CHAPTER - VII

Analysis of Failure of UCBs in India

The Co-operative Movement in India formerly began in 1904, with the main goal of protecting the people, especially with low resource base, from exploitation by moneylenders. Hence, the co-operative movement is already 100 years old. As the co-operative movement progressed, the managers of the system, in the form of members of the committees took advantage of democratic management and milked the co-operatives of their resources by discriminately sanctioning advances to their close relatives and friends at a price. Attempts to recover these loans from the borrowers were thwarted by the members of the committees thereby substantially raising the NPAs in the co-operatives. Further, the limited area of operation of the co-operatives ensured that the persons employed in these organizations were all related to the members of the committees and they neither had the professional approach nor the competence to handle the management job efficiently. All these factors have been, time and again, indicated as factors responsible for the downfall of the co-operative movement in general.

The UCBs faced similar circumstances in their functioning. The UCBs were basically started to provide cheap and timely credit to SMEs making use of the locally available resources. They have to
largely depend upon the deposits available in the urban areas from the people who are wage earners. The RBI has also permitted the UCBs to offer marginally higher rate of interest on the deposits with the UCBs because the UCBs being institutions with low volume of transactions have to compete with the public sector banking system for deposit mobilization. The RBI also stipulates that the UCBs will have to lend 60 percent of their loans to the priority sector while the commercial banks are to lend only 40 percent to the priority sector. The priority sector lending is usually risk proven because the repayments from this sector are usually questionable.

To this problem is added the problem of discriminate lending in UCBs at present. When the UCBs were managed by sincere co-operators, the problem of NPAs was very minimal. The entry of greedy administrators to the management of UCBs resulted in non recovery of loans and decline in performance of UCBs. It must be noted here that the deposits in the UCBs come more from non members than from members. This is because the UCBs offer higher rate of interest on deposits than the commercial banks. Depositors might think that they are getting good deal, but in those high deposit rates lie the seeds of trouble. Co-operative bank to make money on these high cost deposits has to lend at rates higher than those offered by the commercial banks. There in lies real problem of UCBs. The prime borrower tend to ignore co-operative banks and access cheaper loans
elsewhere. This leaves only second and third rung borrowers, who have relatively low credit worthiness.

In India there is a history of failure of UCBs due to factors such as apathy of the members, inefficient staff managing important positions, questionable advances, lack of interest in recovery of loans and non professional approach to management. In addition, many UCBs have been permitted to lend to risky sectors such as investment in stock market, gilts, real estate, film production and many other unsecured purposes.

The following paragraphs presents a brief account of the failures of UCBs in different parts of the country and recommendation made by different committees/working groups to prevent such failure in the future.

1. Madhavapura Bank, Ahemadabad:

The Madhavapura Mercantile Co-operative Bank was established on October 10, 1968 to cater to the financial needs of wholesale grocery traders. This bank received scheduled bank status from RBI a few years ago. This allowed the bank to lend to stockbrokers and also to invest 10% of its net worth in the capital market. The chairman of the board is understood to have approved advances to Kethan Parekh, a stockbroker to a tune of around Rs. 200 crores. Further, the bank had given huge bank guarantee to Kethan Parekh as a result of which the bank was left with little cash.
A report in the press from RBI resulted in the depositors panicking and withdrawing huge sum of money from the bank on 8th March, 2001. Finally the bank had to close down its operations in Ahmedabad and Mumbai.

It was not only depositors who were hit by the crisis, but many co-operative banks who had deposited money in Madhavapura Bank also faced payment problem. A preliminary enquiry by RBI showed that Madhavapura Bank had very bad liquidity after it issued pay orders worth Rs. 65 crores to the depositors. Finally, the RBI recommended to the Registrar of Co-operative Banks (RCB) to supersede the board.

It was also reported that the chairman's sons stock market dues which ran up to Rs. 50 crores, were cleared through Madhavapura Bank funds. Bank of India is reported to have lost Rs 120 crores as the pay orders issued by Madhavapura Bank to Khethan Parekh bounced. The State Bank of India has reported that it was exposed to a loss of Rs. 39. 57 crores by sale of gold to a trader who's cheques were drawn on Classic Co-operative Bank bounced. The Dena Bank had loss of about Rs. 30 crores due to lending to Madhavapura Bank.

As many as 50 UCBs had their deposit trapped in Madhavapura Bank and majority of them faced the risk of closure soon. A fall out of all these developments in Madhavapura Bank was immediately felt in Gujarat. The deposits in UCBs in Gujarat dropped by Rs. 1500 crores during 2001-02 and further by 10 percent during 2002-03. On the
other hand the deposits in the commercial bank rose by 14 percent in the same period. This indicated that the depositors had lost faith in UCBs and started shifting their deposits to commercial banks.

It is worthwhile to note that during 2002 the all India ratio of NPAs in UCBs was 15.8 percent while in Gujarat alone the ratio was as high as 47 percent, mainly due to the fact that out of about 370 UCBs in Gujarat many of them had kept their deposits in Madhavapura Bank. (Sources: India Infoline News Team dated 3-4-2001: Times News Network, 13-6-2003)\(^1\)

The fall out of failure of Madhavapura Bank to honour its commitment to depositors was felt as far away as New Delhi. The president of National Co-operative Union of India Mr. S. S. Sisodia alleged that there was an effort being made to tarnish the image of the entire co-operative sector due to the fault of few individuals. He pointed out that there were over 2000 UCBs in India, out of which 51 were scheduled banks and the aggregate deposit with the UCBs exceeded Rs. 72000 crores while the advances stood at Rs. 45000 crores. Further, he added that the Madhavapura Bank had deposits of over Rs. 600 crores kept by 165 banks in Gujarat and another Rs. 600 crores kept by depositors. The Madhavapura Bank had lent nearly Rs. 1500 crores because of which the crisis began. However, the happenings in Madhavapura Bank cannot be taken as yard stick for evaluating other UCBs he said.
In Maharastra about 25 cooperative banks reported losses to the tune of Rs 400 crores due to lending to an agency called “Home Trade”. Home Trade is an online trading company, which deals with buying government securities on behalf of the banks. The co-operative bank must necessarily invest in government securities to meet the requirement of SLR. The UCBs found it convenient in Maharastra to buy government securities through brokering trader such as Home Trade.

The Chairman of Nagpur District Co-operative Bank, filed a police complaint stating that the Home Trade and four other Brokers did not give the receipts of gilts to the tune of Rs. 125 crores. This he said, would result in the bank closure. The case of Nagpur District Co-operative Bank is only symptomatic, it is reported. The Maharastra Co-operative Department is understood to have started investigating such investments as the UCBs in Maharastra have invested as much as Rs.24000 crores in Government securities which is 25 to 40 percent more than the specified norms and have been made through brokers.

The RBI report suggests that the NPAs of Urban Co-operative Banks in the country amounted to Rs. 5500 crores during 2000-01. Till the end of 2001, 118 UCBs were under liquidation while another 261 have been classified as weak. (Source: Shiva Kumar, Indo Asian News Service dated 24-12-2003).
3. Andhra Pradesh:

a) Krushi Bank:

The bank offered very high rate of interest on deposits, which got a lot of media publicity. However, the funds of the bank were diverted by the Board Directors to speculative ventures due to which the bank faced liquidity crunch. The Chairman along with some others fled and the bank collapsed. This triggered a domino effect on other UCBs in the State.

b) Charminar Bank:

The Charminar bank was founded on 7th September 1985 by Abid Hussein Rizvi, retired deputy registrar of cooperative societies with the aim of working for the economic development of Muslims of Hyderabad. One of the aims of the bank was to attract the investments and deposits from Hyderabadis working in Saudi Arabia and other gulf states. The bank had nearly 19000 share holders with paid up capital of Rs. 6.43 crores and turn over of Rs. 8000 crores. In the year 2000-01, it had deposits of Rs.429 crores, advances Rs. 270.76 crores and earned a profit of Rs. 1.92 crores against a profit of Rs. 2.14 crores during 1999-2000. The bank had 21 branches and also got the status of multistate cooperative bank.

Alamdar Hussain became the chairman of the bank after the death of its founder chairman Kazim Nawaz Jung Ali Pasha, son in law of last nizam of Hyderabad. Alamdar Hussain was flambouyant
figure with three wives and was known for his luxurious life style. Alamdar Hussain committed suicide and had reportedly left a suicide note behind which included the list of people who owed huge sums of money to the bank and where not repaying on time.

The preliminary enquiries by RBI and the state government revealed that the charminar bank had thrown all the prudent norms to the wind. To quote an illustration: The bank had advanced a huge amount of Rs. 270 crores, out of which Rs. 185 crores to only 124 individuals without sufficient securities and guarantees. In most of the cases of borrowings by these individuals, worthless land of a small village Bodakonda of Ranga Reddy district was shown as collateral guarantee. As per the RBI guidelines, the bank showed Rs. 18.31 crores towards CRR, but it had only Rs. 1.4 crores; it should have Rs. 84.24 crores as a SLR but it had Rs. 4.70 crores only and Rs. 3.86 crores as cash in hand only Rs. 2 crores. The bank reported its gross NPAs at Rs. 63.20 crores, as against the real NPA figure of Rs. 272 crores. Despite liquidity crunch, the bank sanctioned fresh loans and advances up to Rs. 30 crores during July-September, 2001(Source: Islami Voice, March 2002 volume 15-03 No. 183). 3

c) **VASAVI BANK:**

This UCB had on its Board persons who belonged to business community. It had nearly Rs. 250 crores worth of deposits. When the Krushi bank collapsed, there was run on this bank too. A major share of loans and advances from this bank went to the
Directors of the Board and to their relatives. Out of Rs. 120 crores loans and advances, Rs. 50 crores were advanced to close relatives and friends. Finally, as in other cases, Vasavi Bank collapsed.

d) Prudential Bank:

This bank had more than 82 years of existence with a current business size of a little over Rs. 1000 crores, which includes deposits of around Rs. 560 crores and advances of Rs, 450 crores. There were heavy withdrawals by the depositors when the news that the bank was weak appeared in the newspapers. The alleged irregularities pointed out by the RCS include unsatisfactory recovery of loans, “evergreening” of certain non performing assets by enhancing their limits and huge variation between the budgeted figures and actual spendings. It was found that this bank had lent to a defaulter with many other banks, lent as much as 24 crores to a single borrower and also lent to high risk areas such as real estate clubs and resorts and film studios. The government finally superseded, the bank by appointing an administrator. (Source: Bhale Rao and D. Mastan Academy of Corporate Governance India dated 26-12-2003).

3. Other reports of Failure:

There are several other reports which appear frequently in media about the malfunctioning of UCBs. One of these reports spoke of the crisis with the Great Bombay Co-operative Bank, in which it
was alleged that the relative of a director was lent Rs. 35 Lakh, which had become bad. A counter allegation has surfaced which states that the close relative of a chairman was given a loan of Rs. 20 crores, which is likely become bad. Such doubtful loans have put the bank finances into high risk areas. (Source: Business Correspondent dated 31-03-2004).

Corrective Measures Adopted by Different Agencies:

As seen above, there are a number of instances where the greed of the Directors of the Bank had led to important investment of funds and there by accumulation of losses in UCBs. It has been pointed out time and again that the dual control of the UCBs by RBI and state governments, lack of interaction between members and directors, employing staff without professional orientation and lack of effective monitoring system are all the major reasons for such a bad state of affairs in the UCBs.

The RBI in 2003-04 stated the amount of NPAs of UCBs at Rs. 11922 crores, of Central Co-operative Banks at Rs. 13862 crores and State Co-operative Banks at Rs. 6284 crores thus making the NPAs of Co-operative Sector at a staggering Rs. 32000 crores plus. The RBI itself admits that there is no clear demarcation of regulatory powers between NABARD, State Governments and itself to reduce NPAs in UCBs and also to curb misuse of funds by the Directors. The RBI has banned loans to the Directors and their families. The RBI also directed the UCBs to set up the SLR investments by UCBs. However,
it may be recalled here that about 25 UCBs in Maharashtra have lost money by investment in gilts which is an important avenue of SLR. However, they opted to invest through brokers of questionable integrity. Hence, there is a need to evolve a system where in the UCBs are made to invest in gilts through the brokers whose credibility is rated very high by independent rating agencies. It is rather disheartening to note that out of 1990 UCBs the RBI has classified 732 UCBs graded III and IV meaning there by that they are not financially sound.

A number of committees, namely, Madhava Rao Committee on UCBs (1999), Jagdish Kapoor Task Force on Credit System (2000) and V. S. Vyas Group of Rural Credit (2001) have all suggested withdrawal of dual control over the Co-operative Banks, besides the other measures.

There is a built in limitation in the working of the co-operatives in general and UCBs in particular. This is because the co-operative in the country evolved basically as people's organizations rather than business enterprises adopting efficient managerial systems. This has led to a misunderstanding among the cooperators that co-operatives are a non profit organizations and hence, the word profit is stigma in the system. However, one must understand that without generating sufficient surplus no business could survive and UCBs are no exception.
A number of reports also point out that the employees in the co-operative organizations including UCBs are not professionally oriented managers. It is reported that in most of the UCBs close relatives of the directors are appointed to various posts and sometimes even at a price. In such cases, one can only expect that non meritorious and inefficient persons are employed to manage the positions in UCBs. This further aggravates the problems in UCBs in the form of lending to dubious purposes, lending to persons of questionable integrity and lack of interest in recovery of loans. Thus, putting the entire finances of UCB and the interest of the depositors at stake.

Though the RBI issued directives to the UCBs to have at least two professionals on their boards, most of the UCBs have followed this rule in breach. Thus, it may be seen professionalism in management is scullted here also.

To the misfortune of UCBs it must be said that the procedure to write off the bad loans and to cleanse the balance sheet is very tedious. The UCBs will to first get the approval of a special auditor than take it to the Annual General Meeting for approval and finally wait for the approval of Register of Co-operative Societies (RCS) to write off bad loans. This is a time consuming procedure, which takes at least three to five years for finalization. The commercial banks on the other hand can just get the approval of their board and write off bad loans. Further, the UCBs are not allowed to approach the Debt
Recovery Tribunal for settlement of loans unlike in the case of commercial banks.

In the backdrop of failure of UCBs in many states the new approaches that have been adopted by RBI are:

a) Increasing the frequency of (offsite and onsite) inspections of UCBs.

b) Calling the boards of managements of the banks for reviews, and work out strategies to over come the problem of weak/sickness.

c) More disclosure of information on the risks/weaknesses of banks in their inspection reports and asking RCS too to initiate actions on the banks.

d) Asking the UCBs also to disclose certain information in the balance sheet for the perusal of stakeholders.

e) Taking stringent actions, such as cancellation of licenses when further continuance of bank would be detrimental to the interest of the future deposits.

f) Prohibiting foreclosure of deposits.

g) Constituted a committee (Ganguly Committee) to suggest measure to bring corporate governance in banks. It made certain recommendations they are:
i) The boards of banks be free of politicians, people with proven expertise in technology, marketing, finance, treasury.

ii) Accounting to be inducted to oversee the work of bank executives and provide strategic direction.

iii) Strong and Independent directors are to be taken in the board with a responsibility to maximize the interests of all shareholders and directors to sign a list of "dos and don'ts". The RBI accepted all of them and asked the banks to implement them.

h) Lastly considering a policy measure of constituting a separate supervisory board for monitoring UCBs under the control of Deputy Governor of RBI

Apart from the above new strategies of RBI the UCBs need to adopt some of the key strategies suggested by Dr. Bimal Jalan, Governor RBI while inaugurating the recent banking summit organized by CII. The startagies offered to the bankers are:

i) building competence for competing

ii) observing regulatory (RBI, RCS) system,

iv) reduction in government ownership

v) adopting international best practice in corporate governance

vi) introducing sound human resource policies and management system which would help in strengthening the banks.
Similarities in the Sample Banks:

It may be recalled that the analysis of performance of Guru Bank has shown that the performance indicators have exhibited favourable results in the last 13 years upto 2003. The bank was revisited during 2005 for further assessment. It was observed that the bank has suspended all its transactions and is on the verge of closure. The doors are kept open only for the purpose of recovery of loans wherever possible and refund of deposit to depositor wherever feasible. The bad state of affairs of the bank is due to the factors which are similar to those explaining the failure of other UCBs in the country. It is observed that the Guru Bank had deposited substantial amount in Karnataka District Central Co-operative Bank (DCC) and the KCC bank lost much of its money in indiscriminating lending. Further, Guru Bank had lent money to the borrowers most of whom used their influence in getting loans. In some case, it was also reported that the directors took a share from out of the loans sanctioned. The repayment of loans was tardy and no body bothered to have special drive for recovery of loans as directors and employees of the bank had no such moral courage to insist on borrowers.

It was also observed that the most of the employees of the bank secured employment through dubious means. They were not professionally qualified or experienced to hold important positions. They were also given fancy designation such as Chief General Manager, General Manager and Recovery Officer. They had violated
all prudent norms of lending by lending to persons who agreed to
part with a part of the loan sanctioned to them. Hence, it may be
seen that the malady in the UCBs is not specified to sample banks
but rather is a common phenomena throughout the country. Hence,
the RBI should immediately initiate action to set the things right in
the UCBs by adopting a suitable system monitoring and control over
the UCBs, otherwise bank after bank in Urban Co-operative Sector
will report failure which will ultimately lead to the collapse of the
Urban Co-operative Banking Sector. The depositors in UCBs will be
the worst affected because they will not have any one to turn to.
Finally, people will loose faith in the co-operative system itself.

Analysis of Guru and Kalyan UCBs performance based on
financial statements is quite contradictory with the reality. Both the
banks seem to be profitable, and financially strong. However, the
reality is otherwise. In reality, the Guru bank is a sick bank. The
bank has suspended its operation and the government appointed
administrator has taken over the management of the bank. The
Kalyan bank is a weak bank rather than a sick bank. It exists under
difficult situation. In other words, it is a potentially sick bank.

It is perplexing to say the least. The financial statement,
prepared by management, should indicate the true and fair view of
the business. The profit and loss account shows the areas of revenue
generating and expenses incurring and balance sheet indicates the
ability of the business to withstand the future. In simple UCBs, financial statement shows a different picture.

Due to varying pictures, one can raise a question mark on the authenticity and dependability of financial statements prepared by sample UCBs. In fact, it is a general ailment of all UCBs in the state and in the country.

The financial statement of the UCBs rigged and manipulated. They do not, no longer, indicate the true statement of affairs of the banks. Management, in collusion with the accountant and co-operative auditors successfully manage, to show a picture far from truth. Co-operative auditors, role come under great security because of series of UCBs failure. One can surprise that they are net competent to handle co-operative bank’s audit work and/or something goes beyond the curtain.

There is a need to investigate seriously by the representative state government, Central Government and RBI into the annual accounts of UCBs in the country to prevent the cascading effect of the collapse of UCBs, edifice in the country. Already some signs are forthcoming with the failure of one or two UCBs in every state of the country of the possible calamity in the future.

The road ahead for UCBs is rough. The Urban Co-operative bankers have to modify their behaviour, otherwise they will not be excused by the regulator or by their members and by public at large.
Retaining and rebuilding the confident of public is their top priority. (Source: Bhale Rao, Bringing good governance in Co-operative Banks – Perspective from the Andhra Pradesh Experiences, Academy of Corporate Governance Website June, 2003).
References:

1. India Infoline News Team dated 3-4-2001: Times News Network 13-6-2003

2. Shiva Kumar, Indo Asian News Service dated 24-12-2003


4. Bhale Rao and D. Mastan Academy of Corporate Governance India dated 26-12-2003

5. Business Correspondent dated 31-03-2004