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TRANSITION INTO SMALL FINANCE BANKS- A NEW GROWTH AVENUE FOR URBAN COOPERATIVE BANKS

KEY WORDS: urban cooperative banks (UCBs), financial inclusion, small finance banks (SFBs)

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ABSTRACT

As part of its push for greater financial inclusion, the Reserve Bank of India had, in 2015, granted ten small bank licences. It has recently, decided to allow voluntary transition of UCBs meeting the prescribed criteria into SFBs. This research paper explores the pros and cons for UCBs to convert into SFBs and the possible candidates for conversion.

INTRODUCTION

The RBI defines Urban Co-operative banks as "small sized cooperatively organized banking units which operate in metropolitan, urban and semi-urban centers to cater mainly to the needs of small borrowers, viz. owners of small scale industrial units, retail traders, professionals and salaries classes.

In the formative stage, Co-operative Banks were Urban Co-operative Societies run on community basis and their lending activities were restricted to meeting the credit requirements of their members. With gradual growth and also with the economic boom, urban banking sector received tremendous boost and started diversifying its credit portfolio. Besides giving traditional lending activity meeting the credit requirements of their customers, they started catering to different types of customers viz. self-employed, small businessmen / industries, house finance, consumer finance, personal finance etc.

The area of operation of these banks is usually restricted by its byelaws to a municipal area or a town. Urban Co-operative banks are mostly located in towns and cities and cater to the credit requirement of the urban clientele.

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. These banks with multi-presence are regulated by the Central Governments and registered under Multi-State Co-operative Societies Act.

FINANCIAL PERFORMANCE OF UCBS

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

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.

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. A handful of them like Sararswat, Cosmos and Shamrao Vithal have managed to emerge larger than even some private banks, observed the Gandhi Committee in 2015 (under the then deputy governor R Gandhi). 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.

A NEW GROWTH PATH

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. 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.

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. "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."

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). However, co-operators have argued that cooperative and especially the Urban Coop Banks should be allowed to grow to their full potential and restrictions not be imposed on their aspirations. Instead of addressing the genuine concern of the sector, they feel that RBI seems hell bent on destroying cooperatives.

CRITERIA FOR CONVERSION

Acting on the recommendations of Gandhi Committee, the central bank made an announcement almost three years later in its June 2018 policy statement allowing UCBs to convert into small finance banks.

RBI has issued a notification dated 27th September 2018 asking those UCBs which are eligible and wishing transition into Small Finance Banks to forward their applications to it.

Under the scheme UCBs with a good track record shall be eligible to voluntarily transit into a SFB. RBI will issue an in-principle approval for transitioning and will allow a maximum period of 18 months for commencement of business as SFB.

The new company shall enter into an agreement with UCB for transfer of assets and liabilities, to be executed at a future date (after issuance of SFB licence).

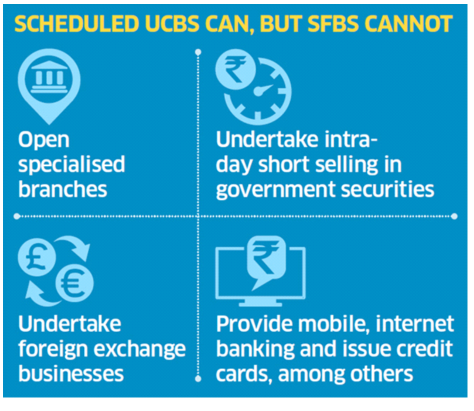
The promoters shall then approach RBI for issuance of SFB licence, with evidence of funds available for infusion as equity in any acceptable form, so as to ensure that the SFB commences operations with a minimum net worth of Rs.1 billion and minimum promoters' contribution of 26% of the paid-up equity capital.

The UCB will surrender its banking licence to RBI. The resultant Co-operative Society will be wound up in due course.

UCBs with a minimum net worth of Rs.500 million and maintaining Capital to Risk (Weighted) Assets Ratio of 9% and above are eligible to apply for voluntary transition to SFB under this scheme.

The minimum net worth of the proposed SFB shall be Rs.1 billion from the date of commencement of business. As small finance banks are required to maintain a minimum capital adequacy ratio of 15 per cent of its risk weighted assets (RWA) on a continuous basis, availability of adequate capital shall be ensured. Promoters shall maintain at least 26% of the paid-up equity capital.

BANKING ACTIVITIES: UCBs VS. SFBs



CONVERSION TO SMALL FINANCE BANKS PROS:

Do away with dual regulation of state government & RBI Already meeting RBI's statutory pre-emption such as CRR & SLR

CONS:

Will have to remodel their business plans and do away with a number of products.

Will have to increase priority sector lending from the current level of 40% to 75%.

POSSIBLE CANDIDATES

A few of these banks could be interested and eligible but may have to scale up their balance sheets. According to experts, some smaller UCBs like TJSB, Janata Sahakari Bank and Punjab and Maharashtra Cooperative Bank could be interested in conversion. 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.

CONCLUSION

The scheme announced by RBI to allow conversion of large UCBs into small finance banks is being hailed as welcome move as it will avoid risks to the system because of the size and complexity of UCBs. Many of these banks are old and well-established and still form the backbone of smaller towns and cities. They are thus ideally suited to lead the push for financial inclusion into under-banked and un-banked areas. From the point of view of UCBs, it will provide a level playing field with respect to regulation and supervision and also significantly ease barriers to raising capital.

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