What RBI needs to do for transition of urban co-operative banks into small finance banks

BY GAYATRI NAYAK, ET BUREAU | AUG 01, 2018, 07.40 AM IST

About two summers ago, just after Baisakhi, Jalandhar's Capital Local Area Bank (CLAB) ushered in the Punjabi New Year by starting its journey as the country's first small finance bank. It marked a milestone for India's financial inclusion initiatives that seek to take banking services to one of the world's largest unbanked populations.

For the central bank in the second most populous nation on the planet, serving the bottom of the pyramid is as much a priority as helping extricate about $165 billion stuck as bad loans in a stressed banking system. After allowing microfinance institutions and some NBFCs to convert into small banks, the Reserve Bank of India (RBI) has now made public its intention to allow urban cooperative banks (UCBs) to convert into small finance banks, like CLAB from north-central Punjab.

UCBs were initially set up as small banks that offered banking services to people of small means from the lower and middle classes: Now they are seen as another channel to deepen financial inclusion in the country.

India is considered to have one of the oldest community-banking initiatives in the world with UCBs starting way back in 1889. But the real growth happened only after 1966, when the sector was brought under the purview of the Banking Regulation Act. From 1,100 UCBs in 1966, their number went up to 1,926 in March 2004. After the liberalisation of licensing norms in May 1993, 823 bank licences were issued up to June 2001.

But the sector got negative attention after the 2001 Madhavpura Mercantile Cooperative Bank scam became public, involving some illegal loans to some stock brokers, including Ketan Parekh. The scam took its toll on the credibility of cooperative banks and public trust in them fell to a low. There were severe governance issues and the sector is yet to fully emerge from the dark shadows of such unprecedented trust deficit.

The RBI found that nearly a third of the newly licensed UCBs became financially unsound within a short period. In its 2004-05 policy statement, RBI said that it would consider issuance of fresh licences only after a comprehensive policy on UCBs, including an appropriate legal and regulatory framework, was put in place. But some older UCBs that were around for almost a century managed to revive on their own.

UCBs: A Snapshot

FINANCIAL PARAMETERS OF UCBS*

(In %)	Sept 2017	Mar 2018
CRAR	13.6	13.6
Gross NPAs	8.5	6.0
Provision Coverage ratio	47.1	61.8
Returns on Assets	0.9	0.6

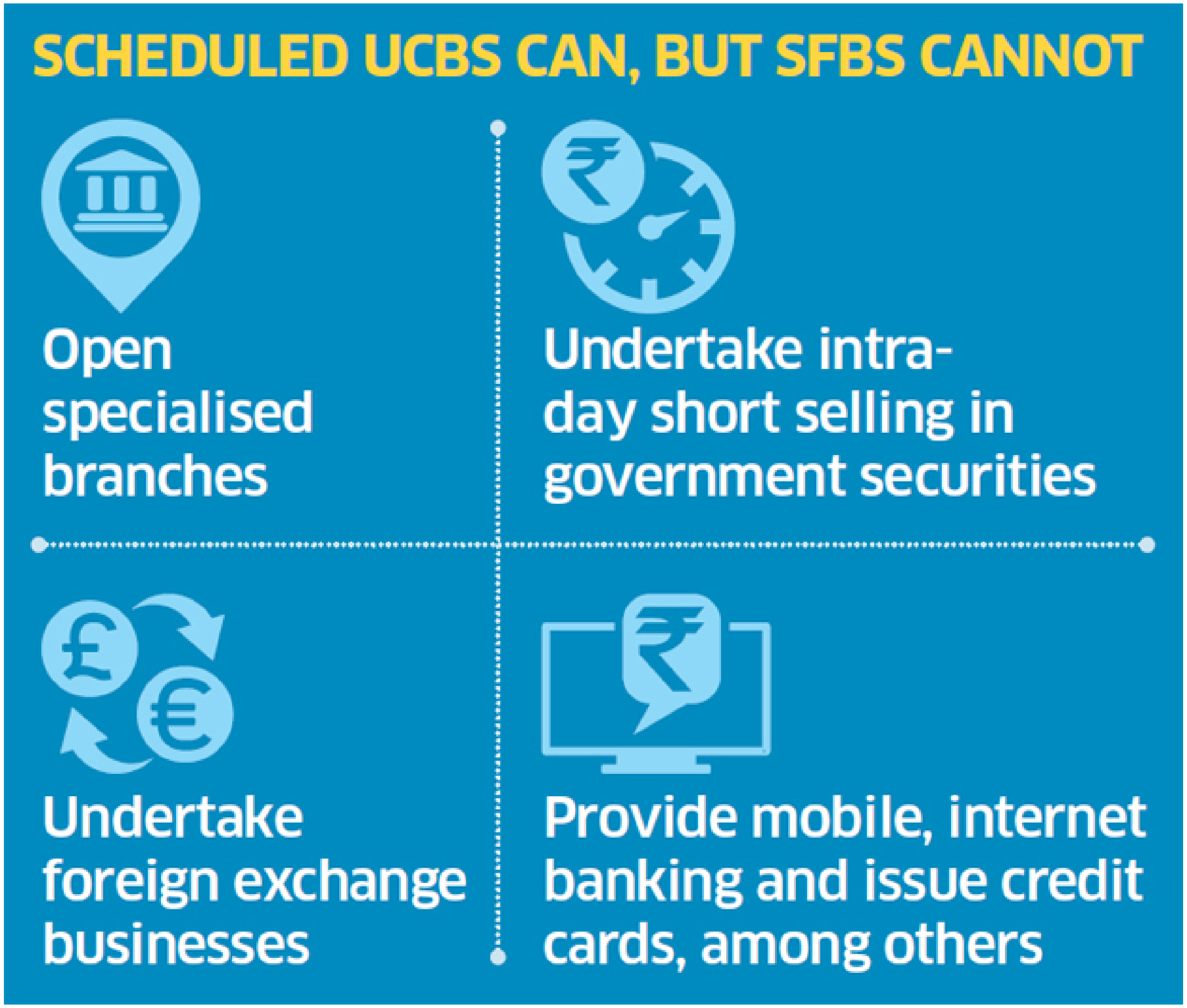
*54 scheduled urban cooperative banks
Source: Financial Stability Report, June '18

A handful of them like Sararswat, Cosmos and Shamrao Vithal have managed to emerge larger than even some private banks, observed the Gandhi Committtee in 2015 (under the then deputy governor R Gandhi). The panel on UCBs was mandated to examine a host of issues, including possible lines of business, benchmarks in terms of size of business, capital requirement, regulatory regime, among others. A few of these banks have created a loyal customer base and are on a par with commercial banks in their service quality, product offerings, and even technology adoption.

After several policy initiatives that added more regulatory power to the RBI and lowered interference from states, the sector has managed to regain some credibility. There is potential in a vast number of UCBs. The Gandhi Committee said that there is an immediate need to chart out a future path for the UCBs, including a well laid out transition road map to convert them into universal/ niche commercial banks.

“This transition is required due to the changing financial landscape in the country and also for giving an opportunity to well-run UCBs to play a major role going forward,” said the committee in its report. Acting on the recommendations, the central bank made an announcement almost three years later in its June policy statement allowing UCBs to convert into small finance banks.

“It has been decided to allow voluntary transition of UCBs meeting the prescribed criteria into small finance banks. The detailed scheme will be announced separately,” the RBI said in its policy statement in June.



Several UCBs could be eligible for conversion into small finance banks, with the internal RBI tests on UCBs indicating that many could make the cut. At the system level, capital adequacy ratio of 54 scheduled UCBs was higher than the regulatory minimum of 9 per cent between September 2017 and March 2018. Only four had capital levels below the regulatory threshold, according to RBI's latest Financial Stability Report. Even NPAs declined 8.5 per cent to 6 per cent and their provision coverage ratio increased from 47.1 per cent to 61.8 per cent during the same period.

But some eligible UCBs might harbour ambitions of qualifying into a universal bank directly instead. Then why have the regulators offered them to convert into small banks? "At the moment, there is no clarity on the guidelines. It appears as a generic announcement," said a retired CEO of one of the larger UCBs. “The target could be the mid-sized UCBs,” he said.

“The gamut under which they operate needs to be rechurned,” says Kalpesh Mehta, partner, Deloitte India. “By converting into SFBs, they will also be able to transform, and become more customer centric and leverage on technology.”

From the regulator’s standpoint, the conversion could provide UCBs better fund access. “One distinct advantage for an UCB to convert into a small finance bank is that it will be able to tap the capital market to raise funds,” says Gandhi.

In the current structure, cooperatives banks are allowed to raise capital only from their customers but have to comply with all other statutory requirements, such as cash reserve ratio (CRR) and statutory liquidity ratio (SLR).

dual regulation of state govt and RBI

- Already meeting RBI's statutory pre-emptions like CRR & SLR

CONS

CONS

- Will have to remodel their business plan. Do away with a number of products

- Will have to increase priority sector lending to 75% from

to 75% from
40% now

“Although there are apprehensions on how the cooperative structure in terms of shareholding format can be transitioned, there are provisions in the new Companies Act that allow for the conversion of such shares,” says Gandhi. “The rationale for allowing the UCB a conversion is that better managed and larger UCBs will have better access to the capital market and the move will help them grow their balance sheets further.”

But an SFB also has to have a niche identified for itself. To be distinct, it will be important to identify the niche segment in which it will operate and devise the right set of products and solutions to meet the specific needs of the customers rather than replicate what other banks have.

“It is about redefining your purpose and providing for their requirements,” says Deloitte’s Mehta. This would require an in-depth understanding about the market along with accepting technology to help analyse and put together a risk compliance model to manage funds prudently and effectively.

The larger UCBs eligible for conversion are equipped with the necessary IT and related infrastructure and also enjoy customer loyalty on a par with some private banks. Some also have balance sheets larger than the RBI threshold of Rs 20,000 crore.

These might be aiming at directly getting a universal banking licence. There are others not keen on conversion as they believe the move is against the spirit of the cooperative movement.

A few of these banks could be interested and eligible but may have to scale up their balance sheets. “Some smaller UCBs like TJSB, Janata Sahakari Bank and Punjab and Maharashtra Cooperative Bank who could be interested in conversion,” says Vikrant Ponkshe, a banking consultant who was heading the multi-state Cosmos Bank.

But it might need some more nudging by the regulator to further incentivise to transition into SFBs.

The UCBs might have to change their business turf besides getting some professionals on the board. The RBI has recently asked them to bring in independent professional directors to bring them closer to corporate banking institutions, a move reportedly many UCBs are not comfortable about. Besides, their business plans also could be restricted as their lending to the priority sector will have to be 75 per cent as an SFB compared to 40 per cent now.

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