

## Credit Risk Management in Cooperative Sector Banks in India

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### ABSTRACT:

Almost around 100 years ago, the setup of Co operative banks was seen in India as the rise of an important constituent in the Indian Financial System. Though the system of cooperative system started in the west and by the west, cooperative banks in Indian scenario have assumed a primal and pivotal role. This is due the unique social and economic structure of India that is un parallel all across the world. Today these banks have become an integral part of rural India by becoming major financers for agriculture and related activities , along with other sectors. However, many banks in recent times have failed in their functionaries to execute their responsibilities to the fullest. A major reason had been the process in which the credit risk management was undertaken. In this paper we will examine the role of these banks and how they function in perspective of the Credit Risk Management in their domain.

### Keywords:

Urban Cooperative Bank(UCB), to NAFCUB (National Federation of Urban Co-operative Banks, Primary Agricultural Credit Societies (PACS), District Central Cooperative Banks (DCCBs), NABARD, State Cooperative Banks (StCB), Reserve Bank of India (RBI), B.R. Act., Non performing Assets (NPA), Deposit Insurance and Credit Guarantee Corporation (DICGC), Deposit Insurance Scheme (DIS).

### Introduction

Today, Credit Risk Management is primal in the process of credit lending process. This is equally true at all levels of corporate structure. Under this either private or nationalized banks should be considered.

However, there exists another sector of banks that are being in existence that is being used by a large number of the middle class section of our society. These are co-operative banks of India.

In the early 19th Century, with the success of cooperative societies outside India in countries like Britain and Germany led to the formation of cooperative banks as a very big moment.

"Anyonya Co-operative Bank "of India is considered to have been the first cooperative bank setup in Asia. With a huge success of Urban Cooperative Bank UCB in Germany and Italy, in the year 1889 this first Cooperative society was setup as 'ANYONYA SAHAKARI MANDALI' in the then princely State of Baroda under the leadership of Late Shri Vithal Laxman Kavthekar.

By the year 1904, the Co-operative society Act was passed in India. After studying various practices in agricultural land banking in European countries, a report by Sir Fredrick Nicholson was submitted which further led to the setup of Sir Edward Law committee? Report of Sir Edward Law committee was instrumental bringing out a special legislation for legal Cooperative setup in India.

With this enactment of law the first urban cooperative credit society (UBC) was registered in Canjeevaram, Madras province in October, 1904. This further led to more of such societies being formed in Madras and Bombay provinces. Co-operative banks are small-sized financial units that are being run in an organized co-operative sector, for both urban and non-urban areas. These banks tend to lend small borrowers and businesses in a small area or locale. In other words, **Cooperative banks** engage in both retail and commercial banking on mutual cooperative basis.

In India, Cooperative movement has its origin in agriculture and related sectors. The first Cooperative Credit Societies Act was enacted in 1904, followed by a more comprehensive law called as the "Cooperative Societies Act" was implemented.

According to this law the provision for "Registrar of Cooperative Societies and Registration of Cooperative Societies" for various purposes including audit was enforced. In 1919, Under the Montague- Chelmsford Reforms, Cooperation became a provincial subject or state subject and provinces or the states were authorized to make their own cooperative laws. Under the Government of India Act 1935, the cooperatives were treated as a provincial subject. Under the Constitution of India, the cooperatives are a state subject under the entry no. 32 of the state list.

In 1942, a Multi-Unit Cooperative Societies Act are enacted to cover Cooperative societies with membership from more than one state. This Act specifically dealt with setting up of corporations and closure of such societies having its jurisdiction in multiple states or provinces. However, a need for a stringer and comprehensive Central Legislation to consolidate the laws governing Cooperative Societies was felt leading to the implementation of "Multi-State Cooperative Societies Act, 1984" by the Parliament under Entry No 44 of the Union List of the Constitution of India.

Soon after Independence, these became an integral part of Five Year Plan by the planning commission with greater stress on removal poverty and improving the socio-economic status of the states. This led to the emergence of Cooperatives as a distinct commercial segment in the Indian economy.

In 1958, the National Development Council (NDC) recommended its national policy on cooperatives. The cooperative sector has been playing a distinct and significant role in the country's process of socio-economic development. During the past few decades, there has been a substantial growth in the type of Cooperatives this sector. from 1.81 lac in the year 1950-51 to 4.53 lacs in 1996-97 and total membership from 1.55 crore to 20.45 crore in the same period. The cooperatives have been operating in various areas of the economy such as credit, production, processing, marketing, input distribution, housing, dairying and textiles. In some of the areas of their activities like dairying, urban banking and housing, sugar and handlooms, the cooperatives have achieved success to an extent but there are larger areas where they have not been so successful.

Urban Co-operative Banks (UCBs) refers to primary cooperative banks situated in urban and semi-urban areas. Until 1996, these banks were allowed to lend for non-agricultural purposes only.

However, with time today this limitation is no longer present. While these banks in rural areas majorly finance agricultural based activities which includes farming, cattle, milk, personal finances and so on other activities like small scale industries (SSI) and self-employment activities are also undertaken.

In India, Co operative Banks in India are registered under the Co-operative Societies Act. These banks are regulated by the Reserve Bank India, and governed under the Banking Regulations Act 1949 and Banking Laws (Co-operative Societies) Act, 1965.

Services like opening and managing savings and current accounts, safe deposit lockers, loan and so on to individuals and business owner customers.

The co-operative banking structure in India is primarily divided into five categories. These are:

- Primary Urban Co-op Banks
- Primary Agricultural Credit Societies
- District Central Co-op Banks
- State Co-operative Banks
- Land Development Banks

Initially, the UBC societies were based on community lending and hence were focused in meeting the expenditure based credit requirements of its members. The term 'bank' was very loosely used by many societies in the initial phase.

At the start of the century these were primarily credit societies which later changed into UCBs. Societies which were not in any banking functions also used the term 'bank'. Since there was no concept of UBC, it was the Joint Reorganization Committee also known as "Mehta Bhansali Committee (1939)" of the Bombay province tried to define, for the first time.

According to the Mehta Bhansali Committee a Society whose paid up share capital was a minimum of Rs.20000, accepted money deposits, did withdrawals by cheque or draft or such were termed as UBC or Urban Credit Banks. However, in Madras province, a society registered under the Registrar of Cooperative Societies, were known as Urban Cooperative Banks (UCBs) irrespective of their share capital. Accordingly in 1966, with the advent of cooperative banks provisions, section 5(CCIV) of Banking Regulation Act, 1949 defined UCB, as under as a primary cooperative bank other than a primary agricultural credit society:

- Prime Objective being business transactions pertaining to banking;
- A fully paid up share capital along a reserve of no less than Rs.1 lakh and
- Restriction of entry of other cooperative society as a member

Since co-operative banks function on the basis of 'no-profit and no-loss', by principle these banks do not pursue the goal of profit maximization. Also, since these banks do not offering no more than the basic banking services. like small borrowers they do not extend this facility to industrial and trade sectors, but professional and salary classes.

- Some cooperative banks in India are more forward than many of the state and private sector banks.
- According to NAFCUB (National Federation of Urban Co-operative Banks and Credit Societies Ltd), the total deposits and lending of cooperative banks is at a higher level than old private sector banks and few new public sector banks.
- This phenomenal growth and development of these co-operative banks is attributed primarily by way of better local reach, close interaction with its customers, finally the ability to catch the pulse of local clientele.

Having achieved so much, these banks are not better enough than their counter part, private banks in especially in terms of facilities that are provided, though the interest rates are definitely competitive and marketable. For instance, interest rate difference for securing automobile loans is around 5-7 percent as compared to private banks.

However, unlike not stringent but lengthy documentation though, these banks sufferer from this difficulty which makes the loan approval rather quick with the private banks. The conditions of Urban Cooperative Bank (UCB) are more stringent than a commercial bank, when it comes to securing a loan, say for instance Education Loan where it does not matter whether the course you are going for is recognized or not when taking a loan. Hence UCB's today are a better option for getting the best rates of interest and getting the clients attention too.

One must know that in general the borrower should be a member of such bank with a min. of 2.5% of loan amount worth as shares. This can also go to a max. of 25,000.

### **Cooperative Bank Requirements**

Rural banking in India started since the establishment of banking sector in India way back in the start of the century. Rural Banks in those days mainly focused upon the agro sector. Regional rural banks in India penetrated every corner of the country and extended a helping hand in the growth process of the country.

SBI for instance has 30 Regional Rural Banks in India known as RRBs. The rural banks of SBI are spread in 13 states extending from Kashmir to Karnataka and Himachal Pradesh to North East. The total number of SBI's Regional Rural Banks in India branches is 2349 (16%). Till date in rural banking in India, there are 14,475 rural banks in the country of which 2126 (91%) are located in remote rural areas.

**However the areas of working for Cooperative banks in India are as under where they support in terms of finance are as under:**

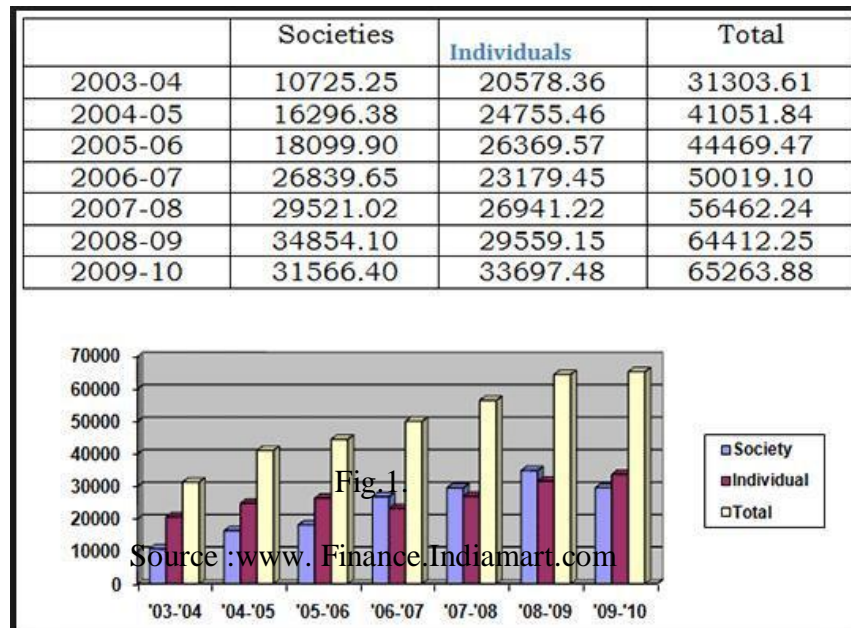
- Farming
- Cattle
- Milk
- Hatchery
- Personal finance

**Cooperative banks in India finance urban areas under:**

- Self-employment
- Industries
- Small scale units
- Home finance
- Consumer finance
- Personal finance

The failure of cooperatives can be attributed to dormant membership and lack of active participation of members in the management of cooperatives. Mounting over dues in cooperative credit institutions, lack of mobilization of internal resources and over dependence on government assistance, lack of professional management, bureaucratic control and interference in the management, political interference and over-politicization have proved harmful to their growth. These are the areas which need to be attended to by evolving suitable legislative and policy support.

For the success of any developmental effort in the agricultural sector is to synergize with the efforts in the cooperative sector. Development of cooperative sector has many benefits. It will involve all sections of the society in development efforts. Cooperative sector of Indian economy has a spiritual content too when it was led by Vinoba Bhave. Cooperative sector has inbuilt democracy and only those who can demonstrate their commitment and efficiency can survive in the cooperative elections. Nowadays most of the financial institutions in the cooperative sector are also run on purely commercial basis. It is here that the State intervention can make the difference. The grant, subsidies and aid meant for the poor farmers must be channeled through the cooperative sector. Once there are enough resources in the sector in terms of money there will be increased participation by the people and will result in the all round development of the village.



Panchayat Raj institutions and cooperative sector can bring about positive change in the rural areas. Cooperatives have extended across the entire country and there are currently estimated 230 million members nationwide. The cooperative credit system has the largest network in the world and cooperatives have advanced more credit in the Indian agricultural sector than commercial banks. In fertilizer production and distribution the

Indian Fertilizer Cooperative commands over 35% of the market. In the production of sugar the cooperative share of the market is over 58% and in cotton they have share of 60%. The cooperative sector accounts for 55% of the looms in the hand-weaving sector. Cooperative process, market and distribute 50% of the edible oil. Dairy cooperative operating under the leadership of the National Dairy Development Board and through 15 state cooperative milk marketing federations as now become the largest producer of milk. With the rapid growth of the cooperative sector a supportive climate has been created for the development of cooperatives with the opportunities for diversification.

With the efforts of National Cooperative Union of India the Central Government passed the Multi State Cooperatives Societies Act and also formulated a national cooperative policy that provides greater autonomy to cooperatives. With the passage of the Insurance Act, cooperatives have been allowed to enter into the insurance business. Insurance is a field where the immense potential of cooperatives still remains untapped. In the new economic environment cooperatives at all levels are making efforts to reorient their functions according to the market demands.

Cooperatives are also considered to have immense potential to deliver goods and services in areas where both the state and the private sector have failed.

### **Constitution of Cooperative Banks**

Though the Cooperative credit structure in India is old enough, yet there are inadequacies that need to be resolved before they turn into a stable and self sustaining systems.



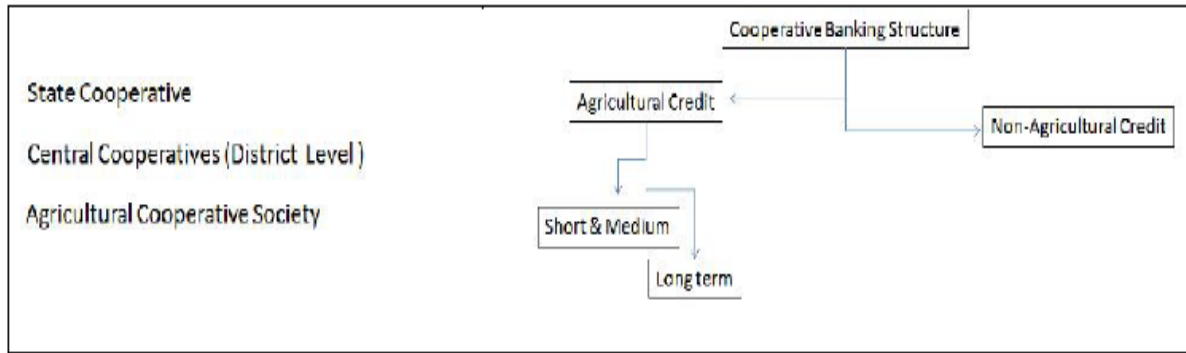


Fig. 2

### Overall functional structure of UCB's

The Structure of Cooperative Banking in India falls mainly into segments, the Agricultural and Non Agricultural credits. These are further categorized as short and Medium and Long Term.

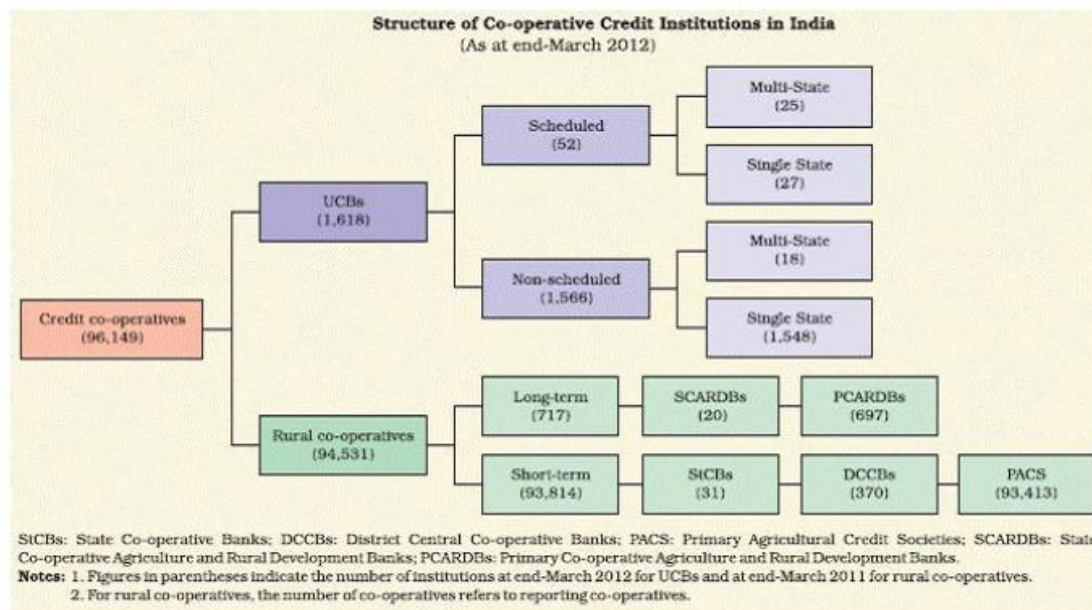


Fig 3

The share capital of the Society is divided into units called shares that are contributed to members. Deposits form the basis of source of finance, while borrowing forms the working capital. The criteria for borrowing differ from state to state. One of the major factors in this being repayment.

2.25 Notwithstanding impressive growth profile of UCBs, the Committee feels that the urban banking sector is facing the following problems : i) Dual control; ii) increasing incidence of weakness; iii) low level of professionalism.

#### Duality of Control

As already mentioned a 'Cooperation' is the subject of the state under the Constitution governed by the respective State Cooperative Societies Acts. At present, the cooperatives are under the control of state governments in all matters relating to registration, membership, election, financial assistance, loaning powers, business operations, loan recovery and audit.

However aspects relating to banking activities are monitored by Reserve Bank of India/NABARD under BR Act 1949. Looking at this, we see that there is no clear demarcation of the legal powers with the bank. This causes a sense of loss of control, hence by affecting the working of these Cooperatives leading to decline in performance.

UCB structure focus on the needs of small and micro credit sector. Noticeably, in 1999 of the 1499 banks reported as on 31 March 1999, the credit base of as many as 933 banks was less than Rs.10 crores each while 1371 banks were between over 10-50 crores as credit base. The main focus of these UCBs were predominantly based in priority sector.

**Urban Credit Bank Base (1999)**

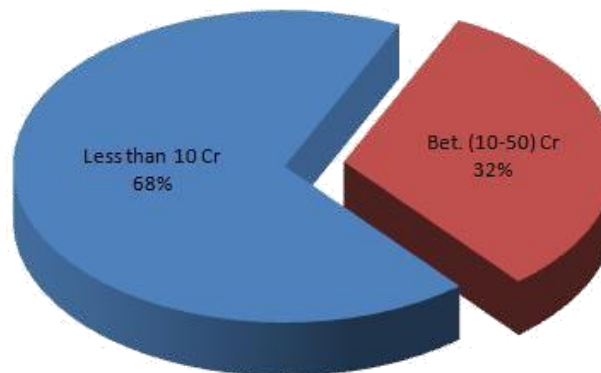


Fig. 1

While the priority sector for UCBs started in 1983, the UCBs were required to deploy at least 60% of their advances into to priority sector as against 40% stipulation for other commercial banks the the end of fiscal year 1998, a large no. of UCBs were able to comply with the targets set for credit deployment for priority sector.

While some 1241 banks that reported for data in priority sector advances deployment, around 84% parked at least 60% of their aggregate credit into the priority sector. Between 1997-98, over 80% of UCBs reported surplus funds.

Point to ponder here is unlike their fellow sectors like the one of Primary Agricultural Credit Societies (PACS), District Central Cooperative Banks (DCCBs), State Cooperative Banks (SCBs), this sector is not supported by any external assistance such as NABARD etc. The formation of Societies has following procedure and steps

#### Cooperative Societies Registration

- To begin with 10 individuals should come together to form a society.
- Provisional committee is formed with a chief promoter elected amongst them and society named.
- An application is presented to the registration authority for registering the name and to Commence the society on that name. This name is valid for a period of 3 months.
- A share capital along with a nominal fee is decided and collected from the prospective Members.
- This followed by opening up of a bank account in the name of the society. The monies so collected from the members is deposited in to the bank account and a certificate from the bank is obtained, besides the registration fee has to be deposited with RBI for which a challan is provided as receipt.
- Once the application is submitted in the concerned Municipal ward to the "Registrar of Societies", the application is examined and further action taken.
- Once details are registered with the register in Form "B" an issue receipt and a serial number is issued.
- The Registrar on the registration will notify the registration of the Society in the Official Gazette and issue Registration Certificate.

Following are the documents submitted while registration:

1. Form No. An in quadruplicate signed by at least 90% of the promoter members
2. List of promoter members.
3. Bank Certificate.
4. Detailed report of working of the society.
5. 4 copies of proposed bye-laws of the society.
6. Proof of payment of registration charges.
7. Other documents like affidavits, indemnity bonds, any other documents as specified by the Registrar needs to be submitted.

#### Urban Banking Architecture

The UCB structure has undergone a lot of change since it was brought under B. R. Act, 1949. The No. of UCBs rose from 1106 in 1967 to 1936 (with single branch) in 1999. The deposits grew from Rs.153 crores to Rs.50544 crores during the corresponding period. While deposits per bank were at Rs.13.83 lakh in 1967, the same grew to Rs.26.11 crore during the aforesaid period.

Even the structure of UCB is heterogeneous. This is vied by the fact that 1936 UCBs at the are unitary in nature i.e with single branch banking. Heterogeneity of UCBs



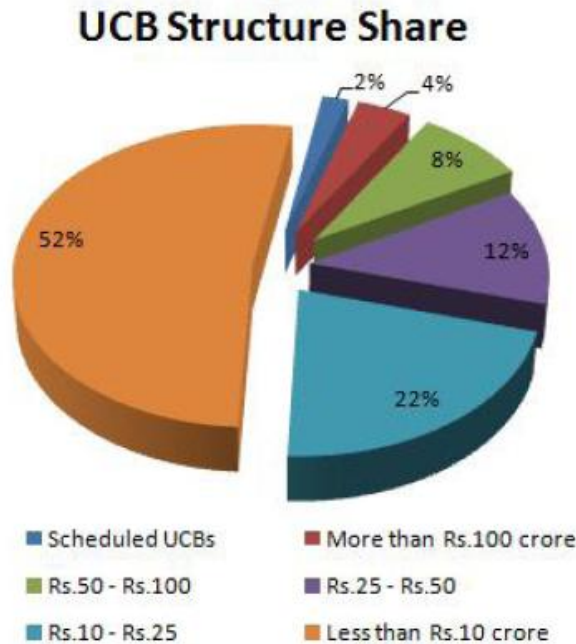


Fig.5

From the figure above, it is clear that scheduled urban banks account for 34% deposits of UCB sector. Deposits of these urban banks together account for over Rs.100 crores which accounts for over 54% of UCB's deposits.

### **Election and Nomination Of Members of Committee**

The election Procedure is as per the RCS for Banks. The voting is done by secret ballot. The term of office of the elected members of such committee is three years. It is expected that all co-operatives hold the election on the date fixed for holding Annual General Body Meeting as provided under section 31. Failure to do so, the committee ceases to hold its office and its affairs are managed by the "administrator", who is appointed by the Registrar. At the same time it is the duty of the registrar to hold election within 90 days of his appointment.

However no person is eligible to be elected as a member of the committee of a co-operative unless he is a shareholder.

### **Partnership**

While the UCBs have traditionally worked in isolation, initially by virtue of their own working style and then by the legal framework, but due to the advent of merger / acquisition policy for these cooperatives, new partnerships started forming banks were now more open to make partnership in order to diversify their services and grow their customer base.

Cosmos cooperative bank started in 1906, with its presence in over 21 major cities partnered with SANOFI software for their Disaster Recovery Management (DRM) approach.

Punjab Cooperative Bank, partnered with Honda Motorcycle & Scooter India (HMSI), to provide retail finance to the Two wheeler buyers. While these partnerships seem smaller, larger partnerships paved their

way in recent times. In the north, Birla Sun life Insurance (BSLI) partnered with the Indian Mercantile Cooperative Bank, based in Lucknow with 11 branches all across Uttar Pradesh. In Bhopal the company tie-up with Krishna Mercantile Cooperative Bank In the west BSLI it entered into the partnership with 'Thane Bharat Sahakari Bank', Maharashtra. The bank has 12 branches with another 10 branches coming in the state.

To boost its reach in the Eastern part of India, BSLI tied up with the Nagaland State Cooperative Bank, Dimapur, and Jamshedpur Urban Cooperative Bank, in the city of Jamshedpur.

### **Association with CIBIL**

Credit Information Bureau (India) Limited, in order to expand its reach and membership announced its partnership with Kolhapur Zilla Nagari Banks Sahakari Association, Pune Zilla Nagari Sahakari Banks Association, Ahmednagar Zilla Nagari Banks Association and Satara Zilla Nagari Sahakari Banks Association. CIBIL now has over 200 cooperative banks as memberships, with over 200 million customers trades with some 70 lac commercial trades.

### **8. NPA-non paying accounts.**

**(NPA in '98 ) –**

#### **A trend analysis**

State Cooperative banks (StCB) are the apex institutions in the rural cooperatives. Hence, the financial health of othese StCBs has a stronger influence on the overall health of short term rural cooperatives.

Looking at the huge losses incurred by district level cooperatives, the StCBs' ability to provide guidance to PACS depends on the financial soundness of their own. Since the data on risk weighted asset is not available at rural cooperative level it is difficult to derive weighted asset ratio (CRAR) for these StCBs.

However, a rough measure for StCBs has been taken as ratio of capital and reserves to investments and advances. Though there is a range of 12-15 % in recent years last two years have shown a decrease

### **Credit Risk and ROLE of Deposit Insurance and Credit Guarantee Cooptation(DICGC)**

In the Year 1948, after the banking crises in Bengal, the demand for insuring deposits with the with banks was raised. However up till 1950, there this idea was kept on hold. The Rural Banking Enquiry Committee also supported the concept.

Subsequently, after the closure of Palai Central Bank Ltd., and the Laxmi Bank Ltd. in 1960, a more serious view was taken by the RBI and the Central Government. This further led to the passing of The Deposit Insurance Corporation (DIC) bill and hence the Deposit Insurance Act, 1961 came into force on January 1, 1962.

DICGC are governed by the provisions of 'The Deposit Insurance and Credit Guarantee Corporation Act, 1961' (DICGC Act) and 'The Deposit Insurance and Credit Guarantee Corporation General Regulations, 1961' framed by the Reserve Bank while deposit insurance remains the principal function of the Corporation. All commercial banks including the branches of foreign banks, Local and Regional Banks are covered under the Deposit Insurance Scheme (DIS). These include new commercial banks that are granted license under RBI.

### **Conclusion**

What ails co-operative banks?

The biggest issue for co-operative banks is that they have more masters — in the case of cooperatives, they have RBI, Registrar of Co-operative Societies (RCS), NABARD. Given the close proximity between politicians and cooperative's management and the fact that RCS works under the state government, all this has led to poor supervision and control of these cooperatives. Also most co-operative banks lack the required in skill and the expertise to manage the cooperatives well enough.

Why are they in the news now?

Co-operative banks have ever been into the news because of fraudulent practices and motives practiced by these banks.

Some of the dire issues faced by these CO-OPERATIVE BANKS include:

- These banks are very small to operate property, looking at the financial support, required skill and expertise aspect. While, these are largely depending upon Government than the share holders, there is very less contribution by the workers as well.
- The NPAs of the cooperative banks are higher than those of commercial bank
- They have a poor recovery of Loan leading to higher NPA ratio. Over involvement of Political and official in their work. Government restrictions prevent them to become self reliant.
- A large no. of the banks are controlled by politicians.
- Existence of multiple regulatory authorities for control and monitoring..
- The areas of operation are restricted and limited.

Today, cooperative banks are playing a important role in rural areas. Besides that they have to face number of issues while working. Khusro Committee rightly proposed that cooperative banks should work as a complete system leading to self reliance. The Govt. and authorities both should assist the cooperatives. They should provide with able leadership, apt guidance and strong supervision & control. Modern practices and technology should be involved. However due to lack of computerization and improper leadership, there are performance gaps. All this can be improved by implementing the principles of cooperation.

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