

Benchmarks >

Nifty LIVE
11,309.65 -50.25

NSE Gainer-Large Cap >

Zee Ent.
244.40 11.25

Precious Metal >

Gold (MCX) (Rs/10g.)
37,311.00

Stock Analysis, IPO, Mutual Funds, Bonds & More

Market Watch

The collapse of PMC exposes the fault lines in the financial system

BY JOEL REBELLO & GAYATRI NAYAK, ET BUREAU | UPDATED: OCT 02, 2019, 12.38

PM IST

Post a Comment

About a year before the First World War ensnared the 'Developed World' into the biggest man-made crisis in history, [John Maynard Keynes](#) had flagged the innumerable minefields dotting India's financial landscape. "In a country so dangerous for banking as India," Keynes believed the practice of lending and borrowing must be "conducted on the safest possible principles."

Of course, John Maynard Keynes had not surveyed India's numerous cooperative lenders that even today largely escape active supervision of the central bank, an institution that itself owes its existence to the celebrated economist's prophetic warnings. It is not hard to imagine, therefore, what his observations would have been if his studies had also included these entities not yet considered 'systemically important' by conventional definitions.

But that's where definitions could be misleading — and conceal the minefields that are not signposted often enough for the grave dangers they present to India's financial system. A simple search on the Reserve Bank of India (RBI) website on urban co-operative banks (UCBs) currently shows that 24 such local area lenders from all four corners of the country have either been placed under fresh central bank directions or have received an extension, requiring them to freeze lending and cap withdrawal of deposits.

These include Bidar Mahila Cooperative Bank from Karnataka, Sri Anand Co-operative Bank from Pune, Kolikata Mahila Co-operative Bank from Kolkata and Hindu Cooperative Bank from Punjab.

These banks have been placed under directions at different times during the year, with a similar Rs 1,000 per account withdrawal limit for depositors. These curbs didn't draw media attention. However, the sudden near-collapse of Punjab Mumbai Co-operative Bank (PMC) last week has once again put the spotlight on UCBs — and risks and problems associated with them.

Together, UCBs accounted for 4% of deposits and 3% of outstanding loans in the banking system in 2018, although they have a major role in bringing the benefits of formal banking to the unbanked and under-banked.

TALES OF THE PRODIGAL BANKS

To be sure, PMC is the largest cooperative bank to be put under RBI watch since the 2001 Madhavpura Bank crisis that was linked to a stock market scam. Both tell similar tales of profligacy and risk exposure. At Madhavpura, the exposure was to a stock broker. At PMC, about two-thirds of loans are to allegedly a single — and now bankrupt — client in the property business. The central bank defines both as 'sensitive' sectors.

PMC's results in FY19 show no issues with the bank, with net NPAs of 2.19% and capital adequacy ratio (CAR) of 12.62% — above the RBI's 9% threshold. It was among the top five co-operative lenders in India, with a loan book of Rs 8,383 crore. However, this exposure excludes the bank's Rs 6,500-crore hidden loans to HDIL as of March 2019, which is facing insolvency proceedings in the NCLT. In other words, PMC's official exposure to HDIL constituted more than 75% of the bank's total loans. The bank management replaced 44 loan accounts with 21,049 dummy accounts, the police FIR says.

"Cooperative banks are a way of distribution and a tool for reaching out to customers in rural and semirural areas. Do they need much better systems and corporate governance? I think so," says [Aditya Puri](#), CEO at [HDFC Bank](#). "We deal with a lot of co-operative banks and when we see any stress in their operations, we immediately ask them to rectify it."

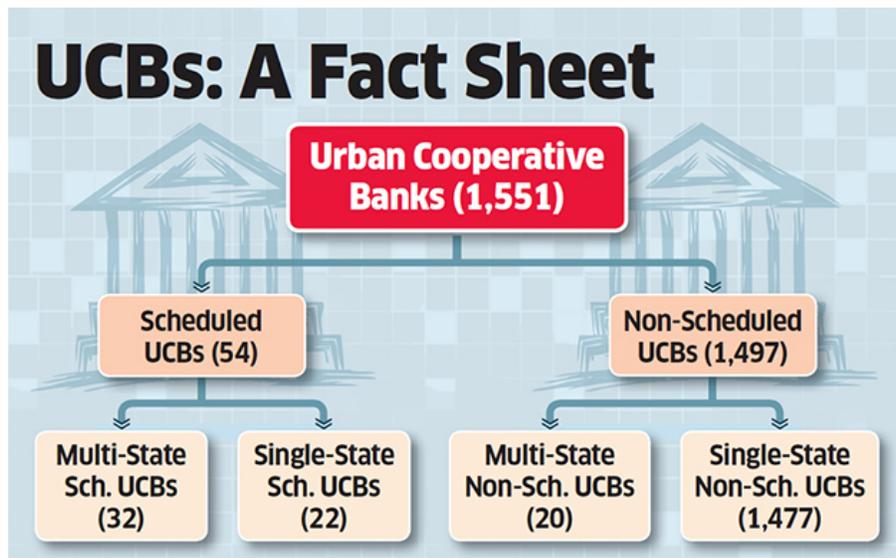
RELATED COMPANIES

EXPAND

Hdfc Bank

Big Change:

The end of Five-Year Plans: All you need to know



Retired RBI official JM Bhorja was appointed administrator of the bank. On Monday, the Economic Offences Wing (EOW) of the Mumbai Police registered a First Information Report (FIR) against the erstwhile chairman Waryam Singh, managing director Joy Thomas, another bank official, HDIL promoters Sarang and Rakesh Wadhawan and seven other realty companies for cheating, criminal breach of trust by banker, forgery, using as genuine a forged document and criminal conspiracy.

Bhorja said that ultimately cooperative banks have been done in by poor management, which is not under RBI supervision.

“If you see other banks also, which are in a similar position that PMC finds itself in, there is always a link to dealings with gold, land or property. RBI is in charge of financial supervision of these banks, but management of these banks is overseen by state and central governments,” Bhorja said. “Employees at these banks are not well equipped and make wrong decisions. Committees and boards at these banks, which are cooperative institutions, have to be elected and since they are elected, they have to keep their voters happy. All these factors are inherent problems in co-operative banks.”

BLINDSIDED FOR A DECADE

The PMC issue came to light when a whistle blower from the bank wrote to the RBI on September 17 warning about the bank’s hidden exposure to the HDIL group. Subsequently, nowsuspended MD Joy Thomas and a few officials at the bank met RBI executive director Rabi Mishra to ask for some time to get their books in order. A central bank inspection of the books on September 20 led to Mint Road directions.

At a press conference on Friday, Thomas sought to absolve the bank’s board of any wrong doing and instead laid the blame on the RBI.

“We have assets of more than two and a half times the exposure to HDIL Group. So, we have enough collateral. If we had come out with these details earlier, it would have led to a run on the bank like the one we are seeing now. We wanted to prevent exactly the kind of situation we find ourselves in now in which depositors are suffering and borrowers can sit tight,” Thomas said. He failed to explain how the bank had hidden the exposure for the period it has been giving loans to this group.

Data from the RBI annual report show that the aggregate position of co-operative banks has deteriorated over the past one year. As of March 2019, there were 1,542 UCBs, down from 1,550 a year earlier. Last year, 39 of these banks had negative net worth, which had increased to 46 in 2019. As of March 2019, 26 banks were under RBI directions, up from 20 last year.

DEVIL IN THE DETAIL

The RBI’s Financial Stability Report, released in June 2019, said that at the system level, CAR of UCBs remained unchanged at 13.6% between September 2018 and March 2019. However, CAR of four lenders was below the minimum required 9%.

“The impact of credit risk shocks ... was observed under four different scenarios. The results show that even under a severe shock of an increase in GNPA’s by 2 standard deviation, the system-level CARs of UCBs remained above the minimum regulatory requirement. At the individual level, however, a number of UCBs (21 out of 54) may not be able to maintain the minimum CAR,” RBI said.

In a June 2018 guideline, RBI stipulated that UCBs have a professional board of management to oversee daily business operations. The central bank specified that this board should have well qualified members who do not have any business relation with the bank. For UCBs with a deposit base of over Rs 100 crore, such a board should come within a year. One is not sure whether such a board exists at PMC.

UCBs face growth constraints because of high cost of capital. Unlike a [commercial bank](#), UCBs have to raise capital from members on a par and cannot charge a premium. Besides, dividend is almost compulsory, making it like a quasi debt instrument. To address this constraint, the RBI allowed UCBs voluntary conversion into small finance banks in September 2018. No UCBs have yet taken that offer.

DOTTED-LINE SUPERVISION

Although RBI regulates co-operative banks from the financial aspects, the management supervision is done by state and central governments. In other words, RBI can prescribe the best practices to run a bank but cannot make any changes in the bank management unless in an emergency situation.

UCBs are primarily registered as cooperative societies under the provisions of either the State Cooperative Societies Act of the state concerned or the Multi State Cooperative Societies Act, 2002.

RBI prescribes prudential norms for capital adequacy, income recognition, asset classification and provisioning, loans and advances, investments and liquidity requirements. Further, guidelines have also been given to UCBs in respect of single/group exposure norms and sectoral exposures.

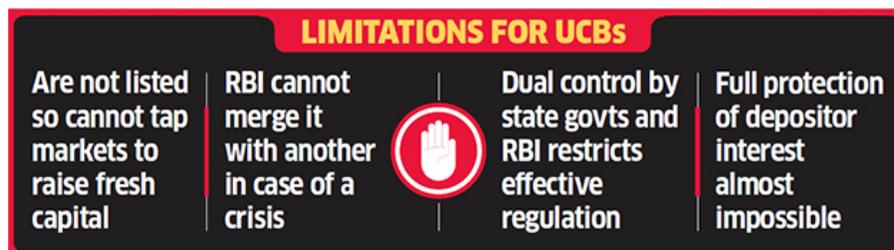
“The issues in co-operative banks span governance, technology, capital and skill sets. This is a 200-year-old sector in India and is, in a way, the genesis for banking in India, so there are legacy issues. Unfortunately, the RBI is not in full control; so it is up to these banks whether they want to change their processes and systems or become extinct,” said a senior RBI official.

There is also the question of cross holding of deposits within these banks, with ultimately the small saver holding the can. PMC, for example, had accounts of other cooperative banks, 1,754 co-operative credit societies, including ironically, the RBI employees’ credit society, and 15,000 other cooperative societies’ accounts that also include co-operative housing societies, said the suspended MD Thomas.

“In Maharashtra, co-operative banks typically hold deposits for other credit societies and also housing societies, as local laws mandate that these societies compulsorily keep their deposits with such banks. Again this is a legislative mandate and the RBI can do nothing to change it,” said the RBI official cited above.

However, co-operative bank officials said that the government and RBI’s attitudes toward these banks has been step-motherly. A little more care and concern for these institutions could help in making these local lenders stronger and further the federal objective of financial inclusion.

They point to public sector banks that, despite record levels of NPAs, are nurtured and sustained by North Block. Then there were private sector banks, such as Ganesh Bank of Kurundwad and United Western Bank (UWB), in which deposit money was saved by merging them with stronger peers. By contrast, PMC depositors may have to wait for years before being able to withdraw all their money.



END OF THE JOURNEY?

So, where does that leave UCBs? Does the RBI’s action warrant a relook at these banks? And do we need these lenders in the present day and age at all?

RBI officials said that the action by the central bank has to be seen as an attempt to save depositors from more damage. "Co-operative banks do a very important function in the financial system, especially for small savers. These local banks are an important element for financial inclusion. It will be wrong to assume that incidents like this would lead to the extinction of these banks. Yes, the challenges are grave but there are solutions being worked out — like converting them to smallfinance banks," said the RBI official cited above.

Former co-operative bank officials say RBI has a tough job of ensuring these banks reform, without causing pain to small depositors.

"The RBI understands the catastrophic impact of such incidents. Currently, what is important is to restore the confidence of the depositors in the banking and financial system. The RBI has been a diligent and dispassionate regulator. It looks at things very objectively. In its mind, a bank's goodwill is not important but the systemic risk is more important," said Vikrant Ponshe, a consultant to fintech companies and banks. Ponshe is a former head of a large co-operative bank.

However, some depositors still trust these banks mainly because of the relationship they have had with the lenders over many years. Like Jagdish Singh, a real estate broker from Andheri who had about Rs 30 lakh of his and his extended family's life savings in the bank. Singh does not know whether he will ever get to withdraw all his deposits but says he still trusts the bank officials.

"I have been banking with PMC for more than 20 years. Their service was excellent and we never found any problem. This has been a shock for us. Not only our family, but also our housing society has Rs 75 lakh with the bank. Now whatever happens with everyone will happen with us. I don't understand the politics behind this all, but if everything becomes normal, we will not hesitate to keep money with the bank again," Singh said.

Perhaps, it is depositors like Singh who need education on the risks associated with co-operative banks.

Stay on top of business news with The Economic Times App. [Download it Now!](#)