), if the instalment of principal or interest thereon remains overdue for two crop seasons. A loan granted for a long duration crop (i.e., with a crop season beyond one year) would be treated as NPA, if the instalment of principal or interest thereon remains overdue for one crop season.

Banks were advised to increase the provisioning on the secured portion of doubtful assets which have remained in that category for over three years from 50 to 100 per cent. In the case of existing assets in this category, a time period of three years is allowed. It is expected that this will facilitate speedy resolution of doubtful assets including through transfer to asset reconstruction companies (ARCs).

The Reserve Bank’s guidelines on country risk management issued in February 2003 require banks to maintain provisions on a graded scale relating to the level of risk in respect of countries to which they have net
funded exposure of two per cent or more of total assets. With effect from
the year ending March 31, 2005 the coverage would be enlarged to
include countries to which a bank has net funded exposure of one per
cent or more of its total assets.

As banks have been putting in place risk management systems and
considering the requirement of banks to cater to the evolving
requirements of their clientele, the Reserve Bank permitted banks to
consider enhancement of the exposure up to a further 5 per cent of capital
funds to 20 per cent of capital funds for a single borrower and 45 per cent
of capital funds for group borrowers. The additional limits to be
sanctioned are subject to approval by banks’ boards and the borrower
consenting to the banks making appropriate disclosures in their annual
reports.

The reporting mechanism for cases of wilful default by banks/DFIs was
strengthened in July 2003. Decisions to classify borrowers as wilful
defaulters were entrusted to a committee of senior functionaries headed
by an Executive Director. The decision to declare a borrower as a wilful
defaulter should be supported by sufficient evidence vis-á-vis the
Reserve Bank’s guidelines. Banks/DFIs should create a grievance
redressal mechanism, headed by the Chairman and Managing Director,
for allowing representation by borrowers who have been wrongly
classified as wilful defaulters.

**Resolution of NPAs**

During the year, the Reserve Bank strengthened the existing mechanisms
for NPA management and initiated some new measures to strengthen the
efforts of banks to recover their dues.
A recent addition to the menu of options available to banks for resolving NPAs is the establishment of ARCs. In terms of the provisions of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002 the Reserve Bank prescribed guidelines for the formation and functioning of securitisation companies (SC) and reconstruction companies (RC). Guidelines were also provided to banks/DFIs to facilitate sale of NPAs to SCs/RCs. One ARC, viz., Asset Reconstruction Company of India Ltd. (ARCIL) was set up during 2003-04. Banks and financial institutions sold assets aggregating Rs.7,099 crore to ARCIL.

Corporate debt restructuring offers an avenue for reorganising the indebtedness of viable entities without reference to the Board for Industrial and Financial Reconstruction (BIFR), debt recovery tribunals (DRTs) and other legal proceedings. The process of corporate debt restructuring gained momentum during 2003-04 after revised guidelines were provided by the Reserve Bank in June 2004 (Table 10.1). The major beneficiaries were iron and steel, refinery, fertilisers and telecommunication sectors which accounted for more than two-thirds of the total value of assets restructured.

In pursuance of the recommendations of the Working Group to review the existing provisions of the Recovery of Debts Due to Banks and Financial Institutions Act, 1993 (Chairman: Shri S. N. Aggarwal), the Central Government amended substantially the
Table 3.2 Progress under Corporate Debt Restructuring Scheme

(Amount in Rupees crore)

<table>
<thead>
<tr>
<th>Item</th>
<th>No. of cases</th>
<th>Amount involved</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cases referred to CDR forum</td>
<td>135</td>
<td>72,139</td>
</tr>
<tr>
<td>Final schemes approved</td>
<td>94</td>
<td>64,017</td>
</tr>
<tr>
<td>Rejected</td>
<td>30</td>
<td>5,445</td>
</tr>
<tr>
<td>Pending</td>
<td>11</td>
<td>2,677</td>
</tr>
</tbody>
</table>

Debt Recovery Tribunal (Procedure) Rules in 2003, especially Rules 7 and 10 relating to application fee and plural remedies, respectively. A Working Group was also set up for reviewing and streamlining the functioning of DRTs. Out of 61,301 cases (involving Rs. 88,876 crore) filed with DRTs by banks as on December 31, 2003, 25,510 cases (involving Rs.23,273 crore) were adjudicated with recovery amounting to Rs.6,874 crore.

A scheme for settlement of chronic NPAs up to Rs.10 crore in public sector banks was introduced in January 2003 to give one more opportunity to borrowers for settlement of their outstanding dues. As on March 31, 2004, 2,12,370 cases amounting to Rs.1,977 crore were decided by banks and recovery was effected in 1,80,117 cases aggregating Rs.1,095 crore.

The SARFAESI Act, 2002, *inter alia*, provides for enforcement of security interest for realisation of dues without the intervention of courts or tribunals. In April 2004, the Supreme Court upheld the right of banks and financial institutions to attach and sell assets of the defaulting companies and the borrower’s right to appeal. It struck down the
provisions contained in Section 17 (2) of the SARFAESI Act requiring the defaulting borrower to pre-deposit 75 per cent of the liability in case the borrower wants to appeal against the order of the attachment of the assets. The Union Budget, 2004-05 has proposed to amend the relevant provisions of the Act to appropriately address the Supreme Court’s concerns regarding a fair deal to borrowers while ensuring that the recovery process is not delayed or hampered. Up to December 31, 2003 27 public sector banks issued 49,169 notices involving an amount of Rs.16,318 crore. An amount of Rs.1,037 crore from 16,490 cases was recovered.

**Inter-Regulatory Co-ordination and Co-operation**

The Reserve Bank announced in November 2003 that it would set up a monitoring system in respect of systemically important financial intermediaries (SIFIs), including (i) a reporting system for SIFIs on financial matters of common interest to the Reserve Bank, the SEBI and the IRDA; (ii) the reporting of intragroup transactions of SIFIs; and (iii) the exchange of relevant information among the Reserve Bank, the SEBI and the IRDA. A Working Group (Chairperson : Smt. Shyamala Gopinath) was set up by the Reserve Bank in December 2003 with representation from the SEBI and the IRDA to recommend a framework for monitoring financial conglomerates. The Working Group, which submitted its report in June 2004, recommended the introduction of a framework for the complementary supervision of financial conglomerates.

The High Level Co-ordination Committee on Financial and Capital Markets (HLCCFCM), set up in 1992 with the Governor of the Reserve Bank as its Chairman and Finance Secretary, Government of India and the
Chairman, SEBI as its members (subsequently, the Chairman, IRDA was also made a member), constituted three Standing Technical Committees in order to provide a more focused inter-agency forum for sharing of information and intelligence. These Committees meet at regular intervals. Reports detailing the outcome of the meetings are presented before the HLCCFCM for its information and any further directions.

The responsibilities of the Technical Committee on RBI Regulated Entities include reviewing exposure of the Reserve Bank regulated entities to the capital market on an ongoing basis in the light of market developments. In case a policy issue of wider interest requires inter-agency co-ordination, it also decides whether the case should be referred to the RBI-SEBI Technical Committee of the HLCCFCM.

**Opening up of the Financial Sector**

In terms of the agreement arrived at under the *aegis* of the World Trade Organization (WTO), India is committed to permitting the opening of 12 new branches by foreign banks per year in the country. Thirty two foreign banks now operate 217 branches in India. During 2003-04, permission was granted to 5 foreign banks to open 18 branches. Three foreign banks, *viz.*, Toronto Dominion Bank, Overseas Chinese Banking Corporation Ltd. and Bank Muscat (SAOG) shut down their branches in India. There was a worldwide merger of Credit Lyonnais and Credit Agricole Indosuez into CALYON Bank, which resulted in the merger of their operations in India as well. In addition to opening of branches, foreign banks can open representative offices which cannot do any banking business. During the year, Everest Bank Ltd., Nepal was permitted to open a representative office in New Delhi and with West LB AG, Germany closing down its
representative office, the number of operating representative offices stands at 26.

Indian banks continued to expand their presence overseas. During the year, ICICI Bank opened representative offices in Dubai (UAE) and Shanghai (China), while IndusInd Bank set up offices in Dubai (UAE) and London (UK) and Punjab National Bank opened an office in London (UK). The number of Indian banks with overseas operations increased by one to 10, although the number of branches remained at 93. The number of representative offices increased by four to 22. The total number of subsidiaries set up by Indian banks stood at 16.

During 2003-04, ten banks were given ‘in principle’ approval to open 14 overseas banking units (OBUs) in Special Economic Zones (SEZs). Of these, six banks, viz., State Bank of India, Bank of Baroda, Union Bank of India, ICICI Bank and Punjab National Bank have begun operations in the Santa Cruz Electronics Export Processing Zone, Mumbai and Canara Bank in NOIDA, Uttar Pradesh.

**Working Group on Monitoring of Financial Conglomerates**

The major recommendations of the Working Group on Financial Conglomerates comprise:

- Identifying financial conglomerates for focused regulatory oversight; capturing intra-group transactions and exposures amongst ‘group entities’ within the identified financial conglomerates and large exposures of the group to outside counter parties; identifying a designated entity within each group to furnish group data to the
principal regulator for the group; and formalising a mechanism for inter-regulatory exchange of information.

- Segments under the jurisdiction of the Reserve Bank, the SEBI, the IRDA, and the NHB should be subjected to complementary regulation. The framework could later be extended to the segment covered by the Pension Fund Regulatory and Development Authority.

- The new reporting framework should track: (i) any unusual movement in respect of intra-group transactions manifested in major markets; (ii) build-up of any disproportionate exposure (both fund based and non-fund based) of any entity to other group entities; (iii) any group-level concentration of exposure to various financial market segments and outside counter parties; and (iv) direct/indirect cross-linkages amongst group entities.

- Individual intra-group transactions beyond threshold levels (Rs.1 crore for fund based transactions and Rs.10 crore for others) should be included in the reporting format, supplemented by exposure ceilings in respect of intragroup exposures.

**Towards More Deregulation**

As a part of the move towards greater deregulation, banks fulfilling certain minimum criteria regarding CRAR and net NPAs have been given the discretion to pay dividend without the prior approval of the Reserve Bank, provided the dividend payout ratio does not exceed 33.3 per cent. Banks which do not meet the minimum criteria or which seek a higher payout ratio are required to obtain the prior approval of the Reserve Bank. Foreign banks operating in India were advised that they
may remit net profits/surplus (net of tax) arising out of their Indian operations on a quarterly basis, without the prior approval of the Reserve Bank. This is conditional on (i) audit of the accounts on a quarterly basis, (ii) appropriate transfers to statutory reserves as per Section 11(2)(b)(ii) and other relevant provisions of the Banking Regulation (BR) Act, 1949, and (iii) compliance with the directions issued by the Reserve Bank.

Banks were not allowed to assume unsecured exposures by way of guarantees and advances beyond a prescribed ceiling in terms of the Reserve Bank’s guidelines prescribed in 1967. In view of the ongoing shift towards financing borrowers based on estimated cash flows rather than on collateral and in recognition of the availability of financial assistance through credit substitutes, *viz.* commercial paper, bonds and debentures, the restriction on unsecured exposures was withdrawn. Banks’ boards are allowed to formulate their own policies on unsecured exposures. The unsecured exposures would, however, attract a higher provisioning of 20 per cent when they become sub-standard.

Effective September 22, 2003 banks are not required to obtain prior approval of the Reserve Bank for engaging in insurance agency business or referral arrangement without any risk participation, subject to their complying with the prescribed conditions. Banks intending to set up insurance joint ventures with equity contribution on a risk participation basis or making investments in insurance companies for providing infrastructure and services support would still require prior approval of the Reserve Bank.
Towards Greater Transparency

In recent years, banks have turned out to be the major investors in bonds issued on a private placement basis. In view of the fact that issuance of such bonds lacked transparency, banks were advised in November 2003 to restrict their fresh investments in unlisted securities to 10 per cent of their overall non-SLR portfolio. A time period was also prescribed for getting the existing outstanding bonds listed. Simultaneously, the SEBI also prescribed guidelines requiring all debt issuances, including private placements, to be rated and listed within a specified time period.

With a view to aligning standards adopted by the Indian banking system with global standards, the Reserve Bank issued detailed guidelines relating to several Accounting Standards (AS) in March 2003. In April 2004, guidelines for compliance with three more standards, viz., AS 24 (discontinuing operations), AS 26 (intangible assets) and AS 28 (impairment of assets) were issued. Banks are required to ensure that there are no qualifications by the auditors in their financial statements for non-compliance with any of the accounting standards.

The Credit Information Bureau (India) Ltd. (CIBIL) took over from the Reserve Bank the responsibility of disseminating the information on suit-filed accounts at banks/FIs in India in respect of defaulters and wilful defaulters with effect from March 31, 2003. The Reserve Bank issued instructions to banks/DFIs to obtain the consent of all their borrowers - not only defaulters - for dissemination of credit information to enable CIBIL to compile and disseminate comprehensive credit information.
Preserving the Integrity of the Banking System

Preventing misuse of the financial system and preserving its integrity is vital for orderly development of the financial system. Prevention of frauds and implementation of Anti Money Laundering (AML) measures are two important aspects of the efforts being made by the Reserve Bank to prevent misuse of the financial system by criminals whose transactions threaten the stability of financial transactions worldwide.

In 2002, banks were advised to follow certain KYC norms while opening accounts, with specific focus on verification and identity. These norms were also required to be applied to the existing accounts in a given time frame. With a view to adopting a risk-based approach and to mitigate the inconvenience to the common man, banks were advised to apply the new KYC norms only to those accounts where the annual credit or debit summation were Rs.10 lakh or more or where the transactions in the account was of a suspicious nature.

Improving Customer Service

The Reserve Bank set up a Committee on Procedures and Performance Audit on Public Services (Chairman : Shri S.S. Tarapore) to advise it on improving the quality of such services. Banks were asked to constitute similar ad hoc committees to undertake procedures and performance audit on public services rendered by them and co-ordinate with the Tarapore Committee. Based on the reports of the Committee on personal transactions of individuals in foreign exchange, government transactions, banking operations and currency management, a number of guidelines have been issued with a view to improving the customer service rendered by banks and the Reserve Bank.
The Reserve Bank provided detailed operational guidelines for banks for the process of takeover of bank branches in rural and semi-urban centres. Due publicity is required to be given to the constituents of the branch concerned by the existing bank as well as of the bank taking over. In cases where the rural branch being taken over is the only one functioning in the village/town, the bank taking over would not be permitted to merge it with any of its existing branches in rural/semi-urban areas (with service area obligation).

**Technology Upgradation / Training**

The Reserve Bank has been emphasising the need to harness the developments in information technology in the business of banking (Box X.3).

**Strengthening the Consultative Process**

The relationship between the Reserve Bank and market participants has continued to evolve over a period through the expansion and reinforcement of the consultative processes. A Standing Technical Advisory Committee on Financial Regulation was set up during the year on the lines of the Reserve Bank’s Technical Advisory Committee on Money and Government Securities Market. The Committee would advise the Reserve Bank on regulations covering banks, non-bank financial institutions and other market participants on an ongoing basis, in addition to the existing channels of consultation. The Committee, constituted with Smt. K. J. Udeshi, Deputy Governor as the Chairperson, comprises experts drawn from academia, financial markets, banks, non-bank financial institutions and credit rating agencies. During the year, the Committee’s views were sought on a wide range of topical regulatory
issues, including (i) issuance of long-term bonds by banks; (ii) adequacy of present prudential credit exposure ceilings; (iii) review of prudential norms in respect of unsecured exposures; (iv) norms for declaration of dividend by public and private sector banks; and (v) review of the calendar of reviews placed before the boards of banks.

With a view to reinforcing this consultative process further and making the regulatory guidelines more user-friendly, a Users’ Consultative Panel was constituted comprising representatives of the Indian Banks’ Association (IBA), public sector, private sector and foreign banks and market participants. The panel provides feedback on regulatory instructions at the formulation stage to avoid ambiguities and operational glitches.

**Supervisory Initiatives**

Keeping in view the emerging scenario under the Basel II accord and the need to use supervisory resources more productively, a beginning towards risk-based supervision (RBS) of banks was made. The Risk-Based Supervision Manual (RBS Manual), customising the international best practices to Indian conditions, was finalised during the year. A pilot study of eight banks was taken up during the year, which was later extended to 15 additional banks. Extensive training was imparted to the Reserve Bank’s supervision staff as also to the risk managers of various banks across the country. The review of the current methodology, based on the first pilot study, is under examination. The scheme of Prompt Corrective Action (PCA), indicating ‘structured’ and ‘discretionary’ actions to be initiated by the Reserve Bank against banks
Computerisation of Banks - Aligning Technology Plan with Business Strategy

The Reserve Bank sponsored a study by the National Institute of Bank Management (NIBM), Pune to assess the computerisation in the banking system with a view to suggesting a broad methodology with which banks could smoothly integrate their technology plan with their business objectives. The report suggested a business-technology model termed as 'Enterprise Maturity Model' (EMM). It has five layers with defined business objectives at each layer starting with 'increasing operational efficiency' and leading up to higher strategic objectives such as 'maximising wealth and stakeholder value'. While every individual bank will need to chart its own course in integrating its business and technology plans, the NIBM report serves as a benchmark for banks to review the direction of their progress. The Reserve Bank advised banks which have not adopted core banking solutions to identify the level at which they are in the Enterprise Maturity Model and accordingly chart their future course of action with the approval of their boards which had hit the trigger points under the PCA framework, was introduced in 2002-03. Since the scheme was introduced on an experimental basis, banks that could potentially attract the provisions of the PCA framework were informed of the possible corrective action required to be taken in case the same were made applicable to them.

Frauds in banks reflect in most cases failure of well laid down systems and procedures, and the boards and the top management in banks need to view frauds with utmost seriousness. With a view to ensuring prompt reporting of frauds, a software package for fraud reporting and monitoring system was developed and supplied to all commercial banks.
They were also advised to constitute a special board-level committee for monitoring and follow-up of cases of frauds involving Rs. one crore and above exclusively, while the audit committee of the board may continue to monitor all the cases of frauds in general.

A separate Fraud Monitoring Cell has been set up at the Reserve Bank to pay focused attention to the monitoring and follow-up of frauds in commercial banks, co-operative banks, financial institutions, NBFCs, local area banks and regional rural banks.

On an application by the Reserve Bank, the Central Government issued an Order of Moratorium in respect of Global Trust Bank (GTB) on July 24, 2004 in public interest, in the interest of depositors and the banking system. Keeping in view the need to minimise the period of moratorium, the available options and the synergies of strategic advantages in merging with Oriental Bank of Commerce (OBC), the Reserve Bank prepared a draft scheme of amalgamation of GTB with OBC and announced it on July 26, 2004 soon after both the banks, which are listed, had notified the information to the stock exchanges. After due sanction from the Central Government, the scheme came into force with effect from August 14, 2004 from which date customers, including depositors of GTB, were able to operate their accounts as customers of OBC.

The BFS took several steps to streamline the long outstanding entries under inter-branch accounts, balancing of books, reconciliation of inter-bank accounts (including nostro accounts) and clearing differences, especially in respect of public sector banks. While institution-specific action, as advised by the BFS, was taken, the time period allowed for reconciliation of accounts was also reduced from one year to six months
with effect from March 31, 2004. On account of the initiatives taken by the BFS, the amount of outstanding entries under inter-branch accounts declined steadily.

**Co-operative Banks**

Membership of co-operative credit institutions comprises largely lower and middle-income sections of society. UCBs are supervised by the Reserve Bank, while district central co-operative banks (DCCBs) and state co-operative banks are supervised by the NABARD. Both are regulated by the State Governments in respect of certain types of functions. In addition, multi-State UCBs are regulated by the Central Government. UCBs are concentrated in five states, viz., Maharashtra, Gujarat, Karnataka, Andhra Pradesh and Tamil Nadu which account for 79 per cent of the urban co-operative banking sector and 90 per cent of deposit resources. The focus of supervision of urban co-operative banks by the Reserve Bank has been on strengthening the prudential norms, resolving the issue of dual control, addressing the lack of professionalism, use of unscientific loan policy and increasing incidence of financial weakness.

A system of gradation of UCBs, based on critical financial parameters, viz., capital adequacy, net non-performing advances and profitability was introduced as a framework for initiating prompt corrective action. The gradation is communicated to problem banks to enable them to formulate action plans for corrective action. The content and structure of off-site surveillance returns were modified and the revised returns came into effect from the quarter ended March 2004. The period for recognition of
loan impairment was reduced from 180 days to 90 days with effect from March 31, 2004 in line with the international best practice and to ensure greater transparency. Gold loans and small loans up to Rs. one lakh, however, continue to be governed by the 180-day impairment norm. The Registrars of Co-operative Societies of all States were advised to issue suitable instructions enabling UCBs to take recourse to the SARFAESI Act for recovery of NPAs. UCBs were also advised to build up Investment Fluctuation Reserves (IFR) out of realised gains on sale of investments of a minimum of 5 per cent of the investment portfolio within a period of 5 years, subject to available net profit, in order to mitigate interest rate risk.

**Off-site Surveillance System for UCBs**

The system of off-site surveillance, introduced in April 2001 under Section 27 (2) of the Banking Regulation Act, 1949 (As Applicable to Co-operative Societies), requires scheduled urban co-operative banks to submit returns to the Reserve Bank on a quarterly basis. The content and structure of OSS returns was modified to enlarge the breadth and depth of information obtained while reducing the volume of data submission. Seven quarterly returns (submitted from April 2004) and one annual return have been prescribed to obtain information on areas of supervisory concern, and at the same time, to strengthen MIS systems within the scheduled UCBs and sensitise their managements about the prudential concerns of the supervisory authority. The OSS is proposed to be extended to non-scheduled UCBs with a deposit base of Rs.100 crore and above and thereafter to other UCBs. A project is underway for development of software for UCBs that would assist them in preparation
and submission of all the regulatory and supervisory returns including OSS returns in an electronic format.

It was observed by the BFS that some of the large UCBs are facing serious problems with regard to solvency and liquidity. The State Governments concerned were advised to infuse capital funds to ensure that the banks attain the minimum CRAR level.

In pursuance of the recommendations of the Joint Parliamentary Committee (JPC) on Stock Market Scam and Matters relating thereto, a complete ban was imposed on granting of loans and advances to the directors and their relatives or the concerns in which they are interested, with effect from October 1, 2003. Only UCBs with strong financials are allowed to declare dividend.

The Reserve Bank is concerned with the existence of a large number of financially weak UCBs, some of which are unlicensed. As some UCBs have faced problems of liquidity and solvency in recent years, a scheme of reconstruction was approved by the Reserve Bank in respect of two scheduled UCBs in exceptional circumstances which, *inter alia*, require payment of insured deposits by the DICGC. However, the Reconstruction Scheme has not yielded the desired results. Therefore, in the light of experience gained, the Reserve Bank decided that it would only consider a scheme of reconstruction which envisages recapitalisation by the stakeholders, *viz.*, the shareholders/co-operative institutions/Government to the extent of achieving the prescribed capital adequacy norms, without infusion of liquidity through settlement of insurance claims by the Deposit Insurance and Credit Guarantee Corporation (DICGC).
Furthermore, the scheme should lay a clear road map for reducing the NPA level to a tolerable limit within the stipulated time frame.

In order to examine new applications for licence by proposed UCBs, the Reserve Bank constituted a Screening Committee consisting of eminent experts. In the light of experience gained, the policy of licensing co-operative banks was revised and it was decided to consider applications for licence of UCBs only after a comprehensive policy, including an appropriate legal and regulatory framework for the sector, is put in place and a policy for improving the financial health of the urban co-operative banking sector is formulated.

Scheduled UCBs with a minimum net worth of Rs.100 crore and complying with the exposure norms and connected lending were allowed to act as corporate agents for undertaking insurance business without risk participation, after obtaining the approval of the Reserve Bank.

The Central Government had enacted a Multi-State Co-operative Societies (MSCS) Act, 2002 by repealing the MSCS Act, 1984. The MSCS Act, 2002 does not contain provisions empowering the Reserve Bank on matters relating to supersession of boards of UCBs, which is one of the pre-requisites for banks to have deposit insurance cover of the DICGC in terms of Section 2(gg) of the DICGC Act, 1961. Therefore, deposits of UCBs registered under the MSCS Act, 2002 lose insurance cover of the DICGC.

The Supreme Court, in its judgement in a case relating to the Apex Urban Co-operative Bank of Maharashtra and Goa Limited, Mumbai in October 2003 ruled that the UCBs registered under the MSCS Act, 2002 do not fall within the meaning of ‘primary co-operative bank’ as defined under
the Banking Regulation Act, 1949. In order to rectify the deficiencies, the Reserve Bank has suggested to the Government amendments in the BR Act, 1949 and the DICGC Act, 1961 with the objective of bringing all UCBs registered under the MSCS Act, 2002 under the BR Act, 1949 and extend deposit insurance cover of the DICGC.

In 2003-04, licence applications of two DCCBs were rejected by the Reserve Bank in view of their precarious financial position. Besides, show cause notices were issued to 3 DCCBs as to why their licence applications should not be rejected. As on June 30, 2004 seven DCCBs were placed under the Reserve Bank’s directions prohibiting them from granting any loans and advances and/or accepting fresh deposits.

**Development Finance Institutions (DFIs)**

With the change in the operating environment, DFIs have been facing difficulties in sustaining their operations. Several policy initiatives have been taken to facilitate the process of transition of DFIs opting for conversion into banks through a series of measures aimed at financial restructuring, provision of regulatory relaxation for restructured investments of creditor banks or providing Government support, transfer of stressed assets of DFIs to asset reconstruction companies/asset management trusts for managing the NPA level and harmonisation of prudential norms between banks and DFIs.

A Working Group on DFIs (Chairman : Shri N. Sadasivan) was set up by the Reserve Bank. The Working Group, which submitted its Report in May 2004, has suggested a road map for development financing and the future role of DFIs.
Strengthening of Prudential Norms

DFIs were advised that, with effect from end-March 2006, an asset should be classified as non-performing if the interest and/or instalment of principal remain overdue for more than 90 days. DFIs would have the option to phase out the additional provisioning required for moving over to the 90-day income recognition norm over a period of three years beginning from the year ending March 31, 2006, subject to at least one fourth of the additional provisioning being made in each year. Guidelines provided to banks to prevent the slippage of accounts in the ‘sub-standard’ category to the ‘doubtful’ category were extended to DFIs as well. They were advised to place the guidelines before their boards of directors and take appropriate actions for implementing the recommended measures. As in the case of banks, “special mention” accounts,

Report of the Working Group on Development Financial Institutions

The major recommendations of the Group are set out below:

• Banks may be encouraged to extend high risk project finance with suitable Government support.

• As a market-driven business model of any DFI is inherently unsustainable, a detailed social cost benefit analysis should identify activities which require development financing. The rest of the DFIs must convert to either a bank or a NBFC, as recommended by the Narasimham Committee.

• Concessions in the form of according “approved investment” status to paper issued and a lower risk weight of 20 per cent allowed for
exposure by banks, DFIs, NBFCs and RNBCs should be withdrawn for public financial institutions, as many of them have become financially weak and act without any assurance of Government support.

- DFIs which convert into banks could be accorded certain exemptions/relaxations for a period of 3-5 years after conversion.

- Regulation of DFIs should ensure that overall systemic stability is not endangered.

- The Reserve Bank should continue to regulate the Exim Bank, NABARD, SIDBI and NHB which would continue to function as DFIs. As there is a scope for conflict of interest, the Reserve Bank may divest its ownership in NABARD and NHB.

- The Reserve Bank may ensure that the standards of regulation and/or supervision exercised by NHB (in case of Housing Finance Companies), SIDBI (SFCs and SIDCs) and NABARD (state co-operative banks, district central co-operative banks and RRBs) are broadly at par with those maintained by the Reserve Bank.

- DFIs which have been constituted as companies and are performing developmental roles should be classified as a new category of NBFCs called ‘Development Financial Companies’ (DFCs) and subjected to uniform regulation. Considering the nature of business of development financing, DFCs may be permitted to maintain 9 per cent CRAR as against 15 per cent prescribed for NBFCs in general.

- Public deposit mobilisation by RNBCs should be capped at 16 times the net owned fund (NOF) as an initial measure and finally to the level for other NBFCs in five years. This should be accompanied by
deregulation in the quantitative restrictions (alongside more stringent quality criteria) on the asset side.

In December 1998, DFIs were advised that their investments in the bonds/debentures of certain Public Financial Institutions (PFIs) would attract a uniform risk weight of 20 per cent. In the Annual Policy Statement for the year 2004-05, it was announced that with effect from April 1, 2005 exposures to all PFIs will attract a risk weight of 100 per cent. In terms of the guidelines provided in January 2004, FIs must not, inter alia, invest in unrated debt securities or in debt securities of original maturity of less than one year other than CP and CDs, effective April 1, 2004. All fresh investments in debt securities are required to be made only in listed debt securities.

Transformation into Banks

During 2003-04, the Industrial Development Bank (Transfer of Undertaking and Repeal) Act, 2003 was passed by the Parliament and received assent of the President of India on December 30, 2003. In terms of the provisions of the Act, the undertaking of Industrial Development Bank of India (IDBI) would vest in the company named Industrial Development Bank of India Limited, which has to be incorporated as a Company under the Companies Act, 1956. On the ‘Appointed Date’, the new company would assume all assets and liabilities of IDBI. In this regard, the Government of India has already approved the IDBI’s proposal to set up a Stressed Asset Stabilisation Fund (SASF) wherein stressed assets of IDBI amounting to Rs.9,000 crore would be transferred to the SASF against transfer of an equivalent amount of 20-year maturity
bonds issued by the Central Government in favour of the SASF on cash/fisc neutral basis.

The Board of Directors of the IFCI Limited approved, in principle, a merger with a bank. The Central Government has already decided to take over certain liabilities of the IFCI and correspondingly the Reserve Bank has provided certain regulatory relaxations for restructured liabilities of the IFCI.

While sending the inspection reports of the IDBI, the IFCI and Industrial Investment Bank of India (IIBI) Limited, action was taken on the various directives given by the BFS that included conveying the concerns on IIBI to the Government.

**Consolidated Accounting and Consolidated Supervision**

Guidelines on consolidated accounting and consolidated supervision, which were prescribed for banks, were extended to DFIs as well, effective April 1, 2003 (July 1, 2003 in the case of the NHB). They comprise three components in the supervisory framework, *viz.*, (i) consolidated financial statements (CFS); (ii) consolidated prudential returns (CPR); and (iii) application of prudential regulations such as capital adequacy, large exposures and liquidity gaps on group-wide basis in addition to the solo prudential norms applicable to the parent DFIs/subsidiaries. The publication of the CFS as per the Accounting Standard (AS) 21 of the Institute of Chartered Accountants of India (ICAI) is mandatory for the listed FIs in terms of the Listing Agreement with the Stock Exchanges. The Reserve Bank’s guidelines sought to make such publication mandatory even for the non-listed DFIs from the financial year beginning April 1, 2003.
Non-Banking Financial Companies (NBFCs)

The policy initiatives in respect of NBFCs related to measures for protecting depositors, aligning interest rates offered by NBFCs with those of banks in respect of NRI deposits on a repatriable basis, issuance of KYC guidelines and allowing diversification into insurance business.

The maximum rate of interest that NBFCs (including *Nidhi* companies and Chit Fund companies) could pay on their public deposits was reduced from 12.5 per cent per annum to 11.0 per cent per annum with effect from March 4, 2003 in line with the general softening of interest rates. Similarly, the minimum rate of interest payable by the Residuary Non-Banking Companies (RNBCs) was reduced from 4 per cent per annum to 3.5 per cent per annum on daily deposit schemes and from 6 per cent per annum to 5 per cent per annum on other types of deposits. The rate of interest which NBFCs and Miscellaneous Non-Banking Companies (MNBCs) could pay on NRI deposits was also aligned with that payable by scheduled commercial banks on such deposits. It was clarified that NBFCs were not allowed to accept such deposits for a period less than one year (with a maximum period of three years).

NBFCs were allowed to take up insurance agency business for a fee on a non-risk participation basis without the approval of the Reserve Bank, subject to certain conditions. NBFCs intending to set up joint ventures in insurance with equity contribution on a risk participation basis or making investments in the insurance companies would continue to obtain prior approval as envisaged in the guidelines issued on June 9, 2000.
The KYC guidelines, akin to those issued for commercial banks, were prescribed for NBFCs, including MNBCs (Chit Fund Companies) and RNBCs in January 2004.

The inspection policy of NBFCs was revised in July 2003 to increase the frequency. Inspections of 460 deposit taking companies and 385 non-deposit taking companies as also scrutiny and ad hoc scrutiny of books of accounts of 568 companies were carried out. Important findings of inspection and scrutiny reports were placed before the BFS.

An Internal Group in the Reserve Bank examined the scope of providing insurance cover to depositors of NBFCs on a suggestion made by the Joint Parliamentary Committee (JPC) on Stock Market Scam and Matters Relating Thereto. The Group did not favour extending deposit insurance to NBFCs in view of high risks and inadequate compliance with the regulatory and supervisory framework. These recommendations were endorsed by an external group.

The Reserve Bank issued final guidelines and directions to Securitisation Companies and Reconstruction Companies on April 23, 2003 relating to registration, owned funds, permissible business, operational structure for giving effect to the business of securitisation and asset reconstruction, deployment of surplus funds, internal control system, prudential norms and disclosure requirements. In order to ensure that the size of capital has some relationship to the value of assets acquired by the securitisation company or reconstruction company, the Reserve Bank in March 2004 issued a notification whereby the minimum owned funds for commencing the business of securitisation or asset reconstruction has been stipulated at an amount not less than 15 per cent of the total financial assets acquired
or to be acquired by the securitisation company or reconstruction company on an aggregate basis or Rs.100 crore, whichever is lower. This stipulation is irrespective of whether the assets are transferred to a trust set up for the purpose of securitisation or not. However, the provisions relating to maintaining a capital adequacy ratio which shall not be less than 15 per cent of the total risk weighted assets of the securitisation company or reconstruction company on an ongoing basis, shall continue to be applicable.

In June 2004, the Reserve Bank rationalised the investment pattern of RNBCs for imparting greater liquidity and safety to their investments, enhancing the protection available to the depositors and reducing the overall systemic risk.

**Residuary Non-Banking Companies (RNBCs)**

A Residuary Non-Banking Company (RNBC) is a non-banking financial company which, as its principal business, is engaged in collecting deposits under any scheme or arrangement and cannot be placed in any one of the defined categories of NBFC, *i.e.*, leasing company, hire purchase finance company, loan company or investment company. At present, there are four companies registered under Section 45 IA of the RBI Act, 1934 which operate as RNBCs. Aggregate deposits of these companies stood at Rs.15,062 crore as on March 31, 2003, constituting 74.9 per cent of aggregate deposits of all NBFCs. Two large RNBCs account for deposits aggregating Rs.15,058 crore, constituting 99.9 per cent of the deposits with all RNBCs and 77.3 per cent of public deposits of all NBFCs.
RNBCs are required to invest not less than 80 per cent of the aggregate liabilities to the depositors (ALD) in the manner prescribed by the Reserve Bank which include Government securities, Government guaranteed bonds, fixed deposits with scheduled commercial banks, debentures of public financial institutions, commercial paper (CP) issued by companies and units of mutual funds, within certain limits.

The Reserve Bank recently reviewed the current regulations relating to investments by RNBCs. Modifications include stipulation of minimum rating, exposure norms and an increase in investment in government securities as set out below:

- **RNBCs should invest only in (i) the fixed deposits and CDs of scheduled commercial banks; and (ii) CDs of specified financial institutions provided such CDs are rated not less than AA+ or its equivalent by an approved credit rating agency, with exposure to a scheduled commercial bank not exceeding 1 per cent of the aggregate deposit liabilities of the bank as on March 31 of the previous accounting year and exposure to any one specified DFI not exceeding 1 per cent of the ALD.**

- **RNBCs should invest in the Central and State Government securities issued by the Governments in the course of their market borrowing programme an amount which shall not be less than 15 per cent of the outstanding ALD.**

- **Investment in debt securities should be confined to those having minimum AA+ or equivalent grade rating and listed in any one of the stock exchanges.**
• The investment in units of mutual funds should be in only debt-oriented mutual funds, subject to the aggregate investment in mutual funds not exceeding 10 per cent and in any one mutual fund not exceeding 2 per cent of ALD.

• Effective April 1, 2005, RNBCs will be permitted to invest, as per their discretion, only 10 per cent of the ALD as at the second preceding quarter or up to their net owned funds (NOF), whichever is lower. Effective April 1, 2006 the discretionary investment limit would stand abolished.

The Reserve Bank directed that the NBFCs which were granted Certificates of Registration (CoR) in the non-public deposit taking category should meet the minimum capital requirements of Rs.200 lakh to be eligible to apply to the Reserve Bank for accepting public deposits. Accordingly, NBFCs registered in the non-deposit taking category were advised to ensure compliance with this requirement before applying to the Reserve Bank for approval to accept public deposits.

During the year under review, the Reserve Bank cancelled CoR of twenty NBFCs for reasons other than conversion from category ‘A’ (deposit accepting NBFCs) to category ‘B’ (non-deposit accepting NBFCs). The Reserve Bank launched prosecution proceedings against 63 companies so far and winding up petitions have been filed with the courts in respect of 71 companies.
MACRO-PRUDENTIAL INDICATORS REVIEW

Macro-prudential indicators (MPIs), which comprise both aggregated micro-prudential indicators of the health of individual financial institutions (FIs) and macroeconomic variables associated with financial system soundness, are a useful tool to assess the health and stability of the financial system. The Reserve Bank has been compiling MPIs from March 2000 onwards. Over the last few years, the compilation exercise has been refined in consonance with the methodology given by the International Monetary Fund (IMF). In the Annual Policy Statement for 2004-05, it was indicated that the salient features of the MPI review would be published on an annual basis. Accordingly, the MPI review for the year 2003-04 is set out below.

Capital Adequacy

The capital position of financial intermediaries was generally above the minimum requirement (Table 10.2). The core capital ratio of banks showed some decline during 2003-04. The Capital to Risk-weighted Assets Ratio (CRAR) of the majority of banks as also major bank groups was well above the regulatory stipulation, except for two banks (Tables 10.3 and 10.4). This should enable the meeting of requirements relating to the capital charge for market risk and provisioning for doubtful assets as announced in the Policy Statement. Tier I capital of scheduled UCBs also recorded an improvement, in absolute terms, partly because of the liquidation of two banks with negative net worth, inclusion of one bank in the scheduled category and the attainment of 9 per cent CRAR level by some banks.
In the case of DFIs, although the aggregated CRAR was high, the erosion of capital of two large Government-owned DFIs due to the high level of NPAs resulted in negative CRAR in respect of these institutions.

Table 3.3 Key Financial Indicators of Scheduled UCBs

<table>
<thead>
<tr>
<th>Indicator</th>
<th>March 2004</th>
<th>March 2003</th>
<th>Percentage variation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Scheduled UCBs</td>
<td>55</td>
<td>56</td>
<td></td>
</tr>
<tr>
<td>Paid up capital</td>
<td>707</td>
<td>608</td>
<td>16.1</td>
</tr>
<tr>
<td>Reserves</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(excluding loan loss provisions)</td>
<td>2,488</td>
<td>2,195</td>
<td>13.4</td>
</tr>
<tr>
<td>Tier I capital</td>
<td>297</td>
<td>-10</td>
<td></td>
</tr>
<tr>
<td>Tier II capital</td>
<td>529</td>
<td>434</td>
<td>21.7</td>
</tr>
<tr>
<td>Deposits</td>
<td>39,305</td>
<td>36,024</td>
<td>9.1</td>
</tr>
<tr>
<td>Investment in Government and other approved securities</td>
<td>13,954</td>
<td>10,806</td>
<td>29.1</td>
</tr>
<tr>
<td>Loans and Advances</td>
<td>23,962</td>
<td>22,941</td>
<td>4.5</td>
</tr>
<tr>
<td>Gross NPAs</td>
<td>6,892</td>
<td>6,927</td>
<td>-0.5</td>
</tr>
<tr>
<td>Net NPAs</td>
<td>3,509</td>
<td>3,827</td>
<td>-8.3</td>
</tr>
<tr>
<td>Net Profit#</td>
<td>497</td>
<td>354</td>
<td>40.4</td>
</tr>
<tr>
<td>Net Loss*</td>
<td>101</td>
<td>326</td>
<td>-69.1</td>
</tr>
<tr>
<td>Accumulated Losses</td>
<td>2,320</td>
<td>2,276</td>
<td>2.0</td>
</tr>
<tr>
<td>Memo items: Ratios (in per cent)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gross NPAs as percentage of gross advances</td>
<td>28.8</td>
<td>30.2</td>
<td></td>
</tr>
<tr>
<td>Net NPAs as percentage of net advances</td>
<td>17.1</td>
<td>19.3</td>
<td></td>
</tr>
</tbody>
</table>

# : Relates to 47 banks in March 2003 and 50 banks in March 2004.
* : Relates to 9 banks in March 2003 and 5 banks in March 2004.
Note: Data as on March 31, 2004
A large concentration of credit in a few sectors is an indicator of vulnerability since the lending institutions are exposed to the heightened credit risk, especially in the downturn phase of the business cycle. Data on sector-wise deployment of gross bank credit by 48 major banks showed that the share of food credit declined. The share of credit to the priority sector remained more or less unchanged up to September 2002 before increasing gradually.

The growth in the housing and retail sectors. Industry-wise data showed a steady increase in share of credit to infrastructure industries. The share of engineering industries, however, declined steadily.

The asset quality of DFIs as a group has been deteriorating due to very high NPA ratios in respect of two DFIs. NPA ratios were low in respect of NBFCs.

**Earnings and Profitability Indicators**

The earnings and profitability indicators for the financial system as a whole were positive, except in the case of DFIs. The return on total assets (ROA) in respect of DFIs was negative, reflecting persistent losses combined with limited recourse to low cost funds. Although the ROA of the PDs declined marginally due to increased volatility in securities market, it was still high. The ROA of scheduled commercial banks has been improving steadily even after making substantial provisions. Continued higher income from securities trading, profits from foreign exchange operations and decline in interest expenses are some of the reasons for the buoyancy in banks’ profitability. The return on equity
(ROE) of the commercial banking system remained high which augurs well for their efforts towards raising capital from the market. The operating costs of banks witnessed an increase during April-September 2003, due to increases in staff costs and other operating expenses as a percentage to income. However, the cost income

Table 3.4 Operational Results of Scheduled Commercial Banks - Key Ratios

<table>
<thead>
<tr>
<th>Ratio to Total Assets</th>
<th>2003-04</th>
<th>2002-03</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings before Provisions and Taxes (EBPT)</td>
<td>2.70</td>
<td>2.43</td>
</tr>
<tr>
<td>Profit after Tax</td>
<td>1.18</td>
<td>1.01</td>
</tr>
<tr>
<td>Total Income</td>
<td>9.48</td>
<td>10.29</td>
</tr>
<tr>
<td>Interest Income</td>
<td>7.41</td>
<td>8.39</td>
</tr>
<tr>
<td>Non-Interest Income</td>
<td>2.07</td>
<td>1.91</td>
</tr>
<tr>
<td>Total Expenditure</td>
<td>6.76</td>
<td>7.86</td>
</tr>
<tr>
<td>Interest Expenses</td>
<td>4.52</td>
<td>5.59</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>2.24</td>
<td>2.27</td>
</tr>
<tr>
<td>Provisions and Contingencies</td>
<td>1.53</td>
<td>1.42</td>
</tr>
</tbody>
</table>

Ratio (ratio of operating expenses to total income net of interest expended) declined, reflecting improved efficiency. While containment of such costs is imperative to sustaining improved profitability, the impending wage revision in the financial sector may put pressure on its operating costs in the near future.
A sharp improvement in the commercial banks’ bottomline was due, in large part, to the treasury profits which were fuelled by the decline in interest rates and profit-booking on sale of Government securities. These sources of profits may not be sustained in the future. Banks’ earning capacity would increasingly depend on other sources such as interest earned from lending operations and fee-based business.

Sensitivity to Market Risk

Interest Rate Risk

Given the significant share of investments in Government securities in the assets of commercial banks, the interest rate sensitivity of their balance sheets is critical. The Reserve Bank, therefore, conducts periodic sensitivity analyses of banks’ balance sheets.

Currency Risk

An appreciation in the rupee vis-à-vis the US dollar, combined with soft global interest rates during 2003-04, led to increased recourse to external commercial borrowings as also increased borrowings in foreign currency from the domestic banks. The foreign currency positions of importers and other corporates going in for such borrowings have, however, remained largely unhedged. Banks have, therefore, been sensitised to the need to assess the foreign currency risk of their borrowers spilling over to the credit risk.
Commodity Risk

Banks in India generally do not trade in commodities. Certain banks have, however, been allowed to trade in precious metals and in gold derivatives subject to fulfilment of certain prudential norms. The exposure of the banking system to precious metals is insignificant and is not a cause of systemic concern.

Equity Risk

Banks’ exposure to the capital market at 1.8 per cent of total advances at end-March 2004 was well below the stipulated ceiling of 5 per cent. Some new private sector banks have exposures close to the limit prescribed.

Liquidity

The ratio of liquid assets to total assets of banks declined to 42.6 per cent at end-March 2004 from 44.2 per cent at end-September 2003. This was indicative of the increased credit offtake from the banking system during the last half year.

MPIs also include key indicators of the global economic outlook, prospects for the domestic economy, financial markets, corporate profitability and credit offtake. These have been covered extensively elsewhere in the Report. Besides, exposure of banks to retail credit has also assumed considerable significance as an MPI, which is covered in Section III.
To sum up, the response of the financial sector to the Reserve Bank’s initiatives has been encouraging. This has resulted in improvement in key banking parameters, especially in increased capital adequacy and reduced net NPA ratios. The improved macroeconomic outlook and the pick-up in industrial activity have also resulted in an improved credit offtake. The financial sector has acquired greater strength, efficiency and stability. The performance of the banking sector is noteworthy considering the legacy of past NPAs and progressive tightening of prudential norms. Overall rigidity in lending rates as well as inadequacy in quality of service to some sections continue to be matters of concern.

**Outlook**

The process of financial liberalisation has exposed financial institutions to a wide range of market risks than before. This has necessitated an ongoing restructuring of the regulatory framework, adaptation to the changing landscape of the financial system and a continuous sharpening of the focus of monitoring. Furthermore, recent events have brought issues relating to corporate governance and internal control systems to the centre-stage of the responsibility for financial stability. It also calls for watchfulness among all stakeholders.

The Reserve Bank would continue to strengthen its supervisory initiatives. Risk-based supervision and the PCA framework would be strengthened further. Consolidated supervision would be complemented by a supervisory framework for financial conglomerates. Regulators and regulated entities would have to enhance their risk detection and management systems in order to prepare themselves for the eventual
adoption of the new capital adequacy norms under the Basel II process. The improvement in the asset quality in spite of the adoption of the 90-day delinquency norm is indeed a noteworthy development. The Reserve Bank would continue to ensure a sustained reduction in the non-performing assets to levels comparable with those of industrial countries and even below.

3.3 REPORT OF THE HIGH POWER COMMITTEE ON URBAN COOPERATIVE BANKS

1. The Reserve Bank of India appointed this Committee in May 1999 under the Chairmanship of Shri K.Madhava Rao, Ex-Chief Secretary, Government of Andhra Pradesh to review the performance of Urban Cooperative Banks (UCBs) and suggest necessary measures to strengthen this sector. The terms of reference of the Committee are (i) to evolve objective criteria to determine the need and potential for organising urban cooperative banks; review the existing entry point norms and examine the relevance of special dispensation for less/least developed areas etc., ii) to review the existing policy pertaining to branch licensing and area of operation of urban cooperative banks, iii) to consider measures for determining the future set up of weak/unlicensed banks, iv) to examine the feasibility of introducing capital adequacy norms for urban cooperative banks, v) to examine the need for conversion of cooperative credit societies into primary cooperative banks and vi) to suggest necessary legislative amendments to B.R. Act and Cooperative Societies Acts of various states for strengthening the urban banking movement. (Paras 1.2 & 1.3)
2. The Committee feels that there are 5 broad objectives before it. These are (i) to preserve the cooperative character of UCBs, (ii) to protect the depositors’ interest (iii) to reduce the systemic risks to the financial system, (iv) to put in place strong regulatory norms at the entry level so as to sustain the operational efficiency of UCBs in a competitive environment and evolve measures to strengthen the existing UCB structure particularly in the context of ever increasing number of weak banks and (v) to align urban banking sector with the other segments of banking sector in the context of application of prudential norms in toto and removing the irritants of dual control regime. (Para 1.4)

**Genesis and Architecture of UCBs:**

3. The urban cooperative banks have contributed significantly to the well being of low income groups of the urban and semi urban populace. Perhaps, the urban cooperative movement in India, was the first ever attempt at micro credit dispensation in semi urban and urban areas. The UCBs and other cooperative banks were essentially governed by the State Governments under the provisions of their respective Cooperative Societies Acts. But with the increasing demand for introduction of deposit insurance to cooperative banks, it was felt necessary to bring them under the purview of the Banking Regulation Act,1949 (B.R.Act). The urban cooperative banks were, therefore, brought under the purview of B.R. Act, effective from 1 March 1966. With this, UCBs were subjected to dual command by RBI exercising control over their banking related functions and State
Governments exercising supervision over their managerial, administrative and other matters. (Para 2.1 & 2.11)

4. The deposit resources of UCBs rose from a meagre sum of Rs.153 crores as at the end of financial year 1966-67 (UCBs were brought under the purview of B.R.Act with effect from 1 March 1966) to Rs.50,544 crores as at the end of 31 March, 1999. The number of UCBs had also gone up from 1106 to 1936 during the corresponding period. Heterogeneity is a striking characteristic feature of UCB structure. Gujarat, Maharashtra, Karnataka, Tamil Nadu and Andhra Pradesh alone account for 78.9% of urban cooperative banks and over 75 per cent of their deposit resources. Notwithstanding the phenomenal progress registered by UCBs, today they are facing five major problems (i) dual control, (ii) inadequate legal framework to regulate UCBs compared to the powers RBI has been vested with to regulate commercial banks, (iii) increasing incidence of weakness, (iv) low level of professionalism and (v) apprehensions about the credentials of promoters of some new UCBs. The Committee has attempted to address these issues in this report. (Paras 2.22, 2.23 & 2.25)

**Licensing Policy of New Urban Cooperative Banks**

5. The Committee has examined the feasibility of evolving certain objective criteria for determining the need for urban cooperative banks and assessing the potential of a proposed UCB in a given area. The Committee feels that in a fairly deregulated regime neither it is feasible for the regulator to evolve certain objective criteria for
assessing the need for an UCB in a given area nor does it has the wherewithal to do it. Certain conceptual tools like ‘existence of credit gap’ and the Average Population Per Bank Office (APPBO) are not effective in determining the need for an urban bank in a given locale specific. It, therefore, recommends that the regulator should prescribe the twin criteria i.e., a strong startup capital and requisite norms for promoters eligibility. These two norms will suffice at the entry level for the new UCB. As regards the viability of an entity, it should be left to the judgement of the promoters. The Committee, therefore, recommends that the existing quantitative criteria of viability standards should be dispensed with and they should be replaced by qualitative norms like CRAR, tolerance limit of NPAs and operational efficiency. (Paras 3.7 & 3.38)

6. The twin functions of start-up capital are (i) to meet the initial infrastructure cost and (ii) to provide cushion against the erosion of bank’s assets. Viewed in this context, the existing Entry Point Norms (EPNs) are low. The Committee also feels that EPNs for UCBs should be on par with peer groups like Local Area Banks (LABs) and Regional Rural Banks (RRBs) whose clientele and area of operation are broadly similar to UCBs. The Committee also feels that the existing low EPNs is one of the major causes for weakness of UCBs. The Committee, therefore, agrees with the views of Narasimham Committee Report on Banking Sector Reforms that the existing EPNs are rather low. Accordingly, the Committee recommends the following 5 grades of increased EPNs compared to the existing 3 grades.
Table 3.5  Entry point norms for UCBs other than unit banks

<table>
<thead>
<tr>
<th>Category of Centre</th>
<th>Capital (Rs. in crores)</th>
<th>Membership (Nos.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>- population over 15 lakhs</td>
<td>5.00</td>
</tr>
<tr>
<td>B</td>
<td>- population over 10 lakhs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>but not exceeding 15 lakhs</td>
<td>2.50</td>
</tr>
<tr>
<td>C</td>
<td>- population over 5 lakhs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>but not exceeding 10 lakhs</td>
<td>2.00</td>
</tr>
<tr>
<td>D</td>
<td>- population over 2 lakhs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>but not exceeding 5 lakhs</td>
<td>1.00</td>
</tr>
<tr>
<td>E</td>
<td>- population not exceeding</td>
<td></td>
</tr>
<tr>
<td></td>
<td>2 lakhs</td>
<td>0.50</td>
</tr>
</tbody>
</table>

(Para 3.18)

7. If promoters desire to set up unit banks (1 branch bank), the above entry point capital norms require reduction. The Committee, therefore, recommends that banks which intend to start only unit banking, should be given 50% relaxation in the entry point norms applicable to the particular centre as under.
Table 3.6  Entry Point Norms for unit banks

<table>
<thead>
<tr>
<th>Category of Centre</th>
<th>Capital (Rs. in crores)</th>
<th>Membership Nos.</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>2.5</td>
<td>3000</td>
</tr>
<tr>
<td>B</td>
<td>1.25</td>
<td>2500</td>
</tr>
<tr>
<td>C</td>
<td>1.00</td>
<td>2000</td>
</tr>
<tr>
<td>D</td>
<td>0.50</td>
<td>1500</td>
</tr>
<tr>
<td>E</td>
<td>0.25</td>
<td>1000</td>
</tr>
</tbody>
</table>

However, if any UCB intends to open additional branches, it has to comply with the entry point capital prescribed for the banks as indicated in the Table A. (Para 3.19)

8. The Committee has examined the desirability of continuance of special dispensation i.e., relaxation in entry point norms for certain categories of banks organised in less/least developed areas and banks set up exclusively for women and SCs/STs. There is some merit in the argument of the critics of special dispensation that, urban banks being financial entities, any relaxation in entry point norms would lead to proliferation of weak banks. But in view of constitutional provision for reservation for SCs/STs and the state policy of empowerment of women, the Committee recommends continuation of the relaxations in EPNs to the above categories of banks for a period of 5 years and, thereafter, the RBI should review the policy. (Para 3.32)
9. Good corporate governance is critical to efficient functioning of an entity and more so for a banking entity. The Committee feels that irrespective of the size of the operations, banks need to run on professional lines and UCBs are no exception to this rule. It, therefore, suggests that at least 2 directors with suitable banking experience or relevant professional background should be present on the Boards of UCBs and the promoters should not be defaulters to any financial institution or banks and should not have any association with chitfund / NBFCs / cooperative bank or commercial bank in the capacity of Director on the Board of Directors. (Para 3.25)

Branch Licensing Policy and Area of Operation

10. The Committee while, broadly agreeing with the existing branch licensing policy, recommends a few changes in the policy particularly with reference to dispensing with viability standards as a prerequisite for issue of branch licences. Although UCBs are functioning in a compact area, any restriction on their expansion will hamper their growth. The Committee, recommends that RBI should extend to the UCBs the same freedom and discipline as is applicable to commercial banks in opening branches. If an UCB complies with the following broad norms viz., (a) it should not have been in default of any of the provisions of the B.R.Act or RBI Act or Directives issued by RBI from time to time, (b) its capital adequacy is not lower than the minimum required level, (c) it must have fully complied with the provisioning norms specified by RBI,
(d) its net NPAs are not more than 10%, (e) it has made profits in the last two years and (f) its priority sector advances are not less than 60% of the total loans and advances. The Committee recommends that every UCB must submit to the RBI an Annual Action Plan (AAP). Scheduled UCBs which satisfy the eligibility criteria be given freedom to open new branches under the AAP. Non-scheduled UCB should continue to obtain prior approval of RBI after complying the eligibility criteria. The Committee also recommends that non-scheduled UCBs should not open more than 10% of their existing branches subject to a minimum of one branch, in any given year. No UCB can open more than 2 branches on its inception or within a period of 2 years thereafter. Scheduled UCBs may be permitted to open mobile and satellite offices subject to compliance with guidelines. (Para 4.15)

11. Though urban cooperative banks were initially conceived to be small entities confining their area of operation to small towns and municipal limits of cities, over a period of time some of them have started expanding to the entire state and in some cases beyond their respective states of registration. The opponents of expansion of area of operation of UCBs argue that UCBs would lose their cooperative character and structure which give them their identity viz. local feel, compact area of operation and mutual help, if they indiscriminately expand their area of operation. Proponents of expansion of area of operation, on the other hand, argue that expansion of area of operation does not necessarily dilute the cooperative character
because the clientele of UCBs having common interest belonging to common ethnic group, may spread over different parts of the state or more than one state. When some Cooperative Banks of Europe have nation-wide and worldwide presence, restricting UCBs operations to districts of their registration would place artificial barriers on their growth. (Para 4.22)

12. The Committee, therefore, recommends that (a) new UCBs can extend their area of operation to the entire district of their registration and adjoining districts, (b) when an UCB desires to open a branch in a district in a state other than the district in which it is registered, it must have a net worth which is not less than the entry point norms prescribed for the highest category centre in that state and (c) if an UCB desires to open a branch in a state other than the state in which it is registered, it must have a net worth of not less than Rs.50 crores (which is 50% of the minimum requirement for a new private sector bank). (Para 4.23)

Policy on Weak and Unlicensed Banks

13. Existence of large number of unlicensed banks has become a cause of concern for regulators. As on 30 September 1999, as many as 181 banks are still unlicensed entities. Of these, 97 banks continue to be unlicensed for over 3 decades. Existence of such large number of unlicensed banks over 3 decades places the RBI in a state of "regulatory discomfiture". (Para 5.1)
14. The main reason for proliferation of unlicensed banks is on account of statute induced expansion. Under the provisions of Section 5 (ccv), a primary credit society whose paid up capital and reserves attain the level of Rs. 1 lakh and whose main objective is to carry on banking business automatically secures urban banking status. The Committee, therefore, recommends that in order to choke this automatic route of transformation into UCBs, this Section of B.R.Act, needs to be amended. Many of the unlicensed banks were not given licences due to non-compliance with entry point capital norms, non compliance with the provisions of B.R.Act, 1949 (AACS) and RBI Act, high level of NPAs and unsatisfactory operating results etc. The Committee, expresses its concern about RBI allowing so many unlicensed banks to continue to operate for so long a period. It, therefore, recommends that (a) ubcs which are brought under the purview of B.R.Act, 1949 (AACS) in 1966, should be either given licences by RBI if they comply with the norms prescribed by it by 31 March 2002, or their application for licences be rejected. b) primary cooperative societies which were converted into UCBs after 1 March 1966, and remained unlicensed should be given licences or their application for licence rejected by 31 March 2002 or within 5 years from the date of their conversion into ucbs whichever is later and (c) for all primary credit societies which apply for licence in future, the licence should be granted or rejected within a period of 6 months from the date of application and pending grant of licence, such societies must not be permitted to carry on banking business. (Paras 5.2, 5.3 & 5.6)
15. RBI should also make its policy of licensing of unlicensed banks more transparent and precise. The Committee, therefore, recommends that if an unlicensed bank (a) attains minimum level of CRAR prescribed by the regulator, (b) its net NPAs are not in excess of 10%, (c) it has made profits during each of the last 3 years and (d) it has complied with the statutory framework of B. R. Act / Directives issued by RBI, it should be licensed. (Para 5.6)

16. Increasing incidence of sickness in UCBs has become a constant cause of concern for RBI. As at the end of 31 March 1999, as many as 293 banks have been classified as weak. Of these, 112 do not comply with even the minimum capital requirement of Rs.1 lakh prescribed under section 11 of B.R.Act, 1949 (AACS). The Committee feels that (a) inadequate entry point capital, (b) lack of professionalism and politicisation of management, (c) absence of compliance of prudential norms, (d) absence of system for timely identification of weakness and (e) dual control over UCBs are some of the major attributary factors for sickness in UCBs. (Paras 5.7 & 5.10)

17. Though there are institutional mechanisms like State Level Rehabilitation Review Committee (SLRRC) and Bank Level Rehabilitation Review Committee (BLRRC) to review the performance of weak banks, the progress has not been quite satisfactory. Besides, the existing parameters for classifying weak banks, in the opinion of the Committee, suffer from several defects.
There should be a system to flash early warning signals to detect the incipient sickness so that financial position of a bank may not further deteriorate. The Committee, therefore, believes that there should be separate criteria for identification of weak and sick banks and recommends the following objective criteria. (Para 5.28)

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Weak bank</th>
<th>Sick bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>CRAR</td>
<td>Less than 75%</td>
<td>Less than 50% of minimum prescription, or</td>
</tr>
<tr>
<td>Net NPA</td>
<td>10% or more but less than 15% of loans and advances</td>
<td>15% or more of outstanding as on 31 March, or</td>
</tr>
<tr>
<td>History of Losses</td>
<td>Showing net losses in operation for the last three financial years</td>
<td>Showing net losses in operation for the last three financial years</td>
</tr>
<tr>
<td></td>
<td>showing losses in operation for the last three financial years</td>
<td>showing losses in operation for the last three financial years</td>
</tr>
<tr>
<td></td>
<td>out of the last three consecutive financial years</td>
<td>out of the last three consecutive financial years</td>
</tr>
</tbody>
</table>

18. The Committee also feels that BLRRCs have not achieved much and it recommends dismantling the same. It, however, recommends that SLRRCs should continue. (Para 5.28)
19. The Committee also recommends that once an UCB is classified as a sick bank, action may be taken under the provisions of Section 45 of the B.R.Act, 1949 to place it under moratorium. During the period under moratorium it must, however, reconstruct or amalgamate with another UCB and if this is not possible, the bank’s licence to carry on banking business must be withdrawn. (Para 5.28)

20. If, however, RBI feels that even without reconstruction or amalgamation a sick UCB can be rehabilitated and it should be allowed to continue to operate, then it would be necessary for RBI to ensure that bank’s CRAR is not allowed to deteriorate below the ratio which exists when it is identified as a sick UCB. The Committee, therefore recommends that RBI/GOI create a Rehabilitation Fund which would be used as subordinated debt for the purpose of maintaining the CRAR of sick UCBs at the level which existed when it is declared sick. If the rehabilitation scheme succeeds the loan amount would be returned to the Rehabilitation Fund. Since, CRAR is not applicable to UCBs, it is not feasible to compute exact quantum of the Fund. Assuming the minimum networth needed to be maintained for the sick UCBs would be equivalent to 4% of its loans and advances portfolio, and considering that only some of the sick UCBs with positive networth would be considered as capable of rehabilitation, the size of the Fund is estimated at around Rs.40 crores. (Para 5.28)
Application of CRAR to UCBs

21. In the opinion of the Committee, the continued financial stability of UCBs cannot be ensured unless they are subjected to the discipline of maintenance of prescribed minimum capital to risk assets ratio (CRAR). While a quick review of 50 (other than weak banks) UCBs showed that 76% had reached the minimum CRAR prescribed for commercial banks, the Committee realises that it may be difficult for all UCBs to immediately comply if a minimum norm is made applicable to the whole UCB sector. (Paras 6.4 & 6.5)

22. It has been represented to the Committee that the ability of UCBs to raise additional capital to meet CRAR norms is limited (a) by their inability to make public issue of capital, (b) the fact that members can reduce their capital and (c) particularly by the quantitative ceiling imposed by the State Cooperative Societies Acts, and Multi-State Cooperative Societies Act,1984, on the number of shares an individual can hold. The Committee is in favour of removing these quantitative restrictions but is in favour of imposing a percentage ceiling whereby no single individual can hold more than 5% of the share capital of an UCB. (Para 6.8)

23. The Committee is also in favour of UCBs being subjected to CRAR discipline in a phased manner with initially a lower CRAR norms being prescribed for non-scheduled UCBs as compared to scheduled UCB. The following norms are, therefore, recommended.
Table 3.8  **Recommended Norms**

<table>
<thead>
<tr>
<th>Date</th>
<th>Scheduled (UCBs)</th>
<th>Non-Scheduled  (UCBs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>31st March 2001</td>
<td>8%</td>
<td>6%</td>
</tr>
<tr>
<td>31st March 2002</td>
<td>9%</td>
<td>7%</td>
</tr>
<tr>
<td>31st March 2003</td>
<td>As applicable to Commercial banks</td>
<td>9%</td>
</tr>
<tr>
<td>31st March 2004</td>
<td>- do -</td>
<td>As Applicable to Commercial banks</td>
</tr>
</tbody>
</table>

(Para 6.14)

24. Until an UCB attain the specified CRAR norms, the Committee recommends that it should be required to transfer not less than 50% of its net profits to the Reserve Fund and there should be a ceiling of 20% on the percentage of dividend it can distribute to its members. (Para 6.14)

**Conversion of Cooperative Credit Societies into UCBs:**

25. RBI had been pursuing the policy of allowing cooperative credit societies as defined in secn. 5 (ccii) of B.R. Act, (AACS) to convert themselves into urban cooperative banks, provided that they attain
entry point norms prescribed by RBI. But it has been suggested that allowing conversion of credit societies into UCBs in over banked areas might tantamount to back door entry into the Urban Banking fold. (Para 7.6)

26. The Committee, however, believes that denying the benefit of conversion of cooperative credit societies which have a good track record of profits, which comply with entry point norms prescribed by RBI and have already been serving certain sections of a given area, while allowing new urban cooperative banks whose promoters’ antecedents are untested, would be an unfair policy stance. It, therefore, recommends that such of the credit societies whose networth is not less than the entry point capital prescribed for new banks in that given centre, which have been posting profits during each of the last 3 years, which have earned "A" audit rating and whose methods of operation are not detrimental to the interests of the depositors may be allowed to convert themselves into UCBs. (Para 7.11)

**Legislative Reforms in Central and States Statutes**

27. Application of certain provisions of B.R. Act, 1949 to urban cooperative banks in 1966, inaugurated regime of dual control. The dual control has become a very serious problem affecting the functioning of the urban cooperative banking sector. After interaction with urban cooperative banks and their federations,
independent observers of cooperative movement and banking sector and after perusal of certain provisions of State Cooperative Societies Acts, the Committee is convinced that dual control regime is perhaps one of the most vexatious problems of urban cooperative banking movement. The Committee is of the view that duality in command, per se, is not the issue but it is the absence of clear cut demarcation between the functions of the State Government and the Reserve Bank of India that has been responsible for the irritants thrown up by the dual control regime. (Paras 8.1 to 8.3)

28. Branch licensing, expansion of area of operation, fixing interest rates on deposits and advances, audit, and investments are essentially banking related functions. The Registrars of Cooperative Societies of many States continue to exercise their powers over these areas under the mistaken impression that they can do so under the general provision of Cooperative Societies Act which empowers them to exercise general supervision and control. The Committee, therefore, strongly feels that the State Acts should be amended so as to categorise the banking related functions and the functions of the State Governments separately. The Committee feels that areas relating to investment, prudential norms, branch licensing, remission of debts, change of management should exclusively come under the realm of banking related functions and RBI should be the sole regulatory authority. Registrar of Cooperative Societies of the State concerned should confine his activities to registration, approval and amendments to by-laws, election to management committees,

29. The Committee is conscious that in a competitive federal polity, the State Governments may be reluctant to carry out these amendments to the Acts. It, therefore, recommends that unless necessary amendments are made to the respective State Act and Multi State Cooperative Societies Act as suggested above, RBI may not licence any new banks, nor allow the branch expansion of the existing banks in a State which does not carry out these amendments. Pending amendments to State Cooperative Societies Acts, UCBs will have the freedom to register under the amended Multi-State Cooperative Societies Act. (Para 8.14)

30. With a view to contain the growth of weak banks, the Committee suggests amendments under section 5(ccv) of B.R. Act (AACS) so as to arrest automatic transformation of primary cooperative credit societies into urban cooperative banks. Similarly section 5(ccvi) also needs to be amended to delete the word "primary" and Primary Cooperative Banks should be known as Urban Cooperative Banks. UCBs must also to be allowed to admit any cooperative society, other than a cooperative credit society or a cooperative bank, as their members. It also recommends amending Section 7 from
stopping primary credit societies using the words "bank", "banker" etc. Besides, Section 30 of B.R. Act with regard to appointment of auditors should also be made applicable to UCBs. The Committee feels that RBI should be vested with powers to remove Directors, CEO of a bank and recommends that Section 36AA of B.R. Act, 1949 [As Applicable to Banking Companies (AABC)] may be extended to UCBs. RBI should also be vested with powers in regard to moratorium of UCBs on the lines of Section 45(4) to 45(15) of B.R. Act (AABC). The Committee also suggests amendments to B.R. Act (AACS) so as to make the format of Balance Sheet be in consonance with Schedule III of B.R. Act (AABC). (Para 8.21 to 8.34)

**Other Related Issues**

31 During its interaction with the State Government officials, bankers and federations certain related issues which are outside the scope of the terms of reference but have an important bearing on the functioning of UCBs were brought before the Committee. One of them relates to reduction in the target set for priority sector advances. The Committee feels that urban cooperative banks are essentially required to cater to the needs of low/middle income groups. Bringing down the targets of priority sector advances will go against the stated objective. Besides, of over 1400 reporting urban cooperative banks on 31 March 1998, 84.1% have attained the target in deploying over 60% of their advances to priority sector. The Committee is, therefore, not inclined to agree for reduction in the existing priority sector targets for UCBs. (Paras 9.20 and 9.21)
32. The Committee, during its visits to various centres, was told by UCBs that there is need for larger currency chest facility as many a time, RBI offices and scheduled commercial banks, who are maintaining currency chests, either do not entertain them nor the surplus cash is accepted for deposits. The Committee feels that this is a genuine grievance and requests RBI to increase the currency chests facilities by allowing other scheduled commercial banks as well as scheduled urban cooperative banks to open currency chests by giving incentives to meet the initial and the recurring expenditure. (Para 9.11)

33. Under provisions of section 24 of the B.R. Act, urban cooperative banks are required to invest their SLR funds either in approved securities or with DCCBs/SCBs. Many representatives of urban cooperative banks have expressed their concern over the financial health of DCCBs and felt that they should be given an opportunity to invest their funds with scheduled urban cooperative banks and scheduled commercial banks. While there is some merit in this representation, the Committee is also aware of the impact of adoption of such a policy on the viability of DCCBs/SCBs in the event of flight of deposits from DCCBs/SCBs to other banks. It, therefore, suggests that RBI may examine this request in the light of recommendations to be submitted by Task Force under the Chairmanship of Shri Jagdish Capoor, Deputy Governor, Reserve Bank of India, to suggest suitable package for cooperative banks. (Paras 9.14, 9.15 & 9.16)
34. One member (Dr. Sawai Singh Sisodia) suggested a different Entry Point prescription. Another member, (Dr. Mukund L. Abhyankar) is unable to agree with our recommendation on non-voting shares and prescribing a ceiling on individual share holding in UCBs. Another member, (Shri Subhash S. Lalla) is unable to agree with our recommendations on (1) the area of operation being taken out of the purview of RCS, (2) allowing UCBs to park SLR funds in commercial banks, (3) deleting the word "primary" from the B.R. Act and (4) on dual control. (Paras 3.21, 6.8, 8.14, 8.22 & 9.22)