CHAPTER – VI

A STUDY OF FINANCIAL SYSTEM OF CO-OPERATIVES BANKS

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1. INTRODUCTION

Co-operation banks in India are more than 100 years old. These banks came into existence with the enactment of the Agricultural Credit Co-operative Societies Act in 1904. Co-operative banks form and integral part of the banking system in India. These banks operate mainly for the benefit of rural areas, particularly the agricultural sector. Co-operative banks mobilize deposits and supply agricultural and rural credit with than snider outreach. They are the main source of institutional credit to the farmers. Co-operative banks are chiefly responsible for breaking the monopoly of moneylenders in providing credit to agriculturists. They have also been an important instrument for various operative banks operate for non-agricultural sector also but their role is small.

Though much smaller as compared to scheduled commercial banks, co-operative banks constitute an important segment of the Indian banking system. They have an extensive branch network and reach out to people in remote areas. They have traditionally played an important role in creating banking habits among the lower and middle-income groups and in strengthening the rural credit delivery systems.

Unfortunately, financial reforms have not impacted the functioning of co-operative banks. This was brought out clearly in the following observation of the Reserve Bank of India, “Since the introduction of remora, there has been very little perceptible improvement in either stability or efficiency of co-operative banks. In particular, the asset quality and profitability of scheduled Urban Co-operative Banks (UCBs)
showed some deterioration in the reform period. Positive impact of reforms, ands has been witnessed in the case of commercial banking sector, may take longer to get manifested for co-operative banks given the late start of the reform process in this sector.”

The financial firearms process initiated in 1991 has tried to achieve regulatory convergence among various financial intermediaries in view of their systemic importance. Therefore, the basic objectives and instruments of reforms for co-operative banks have been the same as for State Co-operative Banks (SCBs). However, given the special characteristics of co-operative banks, they have been extended certain dispensation in terms of pace and sequencing of reforms.

2. CLASSIFICATION OF CO-OPERATIVE BANKS

The co-operative banking structure in India comprises urban co-operative banks and rural co-operative credit institutions.

Urban Co-operative Banks (UCBs): UCBs consist of a single tier, ivz. Primary co-operative banks, commonly referred to as urban co-operative banks.

Rural Co-operatives: The rural co-operative credit structure has traditionally been bifurcated into two parallel wings: short-term and long-term.

A. Short-term Rural Co-operatives: These credit institutions have a federal three-tier structure. (i) AT the apex of the system is a State Co-operative Bank (SCB) in each State. (ii) At the middle (or district) level, there are Central Co-operative Banks (CCBs) also known as

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district co-operative banks. (iii) At the lowest (or village) level are the Primary Agricultural Credit Societies (PACS). The smaller States and Union Territories (UTs) have a two-tier structure with SCBs directly meeting the credit requirements of PACS.

1. **State Co-operative Bank (SCB)**: SCB is the highest agency of the three-tier co-operative credit structure in a state. It serves as a link between RBI and the CCBs and PACS. The RBI provides credit to lower level co-operatives through the SCB. This function of the RBI has now been taken over by NABARD. The SCB also acts as a *balancing centre* for CCBS in the sense that surplus funds of some CCBs are made available to other needy CCBs. The SCB exercises general control and supervision over CCBs and PACS.

2. **Central Co-operative Banks (CCBs)**: These banks act a link between the SCB and the PACS. The main task of CCBs is to lend money to affiliated village primary societies. The CCBs are expected to attract deposits from the general public.

3. **Primary Agricultural Credit Societies (PACS)**: These societies form the basic units of the co-operative credit system in India. These voluntary societies based on the principle of one man one vote have posed challenges to the exploitative practices of the village moneylenders. The farmers and other small-time borrowers come in direct contact with these societies. The success of the co-operative credit movement depends largely on the strength of these village level societies. There are around 1 lakh such societies in the country at present.

As a result of the expansion of the activities of PACS, the role of moneylenders in providing credit to agriculturists has decreased over the years. A major objective of PACS is to serve the needs of weaker section
of the society. For this purpose, the people with limited means, particularly scheduled castes and scheduled tribes, are encouraged to become members of these societies. Government has promoted multi-purpose societies in tribal areas for the benefit of people living there.

B. Long-term Rural Co-operatives: Generally, these co-operatives have two tiers, *viz.*

1. **State Co-operative Agriculture and Rural Development Banks (SCARDBs)**: These banks operate at the State level.

2. **Primary Co-operative Agriculture and Rural Development Banks (PCARDBs)**: These banks operate at the *taluka/tehsil* level.

3. **FINANCIAL SYSTEM OF URBAN CO-OPERATIVE BANKS (UCBS)**

Urban co-operative banks play an important role in meeting the growing credit needs of urban and semi-urban areas. UCBs mobilize savings from the middle and lower income groups and purvey credit to small borrowers, including weaker section of the society. The number of UCBs stood at 1,872 at end-March 2005, including 79 salary earner’s banks and 199 *Mahila* banks. Total number of scheduled UCBs was 55 at end-March 2005. Scheduled UCBs are under closer regulatory and supervisory framework of the RBI.

UCBs have grown rapidly since the early 1990s. During the phase of rapid expansion, however, the sector showed certain weaknesses arising out of (a) lack of sound corporate governance, (b) unethical lending, (c) comparatively high level of loan defaults and (d) inability to
operate in a liberalized and competitive environment. The RBI, therefore, has been striving to harness the growth of UCBs with appropriate application of prudential regulation and supervision to safeguard the interests of depositors.

Keeping in view the weak financial position of many UCBs, the RBI has undertaken a series of measures directed towards strengthening of the UCBs. Since March 31, 1993, the UCBs have been advised to adhere to the prudential norms which include, *inter alia*, the following.

1. Applying capital adequacy standards.
2. Prescribing an asset-liability management framework.
3. Enhancing the proportion of holding of Government and other approved securities for the purpose of Statutory Liquidity Ratio (SLR) stipulation.
4. Restriction on banks finance against the security of corporative shares and debentures.
5. Limiting the exposure to capital market investment.

In view of the challenges arising from the functioning of the UCBs for the financial system, the RBI appointed a High Power Committee (Chairman: K. Madhav Rao), 1999 to review the performance of UCBs and to suggest necessary measures to strengthen this sector. Based on the recommendations of this Committee, measures have been initiated to strengthen the existing urban banking structure.

**Vision Document and Medium-Term Framework (MTF) for UCBs:** Various entities in the urban co-operative banking sector display a high degree of heterogeneity in terms of deposits/assets base, areas of operation and nature of business. In view of its importance, it is imperative that the sector emerges as a sound and healthy network of
jointly owned, democratically controlled and professionally managed institutions. In order to achieve these objectives, the RBI has taken a series of policy initiatives in recent years. The most significant initiative in this regard was the Vision Document and Medium-Term Framework (MTF) for UCBs. With a view to protecting depositor’s interests on one hand, and enabling UCBs to provide useful service to local communities on the other, the Medium-Term Framework (MTF) seeks to achieve the following objectives.

1. To rationalize the existing regulatory and supervisory approach keeping in view the heterogeneous character of the entities in the sector.
2. To facilitate a focused and continuous system of supervision through enhancement of technology.
3. To enhance professionalism and improve the quality of governance in UCBs by providing training for skill upgradation and also by including large depositors in the decision making process/management of banks.
4. To put in place a mechanism that addresses the problems of dual control, given the present legal framework and the time-consuming process in bringing requisite legislative changes.
5. To put in place a consultative arrangement for identifying weak but potentially viable entities in the sector and provide a framework for nursing them back to health including, if necessary, through a process of consolidation.
6. To identify the unviable entities in the sector and provide and exit route for such entities.
The above framework is implemented through the measures.

1. A differentiated regulatory regime as opposed to a “one-size-fits-all” approach.

2. A two-tier regulatory regime: (a) simplified regulatory regime for unit banks and single district banks with deposits less than Rs. 100 crore; and (b) regulation for all other banks on the lines of commercials banks.

3. As the strategy to deal with UCBs may need to be State-specific, a State Level Task Force for Urban co-operative Banks (TAFCUB) is to be constituted comprising senior officials from the RBI, State Governments and local/central co-operative Federations.

4. The TAFCUB would be responsible for (i) identifying weak but viable UCBs and devise a time-bound programme for revival; and (ii) recommending (a) the nature and extent of financial support, (b) future set up of unlicensed banks, and (c) the manner and timeframe for exit of unviable banks.

5. To address issues/difficulties relating to dual control within the existing legal framework, it has been proposed to evolve a working arrangement in the form of Memorandum of Understanding (MoU) between the RBI and the State Government.

**Strengthening of the Supervisory System Related to UCBs:**

The regulation and supervision of the urban co-operative banks (UCBs) was brought within the ambit of the RBI’s statutory control under the Banking Laws (as Applicable to Co-operative Societies) Act, which came into force from March 1, 1966. The regulatory powers conferred on the RBI with regard to co-operative banks are limited. While the principles
of supervision with regard to co-operative banks have been formulated and implemented by the RBI in respect of UCBs under the Banking Regulation Act, 1949, the Act does not apply to primary agricultural credit societies and land development banks, thus living them under the regulatory purview of the State.

Instances such as the Madhavapura Mercantile Co-operative Bank’s failure brought to the fore the need to have stringent regulatory control over the co-operative banking system. In order to strengthen the supervisory mechanism, the RBI extended the Off-site Surveillance System (OSS) to all non-scheduled UCBs having deposit size of Rs. 100 crore and above. A supervisory reporting system was introduced for the scheduled UCBs from March 2001 as a first step towards setting up of OSS for all UCBs. The capital adequacy norms were introduced in a phased manner from March 2002. Better risk management through avoidance of concentration of credit risk, off-site surveillance for non-schedule UCBs and following up of Know Your Customer (DYC) guidelines have also been introduced to strengthen the UCBs.

A total ban has been imposed since October 2003 on grant of loans and advances to directors of UCBs, their relatives and concerns in which they have interest with a view to preventing certain irregularities. The RBI has also directed that UCBs should undertake usual due diligence in respect of investments in non-SLR securities. The RBI introduced a new system of grading of UCBs in April 2003, which is based on their CRAR, level of net NPAs, record of losses and compliance with regulatory environment. Similarly, a system of supervisory rating for UCBs under the CAMELS model has also been introduced. Initially, it was
implemented for scheduled UCBs but subsequently its simplified version was extended to non-scheduled UCBs in March 2004.

Despite the structural and cultural differences between UCBs and commercial banks, the above measures suggest that the RBI has exercising its regulatory and supervisory powers to ensure that the cooperative credit structure is strengthened on the lines similar to the regulation and supervision of commercial banks.

The RBI is entrusted with the responsibility of regulation and supervision of the banking-related activities of UCBs under the Banking Regulation Act, 1949 As Application to CO-operative Societies (AACS). Other aspects such as incorporation, registration, administration, management and winding-up of UCBS are supervised and regulated by the respective State Governments through Registrars of Co-operative Societies (RCS) under the Co-operative Societies Acts of the Respective States. UCBs with a multi-state presence are registered under the Multi-State Co-operative Societies Act, 2002 and are regulated and supervised jointly by the Central Government through Central Registrar of Co-operative Societies and the RBI.

Thus, current legislative framework provides for dual control over UCBs. For resolving problems arising out of dual control regime, a draft legislative bill proposing certain amendments to the Banking Regulation Act, 1949 (AACS), based on the recommendations of the High Powered Committee on UCBs, was forwarded to the Government. Pending the amendment to the Act, the RBI is entering into a regulatory arrangement with the State Governments through Memorandum of Understanding (MoU) to facilitate proper and coordinated regulation and supervision of UCBs. MoUs have already been signed between the RBI and three States.
that have a large network of UCBs, viz. Andhra Pradesh, Gujarat and Karnataka. As a follow-up to the signing of MoUs, the RBI has constituted State Level Task Force for Urban Co-operative Banks (TAFCUBs) in these States.

A. Memorandum of Understanding (MoU) with the State Governments: The MoUs contain the following commitments by the State Government and the RBI.

The State Governments, through the (MoU), agree to introduce a long form audit report for statutory audit and modify their audit rating models to bring them in alignment with the gradation system adopted by the RBI for UCBs.

Provide for statutory audit by Chartered Accountants (CAs) for UCBs with deposits over Rs. 25 crore and special audit by CAs, if required by the RBI, for any UCB. Put in place ‘fit and proper’ criteria for Chief Executive Officers (CEOs), based on guidelines of the RBI.

B. Licensing of New Banks/Branches: Consequent upon the easing of licensing norms in May 1993, more than 800 licences were issued for setting up urban cooperative banks. However, close to one-third of these newly licensed UCBs became financially weak within a short period. There was, thus, a need to moderate the pace of growth of this sector, particularly given the vexatious issue of dual control over UCBs. The RBI proposed certain amendments to the Banking Regulation Act, 1949 (AACS) to overcome the difficulties arising out of dual control. Pending enactment of these amendments, it was announced in the Annual Policy Statement for 2004-05 that issuance of fresh licences would be considered only after a comprehensive policy on UCBs, including an appropriate
legal and regulatory framework for the sector, is put in place and policy for improving the financial health of the urban cooperative banking sector is formulated. Accordingly, at present, applications for banking licence, including licence for opening of new branches, are not considered.

C. Income Recognition, Asset Classification and Provisioning Norms: In line with the international best practice and extant practices in commercial banks in India, the RBI decided to reduce the time period for reckoning an advance as non-performing from the existing 180 days to 90 days with effect from March 31, 2004. However, subsequently keeping in view the representations received from co-operative federations/banks, small loans up to Rs. 1 lakh were exempted from the purview of the 90 days norm and continued to be governed by 180 days norm. This exemption was granted only up to March 31, 2006. It was also decided to grant additional time of two years, in comparison with commercial banks, to meet the 100 per cent provisioning required for advances identified as doubtful for more than three years.

Further, taking into consideration representations received from UCBs, it was decided to permit certain categories of UCBs to classify loan accounts as NPAs based on 180 days delinquency norm instead of 90 days norm. These included unit banks, i.e. banks having a single branch/HO and banks having multiple branches within single district with deposits up to Rs. 100 crore. The relaxation was given up to the financial year ending March 2007 and banks were advised to build up adequate provisions to comply with the 90 days delinquency norm after the stipulated date.
The RBI also decided to delink the asset classification and provisioning requirements in respect of State Government guaranteed advances and investments from the invocation of the State Government guarantee. Accordingly, asset classification and provisioning norms on State Government guaranteed advances were made applicable in the same manner as exposures not guaranteed by the State Governments from the year ending March 31, 2006.

D. **Exposure Norms**: With a view to avoiding concentration of credit risk, UCBs were advised to fix the prudential exposure limits at 15 per cent and 40 per cent of the ‘capital funds’ in the case of a single borrower and a group of borrowers, respectively. Banks were also advised that ‘capital funds’ for the purpose of prudential exposure norms would be in relation to banks’ total capital funds and the exposure for the purpose includes both credit and investment exposure (non-SLR).

E. **Inspections**: The on-site financial inspection carried out by the RBI continues to be one of the main instruments of supervision over UCBs.

F. **Off-site Surveillance**: The off-site surveillance system (OSS) for supervision was made applicable to all scheduled UCBs from March 2001. The returns for OSS were reviewed by the RBI and a revised set of 8 returns was prescribed from March 2004. The OSS returns of UCBs are designed to monitor compliance and obtain information from the on areas of prudential regulation. The main objective of the OSS returns is to obtain relevant information on areas of prudential interest, address the management information needs, strengthen the management information system (MIS).
capabilities with in the reporting institutions and to sensitise bank management about concerns of the supervisory authority.

Compliance monitored through these returns covers assets and liabilities, earnings, asset quality, sector/segment-wise analysis of advances, concentration of exposures, connected or related lending and capital adequacy. These concerns earlier were being addressed through periodical on-site inspections of banks undertaken at intervals ranging from one to two years. The OSS system was extended to non-scheduled banks with deposit base of over Rs. 100 crore from June 2004.

**Know Your Customer (KYC) Guidelines** : Know Your Customer (KYC) guidelines were issued to UCBs by the RBI in the context of the recommendations made by the Financial Action Task Force (FATF) on Anti-Money Laundering (AML) standards and Combating Financing of Terrorism (CFT). UCBs were advised to ensure that a proper policy framework on KYC and also AML measures is formulated and put in place with the approval of their Boards. UCBs were also advised to ensure full compliance with the provisions of these guidelines before December 31, 2005.

**Priority Sector Lending** : UCBs are required to lend 60 per cent of their total loans and advances to the priority sector of which 25 per cent should go towards weaker sections.

**A. Housing Loans under the Priority Sector** : In order to improve flow of credit to the housing sector, it was decided that UCBs with the approval of their Boards may extend direct finance to the housing sector up to Rs. 15 lakh per beneficiary of a dwelling unit, irrespective of location, against the earlier limit of Rs. 10 lakh, as part of their priority sector lending.
Mergers/Amalgamations of UCBs: With a view to encouraging and facilitating consolidation and emergence of strong entities and as well as for providing an avenue for non-disruptive exit of weak/unviable entities in the co-operative banking sector, guidelines were issued to facilitate merger/amalgamation in the sector. The RBI, while considering proposals for merger/amalgamation, confines its approval to the financial aspects of the merger taking into consideration the interests of depositors and financial stability. The RBI considers proposals subject to the post-merger entity meeting the prescribed following prudential norms.

1. When the net worth of the acquired bank is positive and the acquirer bank assures to protect entire deposits of all the depositors of the acquired bank.

2. When the net worth of acquired bank is negative but the acquirer bank, on its own, assures to protect deposits of all the depositors of the acquired bank.

3. When the net worth of the acquired bank is negative and the acquirer bank assures to protect the deposits of all the depositors with financial support from the State Government extend upfront as part of the process of merger.

The RBI had conveyed its no objection to five merger proposals up to August 27, 2005.
4. **FINANCIAL SYSTEM OF RURAL CO-OPERATIVE BANKS:**

The co-operative banks in India play an important role in catering to the banking needs of the rural population. Soon after Independence in 1947, the inadequacy of rural credit engaged the attention of the Government of India and the RBI. The agricultural credit system as it has emerged over the years is the result of both evolution and intervention, and symbolizes the nation’s response to the dissatisfaction with the discredited colonial credit delivery system.

The Reserve Bank of India Act, 1934 has specific provisions relating to agricultural credit. Section 54 of the RBI Act specifically authorized the creation of an Agricultural Credit Department within the RBI to deal not only with the rural credit but also with the long-term finance including refinance. Section 17 of the Act empowered into to provide agricultural credit through state co-operative banks or any other banks engaged in the business of agricultural credit.

The foundation for building a broader credit infrastructure for rural credit was laid down by the All India Rural Credit Survey (1954). The Committee of Direction that conducted the survey recommended the creation of National Agricultural Credit Fund, which was subsequently created by the RBI. The Agricultural Refinance Corporation (ARC) set up by the RBI in 1963 provided funds by way of refinance, but credit co-operatives still did not function too well. Decentralized credit planning

through the Lead Bank Scheme was also introduced to spearhead the credit allocation for, *inter alia*, agricultural lending. In order to emphasize the developmental and promotional role assigned to the ARC in addition to refinancing, the ARC was renamed as the Agricultural Refinance and Development Corporation (ARDC) in 1975.

Despite all these efforts, the flow of credit to the agricultural sector failed to exhibit any appreciable improvement as the co-operatives lacked resources to meet the expected demand. To solve these problems, the Regional Rural Banks (RRBs) were set up in 1975. In order to strengthen the institutional credit for agriculture and rural development, National Bank for Agriculture and Rural Development (NABARD) was set up on July 12, 1982. On its establishment, NABARD took over the entire function of the ARDC, the refinancing functions of the RBI in relation to cooperatives and Regional Rural Banks (RRBs).

The rural credit co-operative system has served as an important instrument of credit delivery in rural and agricultural areas. The separate structure of rural co-operative sector for long-term and short-term loans has enabled these institutions to develop as specialized institutions for rural credit delivery. At the same time, their federal structure has helped in providing support structure for the guidance and critical financing for the lower structure. These institutions have wide outreach with as many as 1,105,735 primary agricultural co-operative societies (PACS), the grass root organization of the rural co-operative banking structure, operating the country at end-March 2004.

The rural co-operative credit institutions, however, are beset with many problem which include the following.
1. Low resource base.
2. High dependence on refinancing agencies.
3. Lack of diversification.
4. Huge accumulated losses.
5. Persistent NPAs.
6. Low recovery levels.
7. Various other types of organizational weaknesses.

NABARD and the RBI, therefore, have been taking several supervisory and developmental measures in consultation with the Government of India for the revival of weak institutions and orderly growth of this important segment of the financial sector.

Asset Classification for State Government Guaranteed Advances: Revised guidelines on asset classification norms for State Government guaranteed exposures (i.e. advances and investments), as applicable to commercial banks, were issued to SCBs and CCBs on January 20, 2005 which are to be implemented in a phased manner. Accordingly, it was decided to delink the asset classification and provisioning requirements in respect of State Government guaranteed loans and advances from invocation of State Government guarantee and treat such exposures for asset classification purpose in the same manner as applicable to exposures not guaranteed by the State Governments guaranteed exposures (i.e. both advances and investments) will be implemented in a phased manner in two stages.

With effect from the year ending March 31, 2006, State Government guaranteed advances and investments in State Government guaranteed securities would attract asset classification and provisioning norms, if interest and/or installment of principal or any other amount due
to the bank remains overdue for more than 180 days. In the second stage, which would begin from the year ending March 31, 2007, State Government guaranteed advance and investment in State Government guaranteed securities would attract asset classification and provisioning norms, if interest and/or installment of principal or any other amount due to the bank remains overdue for more than 90 days.

**Additional Provisioning Requirement for NPAs:** For the sake of convergence in policies governing all banks, guidelines for additional provisioning for all advances classified as *doubtful for more than three years* were issued on March 01, 2005, to be implemented in a phased manner from April 01, 2005. In terms of the guidelines, for the unsecured portion of the advance, which is not covered by the realizable value of tangible security to which the bank has a valid recourse and the realizable value is estimated on a realistic basis, provision will be to the extent of 100 per cent, as hitherto. The secured portion, on the other hand, would be divided into two categories. Outstanding stock of NPAs classified as *doubtful for more than three years* as on March 31, 2007 would need to be provided for in a phased manner up to 100 per cent till March 31, 2010. Also, 100 per cent provisioning would need to be made of the advances classified as *doubtful for more than three years* on or after April 1, 2007.

**Task Force on Revival of Rural Co-operative Credit Institutions (Chairman: A. Vaidyanathan), 2005:** The Government of India had constituted this Task Force to propose an action plan for reviving the rural co-operative banking institutions and suggest an appropriate regulatory framework for these institutions. The Task Force in its Report submitted to the Central Government on February 15, 2005
made several recommendations to strengthen the rural cooperative credit structure in the country. The Government has accepted the recommendations of the Task Force in principle and held consultative meetings with the State Governments.

**Major recommendations of the Task Force are as under.**

1. The Co-operative Credit Structure (CCS) is impaired in governance, managerial and financial fronts and hence needs to be revived and restructures.

2. The financial restructuring shall be contingent on commitment to and implementation of legal and institutional reforms by the State Governments.

3. Financial assistance be made available for Wiping out accumulated losses; Covering invoked but unpaid guarantees given by the State Governments; Increasing the capital to a specified minimum level; Retiring government share capital; and Technical assistance. Availability of financial assistance from the Government of India shall be strictly subject to legal and institutional reforms in the co-operative sector to ensure that the co-operatives become truly democratic and member driven.

4. The Task Force has also recommended certain major amendments to the provisions of the B.R. Act, 1949 enabling removal of dual control and bringing the cooperatives under the regulatory control of the RBI. These include : (i) all co-operative banks would be on par with the commercial banks as far as regulatory norms are concerned; (ii) the RBI will prescribe ‘fit and proper’ criteria for election to the Boards of cooperative banks; (iii) the RBI will prescribe certain criteria for professionals to be on the Boards of
co-operative banks; (iv) the CEOs of the co-operative banks would be appointed by the respective banks themselves; and (v) co-operatives, other than cooperative banks as approved by the RBI, would not accept non-voting member deposits. Such cooperatives would also not use words such as bank, banking, banker or any other derivative of the word bank in their registered name.

5. Total financial assistance has been estimated tentatively at Rs. 14,839 crore. The Task Force, however, has recommended a special audit to ascertain the exact requirement of assistance. The financial assistance be shared by the Government of India, State Governments and the CCS based on the origin of losses within a flexible matrix.

6. NABARD be designated as the Nodal Implementing and Pass Through Agency to coordinate and monitor the progress of the programme model balance sheet proforma for PACS and CCBs.

7. The Scheme be kept open for a period of two years for the State Governments to decide on their participation.

8. The Scheme be operationalised through National Guidance and Monitoring Committee, State Level Implementation and Monitoring Committees and District Level Planning and Implementation Committees at national, State and district levels, respectively.

In the context of an urgent need for strengthening the long-term co-operative credit structure, the Government of India entrusted the Task Force to study also the long-term co-operative credit structure for agriculture and rural development.
Prudential Guidelines on Agricultural Advances: As mentioned in the Annual Policy Statement of the RBI for the year 2004-05, prudential norms on income recognition, asset classification and provisioning with respect to agricultural advances were modified on July 12, 2004 with a view to aligning the repayment dates with harvesting of crops. Accordingly, effective September 30, 2004 a loan granted for short duration crops is required to be treated as NPA if the instalment of the principal or interest thereon remains unpaid for two crop seasons beyond the due date. A loan granted for long duration (with crop season longer than one year) crops is required to be treated as NPA, if the instalment of principal or interest thereon remains unpaid for one crop season beyond the due date.

Management of Co-operatives: Although NABARD has been emphasizing, time and again, the need for co-operative banks to be managed by duly elected Boards of Management, the phenomenon of supersession of elected Boards of Management continues.

Primary Agricultural Credit Societies (PACS): Primary agricultural credit societies (PACS) are the foundation of the co-operative credit system on which the superstructure of the short-term co-operative credit system rests. It is the PACS which directly interface with individual farmers, provide short-term and medium-term credit, supply agricultural inputs, distribute consumer articles and arrange for marketing of produce of its members through a co-operative marketing society.

PACS continue to rely heavily on external support and have not yet been able to become self-reliant in respect of resources through
deposit mobilisation and internal accruals, affecting their growth and expansion of business activities.

PACS need to function as viable units responsive to the needs, aspirations and convenience of its members, particularly those belonging to the more vulnerable sections of the society. The must function effectively as well-managed and multi-purpose institutions mobilizing the savings of the rural people and providing a package of services including credit, supply of agricultural inputs and implements, consumer goods, marketing services and technical guidance with focus on weaker sections.

CRITICAL CHALLENGES:

Some of the critical challenges facing primary level co-operative credit institutions, apart from improving resource mobilization, are the following.

1. Increasing diversification in business portfolio.
2. Improving volume of business.
3. Arresting decline in membership by the borrowers.
4. Reducing cost of management.
5. Correcting imbalance in loans outstanding.
6. Improving skills of the staff and imparting professionalisation.
7. Strengthening management information system (MIS).
8. Reducing involvement in non/less profitable business.
**Micro Credit Programme**

The micro credit programme, which was formally heralded in 1992 with a modest pilot project of linking around 500 Self-help Groups (SHGs), has made rapid strides in India exhibiting considerable democratic functioning and group dynamism. The micro credit programme in India is now the largest in the world. Since independence, the Government of India and the RBI has made concerted efforts to provide the poor with access to credit. Despite the phenomenal increase in the physical outreach of formal credit institutions in the past several decades, the rural poor continue to depend on informal sources of credit. Institutions have also faced difficulties in dealing effectively with a large number of small borrowers, whose credit needs are small and frequent and their ability to offer collaterals is limited. Besides, cumbersome procedures and risk perceptions of the banks left a gap in serving the credit needs of the rural poor.

This led to a search for alternative policies, systems and procedures, saving and loan products, other complementary services and new delivery mechanisms that would fulfil the requirements of the poor. It is in this context that micro credit has emerged as the most suitable and practical alternative to the conventional banking in reaching the hitherto undetached poor population. Micro credit enables the poor people to be thrifty and helps them in availing the credit and other financial services for improving their income and living standards. The SHB-Bank Linkage Programme was formally launched in the year 1992 as a flagship programme by NABARD and aptly supported by the RBI through its policy support. The Programme envisages organization of the rural poor into SHGs for building their capacities to manage their own finances and
then negotiate bank credit on commercial terms. The poor are encouraged to voluntarily come together to save small amounts regularly and extend micro loans among themselves. Once the group attains required maturity of handling larger resources, the bank credit follows.

India has adopted a multi-agency approach for the development of its micro-finance programme. All the major credit institutions, viz. commercial banks, co-operative banks, RRBs along with non-Governmental agencies (NGOs) have been associated with the micro-finance programme. The Role of the delivering agents and their interface has led to alternative models of micro-finance.

The micro-finance initiative of NABARD, i.e. SHG-Banks linkage programme has passed through various phases over the last one and half decades, viz. pilot testing during 1992 to 1995, mainstreaming during 1996 to 1998 and expansion from 1998 onwards.

**Regional Spread** : To spread the outreach of micro credit, NABARD has taken up intensification of SHG-Banks Linkage Programme in 13 identified priority States which account for 70 per cent of the rural poor population, viz. Uttar Pradesh, Maharashtra, Orissa, West Bengal, Madhya Pradesh, Gujarat, Rajasthan, Chattisgrah, Jharkhand, Bihar, Uttarakhand, Assam and Himachal Pradesh. NABARD has adopted a multi-pronged strategy to spread the outreach of microfinance in the country.

The programme has now assumed the form of a micro-finance movement in many parts of the country and has started making inroads in the resource poor regions of the country as well. The target of covering one-third of the rural poor through linkage of 1 million SHGs to be achieved by 2007 was realized much ahead by end-March 2004.
NABARD is adopting the following strategy to spread the outreach of SHG-Bank Linkage Programme.

1. Widening spatial distribution and intensity of the outreach of the Programme with district oriented planning and strategy.
2. Evolving district-wise plan of action/strategy in consolation with existing stakeholders aiming at promotion and linkage of a minimum of 500 SHGs per district every year.
3. Training and exposure programmes for the staff of the stakeholders.
4. Providing promotional assistance to partners for promoting and nurturing the SHGs generally on add-on basis.
5. Widening the range of SHG promoting agencies.
6. Involving banks at their corporative level, organizing training programmes for the regional/zonal managers of commercial banks in association with their Central Offices.
7. Establishing the financing of SHGs as a business proposition for banks.
8. Increasing the participation of the co-operative banks by encouraging them to finance SHGs as financing cooperatives within the co-operatives.
9. Associating village communities, people’s institutions, rural volunteers and individuals to participate in the programme as SHG promotiers.
10. Increasing the quality of the existing SHGs by propagating self-rating tools.
11. Large-scale dissemination of the concept and approach among the rural masses.
12. Encouraging the NGOs to play in important role in correcting the regional imbalances in spread of SHG-Bank Linkage Programme.

**Graduation of Mature SHGs into Micro-enterprises**: Of over 16 lakhs SHGs credit linked with banks, over 4 lakh SHGs are now over three years old. The core needs of savings and credit for consumption and production of these SHGs are being met by the banking system. These SHGs have not only availed loans, but have also availed loans more than once. It is being emphasized that a member of the older SHGs would now be in a position to graduate into micro-enterprises by taking up income generating activities. It is difficult task to find viable micro-enterprises for millions of poor households in rural areas. Though micro-enterprises is not a panacea for the complex problem of chronic unemployment and poverty, yet their promotion is a viable and effective strategy for achieving significant gains in incomes and assets of poor and marginalized people.

However, in the absence of any specific hand-holding strategy to provide financial and non-finance services in an integrated manner, graduation of SHG members from micro-finance to micro-enterprises has not been smooth due to several obstacles. NABARD is, therefore, undertaking a pilot project in select districts, particularly for members of matured SHGs for promotion to the stage of micro-enterprises. NGOs have been selected in each district for implementing the pilot projects.

**Micro-finance and the Government**: It was announced in the Union Budget for 2005-06 that the Government of India intends to
promote micro-finance institutions (MFIs) in a big way. For the is purpose, the Micro-Finance Development Fund (MFDF) was predestinated as Micro-Finance Development and Equity Fund (MFDEF) and the corpus of the fund was increased from Rs. 100 crore to Rs. 200 crore. MFDEF is expected to play a vital role in capitalizing the MFIs and thereby improving their access to commercial loans.

The Central Government is considering the need to identify and classify the MFIs and rate such institutions to empower them to intermediate between the lending banks and the clients. To facilitate the process of rating of MFIs, NABARD has decided to extend financial assistance to commercial banks and RRBs by way of grant to enable them to avail the services of credit rating agencies for rating of MFIs.

**Micro-finance and the RBI:** In view of the new paradigm shift in micro-finance, the RBI is reviewing the issue of micro-finance in a comprehensive manner. Accordingly, several initiatives have been taken in the recent period. A Technical Paper on Policy relating to Development, Regulation and Supervision of Micro-finance Services was prepared and discussed with the representatives of MFIs on July 18, 2005. Similarly, an Internal Group of the RBI on Rural Credit and Micro-Finance (Chairman: H.R. Khan) was set up to examine the issues relating to micro-finance. The final version of the Report was released to the public in July 2005.

The SHG-Banks linkage programme is now considered by the banking system as a commercial proposition, with advantages of lower transaction cost, near zero NPAs and coverage of maximum number of the rural clientele by the bank branches. It has also led to other quantifiable benefits in business expansion. Forty seven commercial
banks, 196 RRBs and 306 CCBs were participating in the programme at end-March 2005.

**Kisan Credit Cards**

The Kisan credit cards (KCC) scheme, introduced in 1998-99, aims at providing crop loans to farmers in a flexible and cost-effective manner. The scheme is being implemented in all the States and Union Territories by all commercial banks, RRBs, state co-operative banks, central co-operative banks, and primary agricultural co-operative societies. Beneficiaries covered under the KCC are issued with a credit card and a pass book or a credit card-cum-pass book incorporating the name, address and particulars of land, borrowing limit, and the validity period. Production credit limits are fixed taking into account the entire production credit needs for a full year plus ancillary activities relating to crop production. Sub-limits are also fixed at the discretion of lending banks. Crop loan/short-term credit is in the form of a revolving cash credit facility involving any number of drawls and repayments within the limit fixed on the basis of operational land holding, cropping pattern and scale of finance.

Till recently, investment credit requirements of farmers remained outside the purview of KCC, causing additional cost and procedural inconvenience to farmers. To address these deficiencies in the KCC scheme, NABARD revised the scheme in August 2004 to cover term loans for agriculture and allied activities. Under the KCC, while the short-term as well as working capital credit is repayable in 12 months, the term loan is to be repaid within maximum period of 5 years.
Conversion/rescheduling of loans is permitted in case of damage to crops due to natural calamities.

KCC scheme has increased farmer’s access to short-term credit. The objective of the scheme is to provide adequate and timely support from the banking system to the farmers for their cultivation needs including purchases of inputs in a flexible and cost effective manner. Loans disbursed under KCCs are now covered under Rashtriya Krishi Beema Yojna of the General Insurance Corporation. KCC holders are being provided personal accident insurance cover of Rs. 50,000 for accidental death and Rs. 25,000 for permanent disability.

At the instance of the RBI, the National Council of Applied Economic Research (NCAER) conducted a survey for assessing the impact of the KCC scheme. The survey has brought out several advantages of the KCC scheme in terms of increase in the flow of credit to the agriculture sector, reduction in borrowings from the informal sector, significant savings in time spent on obtaining credit and an overall reduction in cost of credit delivery. The survey identified areas requiring policy initiatives to make the scheme more effective. These relate to restrictions imposed on the issuance of KCCs by banks, restrictions on use of KCCs only at card issuing branches, non-availability of incentives for timely repayments, low credit limits and low awareness regarding the provision of personal accident insurance scheme. The RBI has advised the Indian Banks Association (IBA) to examine these suggestions and come up with remedial measures.

The introduction of Kisan Credit Cards (KCCs) was a significant innovation in the rural credit delivery mechanism. However, the outreach of the KCCs to cover all eligible farmers under the scheme has been
hampered by the lack of updated land records, small landholdings and illiteracy of borrowers.

With an overwhelming response from the farmers as well as the bankers to the Kisan Credit Card (KCC) scheme, introduced in August 1998, the number of cards issued up to November 30, 2005 was 555.85 lakh. The growing popularity of the KCC scheme reflects its effectiveness in ensuring hassle-free and timely operations as also availability of credit with minimum transaction cost and documentation.

In order to safeguard the interests of the KCC holders for coverage under Personal Accident Insurance Scheme (PAIS) on an ongoing basis on competitive terms, NABARD has allowed discretion to the banks to opt for any insurance company of their choice. This facilitates personal accident insurance coverage on an ongoing basis, at competitive rates/terms. With a view to meet credit needs of the farmers through a single window, NABARD has enlarged the scope of the KCC, beyond the existing facility of providing crop loan limit, to cover term loans for agriculture and allied activities, including a reasonable component of consumption needs.

6. NABARD AND THE CO-OPERATIVE SECTOR

NABARD provides refinance to state cooperative agriculture and rural development banks (SCARDBs), state co-operative banks (SCBs), regional rural banks (RRBs) and other financial institutions approved by the RBI. The ultimate beneficiaries of refinance from NABARD could be
individuals, partnership concerns, companies, State-owned corporations or co-operative societies.

In the Union Budget for the year 2005-06, it was announced that sugar factories that were operational in 2002-03 sugar season would be assisted to restructure themselves. Accordingly, a Committee was constituted by NABARD to work out a scheme in this regard with representation from the RBI. The Vyas committee had also suggested measures to strengthen the Service Area Credit Monitoring and Information System (SAMIS) under the Service Area Approach (SAA). In this regard, NABARD constituted another Working Group to review the SAMIS reporting system and to initiate necessary modifications/changes required therein.

**Resources of NABARD**: The RBI has been providing General Lines of Credit (LGC) to NABARD under Section 17(4E) of the Reserve Bank of India Act, 1934 to enable it to extend the short-term refinance to state co-operative banks and RRBs. For 2004-2005 (July-June), the RBI sanctioned an aggregate credit limit of Rs. 5,200 crore comprising Rs. 5,000 crore under GLC-I and Rs. 200 crore under GLC-II, at a rate of interest of 6 per cent and 6.25 per cent, respectively. For the year 2005-06 (July-June), a GLC of Rs. 3,000 crore was sanctioned at a rate of interest of 6 per cent per annum for providing refinance to state co-operative banks and RRBs for seasonal agricultural operations (SAO).

**Rural Infrastructure Development Fund (RIDF)**: RIDF was set up with NABARD by the Central Government in 1995-96 to provide loans to the State Governments for financing rural infrastructure projects. Even trenches of allocations have been made towards the Fund since then. Commercial Banks make contributions to the Fund in accordance
with the shortfall in their priority/agriculture sector lending. The scope of the RIDF has been widened since 1999-2000 to enable utilization of loan by *panchayati raj* institutions (PRIs), SHGs and projects in social sector covering primary education, health and 2005-06, has a corpus of Rs. 8,000 crore. Loans under RIDF are sanctioned for the projects under the following broad sectors

1. Rural roads and bridges.
3. Community irrigation wells.
5. Drinking water.
7. Watershed development/reclamation of waterlogged areas.
8. Drainage.
10. Forest development.
11. Market yards/godowns and rural *haats*.
12. Cold storages (public or joint sector) at various exit points.
13. Seed/agriculture/horticulture farms.
15. Grading and certifying mechanisms such as testing and certifying laboratories.
16. Fishing harbour/jetties.
17. Riverine fisheries.
19. Modern abattoirs.
20. Construction of school buildings and public health institutions.
22. Installation of *pay and use* toilets in rural areas.

**Credit Extended by NABARD:** NABARD provides short-term credit facilities to SCBs in respect of eligible CCBs for the following purposes.

1. Financing seasonal agricultural operations (SAO).
3. Pisciculture activities.
4. Production and marketing activities of primary weavers/other industrial co-operative societies.
5. Labour contract/forest labour-cooperative societies.
6. Individual rural artisans through PCS.
7. Procurement, stocking and distribution of chemical fertilizers.
8. Approved agricultural, allied and other marketing activities.

Besides short-term credit limits are also sanctioned to SCBs on behalf of apex/regional weavers/other industrial societies for financing procurement and marketing and trading-in-yarn. Short-term limits are also provided to RRBs for financing seasonal agricultural operations, marketing of crops and pisciculture activities.

Medium-term facilities are also provided to SCBs and RRBs for converting short-term into medium-term loans and for approved agricultural investments. Long-term loans are provided to the State Governments for contributing to the share capital of co-operative credit institutions.

In pursuance of the announcement made by the Finance Minister in June 2004 for enhancing the credit flow to the agriculture sector,
NABARD advised SCBs, CCBs and RRBs on the measures to be taken under various schemes to give relief to farmers. It was apprehended that the implementation of these measures coupled with providing conversion/rescheduled loans to farmers may result in a liquidity problem for co-operative banks and RRBs, impairing their ability to provide fresh loans and achieve the desired growth rate during the year. In order to mitigate this, NABARD introduced a liquidity support scheme during 2004-05 for these institutions. SCBs were sanctioned a liquidity support of Rs. 1,770 crore during 2004-05. NABARD also sanctioned long-term loans to 9 State Governments amounting to Rs. 39 crore as contribution to the share capital of co-operative credit institutions.

**Interest Rates charged by NABARD**

Interest rate on refinance by NABARD is determined by the quantum of the loan and the type of activity/region for which the loan is sanctioned. Considering the softening of interest rates in the economy, co-operative banks were given the option of repayment of entire refinance outstanding above 7 per cent without any prepayment charges to NABARD. Weak SCBs were given the option of resetting interest rate on the high cost of outstanding refinance at uniform rate of 8 per cent, provided that they enter into a Memorandum of Understanding (MoU) with NABARD for implementation of Development Action Plans (DAPs). Interest rate charged by NABARD for term loans effective March 16, 2005 ranged from 6.0 to 6.75 per cent.