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CO-OPERATIVE BANKS AND THE RESERVE BANK OF INDIA: THE REGULATORY FRAMEWORK

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INTRODUCTION

The Reserve Bank is given extensive legislative powers of oversight and supervision over cooperative banks under the Banking Regulation Act of 1949. The powers of incorporation, management, and other aspects of these banks, on the other hand, remain with the Registrars of Cooperative Societies in the respective States. Furthermore, the requirements of the Banking Regulation Act, 1949 (as applied to Co-operative Societies) shall be in addition to, and not in derogation of, any other law now in force, unless as expressly stated in the Act. This means that cooperative banks must follow not only the Banking Regulation Act's regulations, but also any additional laws that apply to them. The provisions of the Banking Regulation Act will take precedence over the requirements of the Co-operative Societies Act in matters specifically addressed in that Act. The Act was amended in 1966 to include Section 56, which made it applicable to cooperative banks.

A cooperative bank is a financial institution owned and operated by its members, who are also its customers. What distinguishes cooperative banks from shareholder banks are their unique structure, purpose, values, and governance. They are subject to regulations and oversight by banking authorities in most countries, ensuring compliance with prudent banking standards and operating at par with shareholder banks. This oversight may be conducted directly by state entities or outsourced to cooperative federations or central organizations, depending on the country.

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Cooperative banking organizes both retail and commercial banking activities on a cooperative basis. These institutions, found worldwide, accept deposits and provide loans. Retail banking services are offered through credit unions, mutual savings and loan associations, building societies, and cooperatives. Furthermore, cooperative banking provides commercial banking services to cooperative businesses through manual organizations like cooperative federations.

Commercial banking follows a branch-banking structure, while cooperative banking operates within a three-tier federal structure. At the highest level, there is the State Co-operative Bank, which functions at the state level. At the intermediate level, the Central Co-operative Bank operates (i.e., District Co-operative Banks Ltd. function at the district level), and at the grassroots level, there are primary co-operative credit societies, operating at the village level.

FEATURES OF COOPERATIVE BANKS

Although the organizational regulations of cooperative banks vary based on national legislations, they all share certain common characteristics:

1. **Ownership of the Customers:** Customers are the owners of Cooperative banks, meaning the needs of the owners (who are also members) guide the services provided. Unlike profit-maximizing goals of other banks, cooperative banks prioritize offering the best products and services to their members. While some are exclusively open to members, most allow non-members to use their banking services.

2. **Democratic Member Control:** These banks are governed by their members, who elect the board of directors through democratic processes. The principle of "one person, one vote" ensures equal voting rights among members.

3. Profit Allocation: A significant portion of the annual profit, benefits, or surplus in cooperative banks is usually reserved. This profit can be partially transferred to members, within legal constraints. Members often receive a patronage dividend based on their usage of the bank's products and services or an equity dividend tied to their utilization.

4. Community Involvement: Cooperative banks play an active role in their communities, contributing to local development. Since both members and management usually reside in the

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same communities, these banks have a strong local presence. They address financial exclusion, especially in rural areas, aiding the economic capacity of numerous individuals who lack access to traditional banking services. By operating in markets underserved by other banks, cooperative banks foster economic growth and enhance the efficiency of the international financial system.

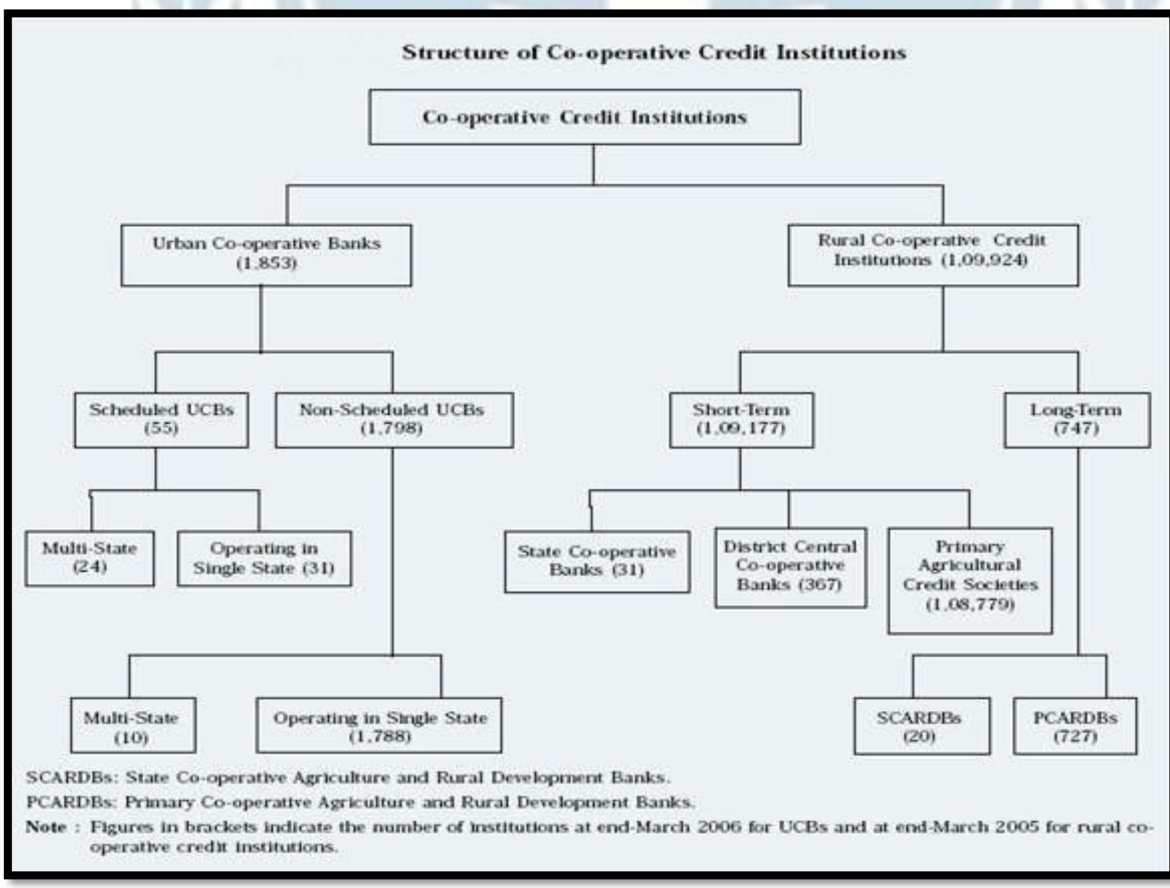
TYPES OF CO-OPERATIVE BANKS

The Co-operative banking structure in India mainly comprises of:

1. **Rural Co-operative Banks**

2. **Urban Co-operative Banks**

The further division of these two ranches can be understood as:



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To qualify as Scheduled Banks, two conditions must be met:

a) The bank's paid capital and collected funds must be at least 5 lakhs.

b) The bank's activities should not adversely affect the interests of depositors.

Scheduled Banks enjoy certain privileges:

a) They are eligible to receive debts/loans from the RBI at the bank rate.

b) They automatically gain membership in the clearing house.

1. RURAL CO-OPERATIVE BANKS

Rural cooperative banking is crucial in servicing the expanding credit needs of India's rural population. It supports agricultural and rural businesses with institutional loans. Throughout the 1950s and 1960s, the insufficiency of rural loans drew the attention of the RBI and the government. The establishment of a vast network of rural financial institutions has been a key component of providing farm loans in India. Because large-scale branch expansion was conducted to create a strong institution rooted in rural areas, the rural credit system comprises of many different types of financial institutions.

It has been a significant tool for providing finance in rural and agricultural communities. Long-term and short-term loans are two major segments in the rural co-operative sector, allowing these organisations to build a specialist institution for rural credit delivery. Credit flows through these banks at a higher rate. Short-term rural co-operatives and Long-term rural co-operatives have traditionally been divided into two wings of the Rural Co-operative framework.[3]

A. Short-term rural co-operative banks

Farmers and rural artisans can borrow working capital through short-term rural co-operatives for a limited time. The federal government has set up a three-tiered framework for these entities. Each state has a State Co-operative Bank at the apex of the system. Central Co-operative Banks, also known as District Co-operative Banks, operate at the middle (or district) level. Primary Agricultural Credit Societies operate at the most basic (or village) level.

[3] "http://www.prsindia.org/uploads/media/vikas_doc/docs/bills/1167469384/bill54_2007010354_ReportoftheTaskForceonRevivalofRuralCooperative_Credit_Institutions_NABARD.pdf"[last accessed: 08/10/2023].

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B. Long-term rural co-operative banks

Long-term rural co-operatives often provide medium and long-term loans for agricultural, rural industry, and, in recent years, housing developments. State Co-operative Agriculture and Development Banks (SCARBDs) at the state level and Primary Co-operative Agriculture and Rural Development Banks (PCARDBs) at the Taluka or tehsil level are the two tiers of these cooperatives. Some States, on the other hand, have a unitary structure, with state-run banks operating through their own branches.

2. URBAN CO-OPERATIVE BANKS

The Reserve Bank of India refers Urban Co-operative Banks as Primary Co-operative Banks. Urban co-operative banks are one of the most major non-agricultural credit institutions. This type of banking in India was commenced with the goal of serving the banking and credit needs of India's urban middle class. Although not formally defined, the term Urban Co-operative Banks (UCBs) refers to primary co-operative banks based in urban and semi-urban areas. Until 1996, these banks were only allowed to lend money for non-agricultural reasons. This distinction is no longer valid. Communities, municipalities, and work place groups were usually the focus of these banks. Their major lending is to the small borrowers and businesses. In the recent times, their scope of operation has quite widened today.[4]

According to the RBI, "Small sized co-operatively formed banking institutions that operate in metropolitan, urban, and semi-urban centres to cater primarily to the needs of small borrowers, viz. proprietors of small-scale industrial units, retail dealers, professional and salary classes."

Urban cooperative banks serve as financial institutions that aggregate funds from middle- and lower-income individuals and provide loans to small borrowers, including the most economically vulnerable members of society. These banks are established with limited liability and usually operate within a single town or locality. Their main objectives include encouraging saving habits by accepting deposits from both members and non-members, and extending loans to their members. These banks are regulated by the Cooperative Societies Act of the respective state

[4]https://www.rbi.org.in/scripts/fun_urban.aspx[last accessed: 08/10/2023].

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governments. Before 1966, all Urban Cooperative Banks were under the direct jurisdiction of the state government.

Certain sections of the Banking Regulation Act became applicable to these banks on March 1, 1966. As a result, the RBI became the regulatory and supervisory body for the operations of Urban Co-operative Banks. Under the respective Co-operative Societies Act, the management of such banks remains in the hands of state governments. The central governments regulate and register these multi-presence banks under the Multi-State Co-operative Societies Act. The Reserve Bank of India (RBI) offers Urban Co-operative Banks refinancing against their lending to small and cottage industrial enterprises.[5]

The objectives and functions of Urban Cooperative Banks include:

1. Lending to Members: The primary goal is to raise funds to provide loans to their members, especially focusing on small borrowers and vulnerable individuals within the community.

2. Encouraging Deposits: Urban Cooperative Banks aim to promote saving habits by encouraging deposits from both their members and individuals who are not members of the bank.

3. Dealing in Financial Instruments: These banks have the authority to engage in various financial activities such as drawing, making, accepting, discounting, buying, selling, collecting, and dealing in bills of exchange, drafts, certificates, and other securities.

4. Providing Safe-Deposit Vaults: Urban Cooperative Banks also offer safe-deposit vaults to their customers, ensuring a secure place for them to store valuable items and important documents.

AREA OF OPERATIONS

Urban Cooperative Banks typically operate within the confines of a municipal territory or a specific town, as stated in their bylaws. Although there are instances where this limit is exceeded, “a study group on Credit Co-operatives in Non-Agricultural Sectors suggests that it is generally advisable for an urban cooperative bank to restrict its operations to the municipality or Taluka town where it is situated. This localized focus allows these banks to better serve and understand

[5]“Babu K.V.S.N. Jawahar, Selkhar B. Muniraja, “The Emerging Urban Co-operative Banks in India: Problems and Prospects” in IOSR Journal of Business and Management, Vol. II, Issue V, Jul.-Aug. 2012, pp. 1-5(1).”

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the needs of their immediate community, fostering a more effective and responsive financial service tailored to the local population."

FUNCTIONS OF CO-OPERATIVE BANKS

Cooperative banks perform fundamental banking functions similar to commercial banks, but they differ in several key ways:

a) Three-Tier Structure:"Cooperative banks have a unique three-tier structure, comprising a state co-operative bank at the apex, a central/district co-operative bank at the district level, and primary co-operative societies at the rural level." This structure facilitates localized operations and community engagement.

b) Cooperative Principles: Cooperative banks operate based on the principle of cooperation rather than solely on commercial parameters. They emphasize community and member welfare in their operations.

c) Partial Regulation: While some provisions of the "Banking Regulation Act of 1949", which are fully applicable to commercial banks, also apply to cooperative banks, there is only partial control by the Reserve Bank of India (RBI) over cooperative banks and their operations. This means that cooperative banks have a certain degree of autonomy in their functioning, although they are still subject to regulatory oversight.

These differences highlight the unique cooperative nature and localized focus of cooperative banks compared to their commercial counterparts.

REGULATORY FUNCTIONS OF RBI

RBI: AN INTRODUCTION

The Reserve Bank of India, "our nation's central bank", was established on April 1, 1935, under the "Reserve Bank of India Act, 1934". Initially, it operated as a shareholders' bank with a paid-up capital of Rs. 5 crores. The Bank took over the responsibilities of currency issuance and credit management from the Imperial Bank of India. Post-independence, in 1948, it was nationalized, aligning with the global trend of central banks' nationalization after World War II. This move was motivated by several factors: firstly, it aimed to address the rampant inflation in India since 1939; secondly, a centrally regulated system was necessary to effectively control the country's

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economic changes; and thirdly, as India embarked on its economic development journey, comprehensive control over banking activities became crucial for the Central Bank to serve as an effective catalyst for economic growth.[6]

GENERAL ROLE OF RBI

Indeed, the Reserve Bank of India (RBI) plays a multifaceted role in the Indian banking and financial system. Its primary concerns are related to establishing a robust and healthy commercial banking system, achieved through effective coordination and control over credit using suitable monetary and credit policies. This oversight ensures the stability and integrity of the country's financial institutions.

Furthermore, the RBI is actively involved in the development of rural banking, aiming to extend financial services to rural areas and promote financial inclusion. It also actively promotes and supports the growth of various financial institutions in the country. Additionally, the RBI plays a pivotal role in the development of India's money and capital markets, working to create an environment conducive to investment and economic growth. Through these varied functions, the RBI significantly influences the overall economic and financial landscape of India.

CONTROL BY RBI OVER CO-OPERATIVE BANKS

The Banking Regulation Act, 1949 gives the Reserve Bank authority to issue directions, to cooperative banks in general and any co-operative bank in particular, regarding any aspect of the working of the co-operative banks/bank concerned. Sec. 35A covers all areas of co-operative bank operations, whereas Sec. 21 provides authorities to make directions regarding advances by cooperative banks or a group of co-operative banks. These two parts combined have given the Reserve Bank the authority to provide all directions relating to the activities of a co-operative bank in particular, or all co-operative banks, or a group of the co-operative bank, in general.

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[6] Tannan M.L., "Tannan's Banking Law and Practice in India", Wadhwa and Company Nagpur, 21st Edn., Reprint 2007, p. 163.

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In addition to conducting regular inspections under this section, the Reserve Bank has the authority to conduct a review of the co-operative bank's business at any time it deems necessary.

The Reserve Bank possesses the power to appoint one or more of its officials to attend any meeting of a cooperative bank's Board of Directors or any other related body. This action can be taken if it is deemed necessary to ensure the responsible growth and development of cooperative credit. Additionally, the Reserve Bank can instruct the bank to allow these appointed officers to present their views at the meeting(s). Furthermore, the Reserve Bank has the authority to assign its officers to observe the operations of the cooperative bank, including its various offices and branches. These officers are then required to submit a detailed report based on their observations.

OTHER RELEVANT PROVISIONS INCLUDE

These sections outline the regulatory powers and authorities of the Reserve Bank of India (RBI) concerning banking companies and cooperative banks:

a) Section 22(4): This grants the "RBI the authority to cancel or reject a license granted to a banking company."

b) Section 23(4A): Cooperative banks seeking "RBI clearance to open a branch must apply through NABARD. NABARD assesses the application and provides an advance copy to the RBI via the Cooperative Bank."

c) Section 24-A: The RBI has "the power to exempt any cooperative bank from all or part of the provisions of Sections 18 and 24 of the Act, granting flexibility in regulatory compliance."

d) Section 35 A: This section "empowers the RBI to issue directives to cooperative banks, either in general or specific to any bank, regulating various aspects of their operations."

e) Section 45: The RBI can "recommend to the Central Government the imposition of a moratorium on a cooperative bank. The Central Government holds the authority to impose such a moratorium, indicating a temporary suspension of the bank's operations."

f) Section 46: This section "outlines the penalties that may be imposed on cooperative banks for non-compliance with different sections of the Banking Regulation Act (B.R. Act), ensuring regulatory adherence."

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g) Section 53: This grants the Central Government, "based on the RBI's proposal, the power to exempt specific banking companies or classes from any or all provisions of the Act, allowing for tailored regulatory approaches."

KEY POINTS

These points outline various regulations and requirements governing cooperative banks in India:

a) The Banking Regulation Act of 1949 does not apply to primary agricultural societies, indicating a specific exemption for these entities.

b) The minimum capital requirement for banks is set at Rs. 1 lakh, implying that banks must have at least this amount of capital to operate.

c) Cooperative banks are prohibited from trading activities, except for government and sanctioned securities, limiting their scope of financial activities.

d) Cooperative banks must maintain a Cash Reserve Ratio (CRR) of 3% of Net Demand and Time Liabilities (NDTL) in cash and current accounts with the Reserve Bank of India and other designated banks. Scheduled cooperative banks must keep the CRR in an account with the RBI. These requirements are less stringent compared to commercial banks.

e) Cooperative banks are obligated to maintain a Statutory Liquidity Ratio (SLR) of 25% of NDTL in gold, state cooperative bank balances, and unencumbered recognized securities, ensuring a level of liquidity in their holdings.

f) Cooperative banks are limited in their ownership stakes, not allowed to own more than 5% of any other cooperative society's private capital, preventing excessive concentration of control.

g) The Reserve Bank of India (RBI) holds the authority to establish the banking policy concerning cooperative bank advances, guiding their lending activities.

h) Cooperative banks are required to obtain a license from the RBI to conduct banking activities, ensuring regulatory approval for their operations.

Cooperative banks and societies are required to provide multiple reports to the RBI, detailing aspects such as CRR/SLR, assets, liabilities, unsecured loans to directors, advances to priority and weaker sectors, shareholding in cooperative societies, non-performing assets, audited

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balance sheet, profit and loss account, and statutory audit report. The frequency of these submissions depends on the specific statements involved. These obligations guarantee transparency and regulatory supervision.

RBI POLICIES FOR CO-OPERATIVE BANKS

The RBI's review of Urban Co-operative Banks (UCBs) highlighted several objectives to strengthen this sector:

a) Preserving Co-operative Character: One of the key objectives is to maintain the co-operative nature and principles of UCBs, ensuring that their functioning remains in line with cooperative values.

b) Protecting Depositors' Interests: Safeguarding the interests of depositors is a crucial goal, emphasizing the importance of maintaining the security and reliability of banking services provided by UCBs.

c) Reducing Financial Risk: Mitigating financial risks is a priority, aiming to enhance the stability and sustainability of UCBs in the face of various economic challenges.

Additionally, the RBI emphasized the accountability of the board of directors, CEO, and senior management in overseeing outsourcing operations and managing associated risks. Cooperative banks were advised to conduct thorough due diligence when engaging service providers, ensuring these partners possess the capacity to fulfill obligations outlined in the outsourcing agreements. It is essential for cooperative banks to guarantee that service providers maintain the same high standards of care and efficiency as the banks themselves would if they were handling the activities internally, rather than outsourcing them. This approach ensures that outsourced functions maintain the quality and reliability expected by both the bank and its customers.

CHALLENGES POSED BEFORE CO-OPERATIVE BANKS

Apart from the inherent weaknesses pertaining to the sector such as politicization dominance of bureaucracy and state interference, lack of member participation, lack of commitment, wrong perception; the co-operative banking sector is facing the following serious issues:

a) Lack of committed and dynamic leadership from the young generation.

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b) Lack of professionalism in management.

c) Impairment in governance; on the financial and managerial fronts.

d) Absence of or inadequate technology adoption by much banks-lowcompetitiveness.

e) Very few banks have strong MIS in place.

f) Not many banks have HRD policies which are conducive to the growth of institution in the context of emerging managerial challenges.

g) Lack of customer intelligence and data base.

h) Poor risk management practices.

i) Lack of customer orientation and marketing initiatives.

j) Low share of non fund based income.

k) Higher cost of funds and the management cost-low margin.

l) Generation gap in membership and customer base.

LINKAGE WITH SUSTAINABLE DEVELOPMENT GOALS

The Sustainable Development Goals (SDGs) are a set of goals that outline the future we want to live in. They apply to all nations and simply mean that no one will be left behind. It has 17 Sustainable Development Goals (SDGs) that prioritise people and the environment, providing a framework for the international community to address the various difficulties that mankind faces, including those in the workplace.

The Sustainable Development Goals that can be linked with the banking system are:

1. **Goal 1:No poverty-** The main aim of this goal is to end poverty in all its forms everywhere. Opening up and maintaining of bank accounts can help people escape poverty and survive unexpected expenses. Digital payments based on accounts are a game-changing breakthrough in the fight against poverty. For instance, a farmer would be

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able to manage his investments, earnings and household savings if he is able to deposit all his funds into an account.

2. **Goal 8:Decent work and economic growth-** The primary objective of this goal is "to Encourage long-term, inclusive, and sustainable economic growth, as well as full and productive employment and decent labour for all people." The development of banking opportunities in an economy is a good indicator of economic growth. The opportunities in banking sector also open the gate of employment for many people.
3. **Goal 9:Industry, Innovation and Infrastructure-** The purpose of this goal is "to Build resilient infrastructure, promote inclusive and sustainable industrialization, and foster innovation." With better banking facilities, an economy has he capacity to have a good infrastructure, can help in sustainability of industrialisation and foster innovation.

The foundation of any economy lies in its banking sector, which facilitates growth and development. A nation's banking system channels savings into investments, driving economic progress. In India, the banking industry holds a significant position within the financial sector, contributing significantly to the country's economic advancement. Banks play a vital role in directing savings towards investments with high returns, promoting economic growth and development.

CONCLUSION AND SUGGESTIONS

Lack of availability of credit was used as an opportunity and a high rate of interests was imposed by the moneylenders to exploit the poor and marginalised. The widespread reach of co-operatives in providing credit facilities to sectors like agriculture, small scale industries and housing construction gives it an advantage over all other financial institution.

The will to bring reform in sectors which comes under the dual authority is generally absent due to transfer of accountability. An evident example can be seen in electricity which comes under the concurrent list of the Indian Constitution and also a major area of the rift between the states and the union. Co-operative banks also face a similar kind of stigma as they come under the state list but the functions related to banking rests with the union. It means that the administrative and

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management issues of co-operative banks will be dealt with by the respective state but banking regulations and standards must be in par with those of the central bank.

Owing to a large number of state and multi-state co-operative banks and their substantial impact on the rural economy of India, the ordinance is a welcome step in the right direction. But there is a need to bring a series of reforms to strengthen the distressed financial sector of the country. One such reform could be a distinct bankruptcy law for financial corporations. The need to bring a separate law arises because (1) they are managing public funds and (2) their failure could have a deeper impact on the economy of the country.

Initially the IBC, 2016 was only concerned with the corporate entities and financial institutions were out of its ambit. But the liquidity crisis of IL&FS and DHFL forced the government to invoke section 227 of the above act to introduce a “generic framework” (FSP rules) for NBFCs including housing finance companies with asset size exceeding 500 crore mark as per the last audited balance sheet.

The above resolution only solves one aspect of the problem as it excludes banking institutions from its purview. The major impediments in including these institutions are interconnectedness and interdependence of financial institutions. Even the slightest news of a bank going for solvency proceedings could instil a feeling of fear and distrust among the masses. The obvious consequence would be free-falling of the economy. The FRDI Bill, 2017 was a major initiative to include all financial institutions but it was withdrawn within a year as it faced severe backlash from depositors and retail investors. The principal reason behind facing severe backlash was the bail-in clause of the bill. The proposed clause gives the power to cancel the debt due to creditors or convert them into equity. Also the deposit -holders would get maximum insurance of one lakh only against their deposit. Without increasing deposit insurance cover the said bill, if enacted, would revive the financial sector at the expense of depositors which is not acceptable at any cost. To conclude, the step taken by the government to introduce FRDI bill in 2017 was laudable but the provisions of the bill neglected the safety of depositors and creditors to a large extent. Therefore a need to bring a comprehensive act which covers all the financial institutions is

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inevitable. If enacted in the future the act would be another milestone in strengthening the financial sector of the country.

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