

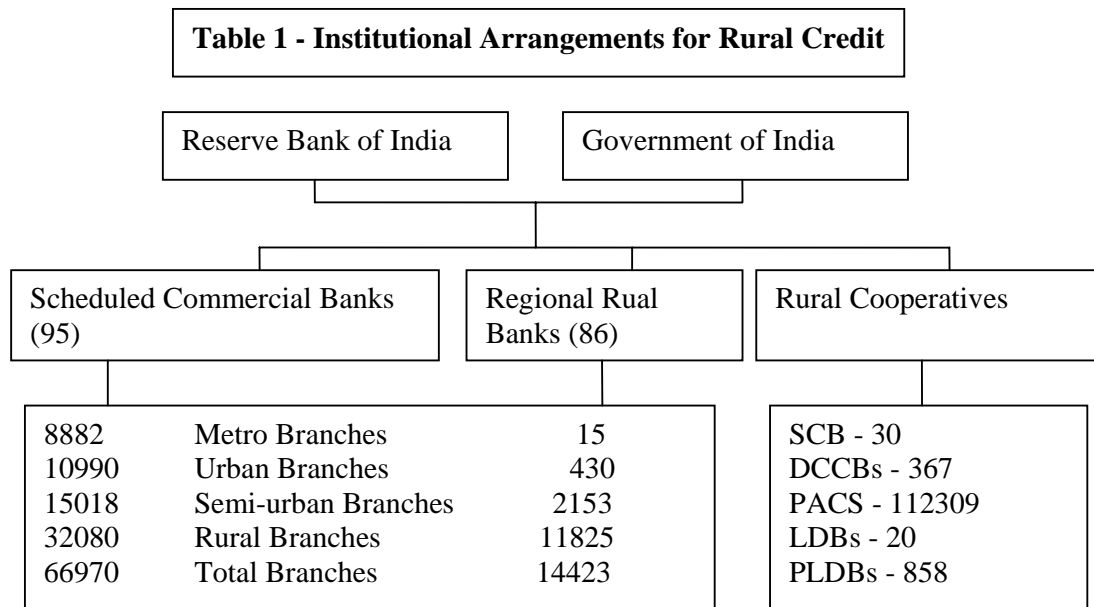
**RESERVE BANK OF INDIA  
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**Managing District Central Cooperative Banks**

*This lesson will provide an overview of the role and functions of a District Central Cooperative Bank and its important place in the Banking System. It will highlight the key areas in a DCCB that require attention for effective functioning of a DCCB.*

**Historical Backdrop**

Cooperatives were the pioneers in the field of rural credit in India. The entire rural credit delivery was more or less a preserve of the cooperative credit institutions from 1904 to 1969, when the nationalization of Commercial Banks and the subsequent emergence of Regional Rural Banks in 1975 heralded the adoption of the Multi Agency Approach to rural lending. Even today, the cooperative credit structure has the largest outreach and delivers credit to the largest numbers of clients in the rural areas in comparison to other institutions, although the quantum of credit delivered is second to commercial banks (Table 1 and 2).



**Table 2 - Agency-wise credit flow 2005-06 and 2006-07**

| Agency       | Credit Flow (Rs. in crores) |                |
|--------------|-----------------------------|----------------|
|              | 2005-06                     | 2006-07        |
| Comm. Banks  | 125,477                     | 140,382        |
| RRBs         | 15,223                      | 20,434         |
| Cooperatives | 39,404                      | 42,480         |
| <b>Total</b> | <b>180,486</b>              | <b>203,296</b> |

Cooperative banking is no different from banking except that in the cooperative structure, the clients are also the owners of the institution and not mere customers. In this way, the bank is basically mandated to serve the local banking requirements

### The Three Tier Structure

The Cooperative Credit Structure in our country has two separate structures. The short term credit structure and the long term credit structure. In the present lesson, we are only examining the short term credit structure.

| <b>TABLE 3</b>  |             |              |             |
|---|-------------|--------------|-------------|
| <b>The Short Term Cooperative Credit Structure in India</b> |             |              |             |
| <b>As on March 31</b>                                       | <b>2006</b> | <b>2006</b>  | <b>2005</b> |
|   | <b>SCBs</b> | <b>DCCBs</b> | <b>PACS</b> |
| Number  | 31          | 366          | 1.09 lakh   |
| Membership(lakhs)   |             |              | 1274        |
| Borrowing Members   |             |              | 451         |
| Own funds (Rs.crore)  | 10420       | 22381        | 9197        |
| Deposits (Rs.crore)   | 45403       | 87996        | 18976       |
| Borrowings(Rs.crore)  | 17030       | 24329        | 40429       |
| Loan Issued(Rs.crore)                                       | 48260       | 73583        | 39212       |

The short term credit structure consists of the Primary Agricultural Credit Societies at the base level, which are affiliated at the district level into the District Central Cooperative bank and further into the State Cooperative Bank at the State level.

| <b>TABLE 4</b>   |                                     |                                  |
|--|-------------------------------------|----------------------------------|
| <b>Number of Loan Accounts and Average Amount of Loan (2004)</b> |                                     |                                  |
| <b>Agency</b>  | <b>No. of loan accounts (Lakhs)</b> | <b>Average loan amount (Rs.)</b> |
| Public Sector Commercial Banks                                   | 164                                 | 32000                            |
| Primary Agricultural Credit societies                            | 639                                 | 7000                             |

Being federal structures, the membership of the DCCB comprises all the affiliated PACS and other functional societies and for the SCB, the members are the affiliated DCCBs.

The DCCB being the middle tier of the Cooperative Credit Structure, it is functionally positioned to deal with the concerns of both the upper and lower tiers. This very often puts the DCCB in a position of balancing competing concerns. While the SCB may

wish the DCCB to prioritize its task in a particular manner, the PACs may have their own demands on the DCCB. Balancing these competing concerns could often be a dilemma for the DCCBs.

### **The DCCB in the Banking System in the District**

The DCCB as the name suggests has an area of operation covering a single district. In any district, the banking system would comprise Commercial Banks, Regional Rural Banks, Cooperative Banks and other agencies like SFC, MFIs, Non Formal Credit institutions and Non Banking Credit agencies. In such a situation, how does a DCCB position itself in the market? This is an issue that needs to be understood by the chief executive of the DCCB. With the available resources and the unique strengths of the DCCB, a market needs to be developed which is appropriate, adequate and profitable. There is room for all, but the capacity to identify ones' niche market enables a bank to be focused and devote its resources to that activity rather than spreading out the resources too thinly across several activities or worse still just drifting along without any clear business plan.

### **ROLE AND FUNCTIONS OF A DCCB**

The District Central Cooperative Banks play multiple roles. Some of these are discussed below:

#### **1. Banking Entity**

The DCCBs are banking entities recognised by the Reserve Bank of India under the Banking Regulations Act. They accept deposits from general public and provide loans to individuals and institutions including primary cooperative societies. They are governed by the various regulations stipulated by the Reserve Bank of India from time to time. Special provisions have been incorporated in the Banking Regulations Act 1949 considering the special nature of their ownership, development role etc.

#### **2. Leader of Cooperative Movement**

One of the most important functions of the District Central Cooperative Banks is to provide financial support to the Primary Cooperative Societies that are affiliated to it in the district. These societies belong to highly diverse categories like the primary agricultural credit societies, the producers cooperative societies, handloom and handicrafts cooperative societies, salary earners' cooperative societies consumers' cooperative societies, primary urban cooperative banks, etc. However, one of the

most important role of the District Central Cooperatives Bank is to support and develop the Primary Agricultural Credit Societies. The officials of the DCCB inspect the PACS affiliated to them periodically. The main source of funds for the PACS is the DCCB and the lending programme of PACS is regularly supervised by the supervisors of the DCCBs. Among the most important line of credit provided by the DCCB to PACS is that for providing production loans for crops to members of PACS. Many PACS also undertake multiple activities like sale of fertilizers and other agricultural inputs and several act as distributors of ration items under the Public Distribution System (PDS). The financial assistance for such activities and other loans provided to members are also sourced from the DCCBs as the PACS usually do not have major resource base of their own. The important source of own resources of the PACS is the deposits placed with it by the members. A specified percentage of such deposits collected by PACS are kept with the DCCBs as reserve deposits to protect the interest of the member depositors.

The DCCBs also provide capacity building support to PACS. They conduct training programmes for secretaries and directors of the board of the PACS. Periodical seminars are also conducted to update the staff and members of PACS on important developments affecting them.

### **3. Leader in Agricultural Lending**

Historically, the DCCBs have been considered as the most important financial institution to support the short term credit requirements of the agricultural sector. These loans include both production loans and marketing loans provided to the members. Usually the production loans are provided on the basis of the "Scale of Finance" which is fixed for each major agricultural crop in the district. The scale of finance is computed by taking the total cost of production of the crop based on average price of inputs, including labour. The yield and market value of the output are also computed and the credit required per hectare for raising the crop is determined. The scale of finance is fixed by a committee called the "District Level Technical Committee" and the DCCB is the convener of this committee. The members of the DLTC include the representatives of the agricultural department, banks, NABARD etc.

**Board of the DCCB**

The Board of the DCCB comprise elected Chairmen of PACS, representative of the State Government and the State Cooperative Bank apart from the CEO of the DCCB who would be the member secretary. The board meets periodically to review the performance of the bank and provide policy guidance.

The board of the DCCB thus represents the interests of the major stakeholders in the bank. The Directors from the PACS take care of the PACS who are major borrowers from DCCBs. The representative of the State Cooperative Bank protects the interest of the major provider of funds to the DCCB. The Government is an important stakeholder as the DCCBs functions under the administrative control of the registrar of cooperative societies. Moreover the bye-laws of the DCCBs are framed under the Cooperative Act of the respective states in which they function. In terms of competencies the Directors from PACS bring in are empathetic understanding of the needs of the members of the cooperative sector in the district. The State Cooperative Bank representative provides mainly banking and regulatory competency while the State Government representative adds administrative skills to the board.

In order to carry out its functions effectively, the board can constitute sub committees of the board.

**Cooperative Governance**

Governance is all about how an institution fulfils its mandate to its members and other stakeholders. It is about commitment to values and ethical business conduct and a high degree of transparency. The governance structure defines the distribution of rights and responsibilities among the different participants in the organization such as the board, executives, shareholders, borrowers and the government and spells out the rules and procedures for making decisions on affairs of the bank. With regard to governance in banks, the issues involved include greater transparency in balance sheet, appropriate internal control systems and having defined and well stated policies. The board is expected to exercise objective judgment on corporate affairs, provide direction, oversee and monitor and act in good faith, emphasis ethical practices, review performance of top management, ensure a wise asset use policy and assure a sound long term policy. The management is responsible for day to day

operations, and the board should provide adequate operational freedom and avoid micro-management.

### **Resource Mobilization**

Any banking institution performs two primary functions; raising resources from those who have financial surpluses and deploying them by providing those to persons who can utilize them productively.

### **Mobilising Deposits**

If raising resources is the key, then from whom are they raised, at what rates are they raised and for what period they are raised become relevant? DCCB being local district level banks, their catchment is the local population. But their own clientele are farmers whose credit needs may exceed the resources available. Beyond their own clients, the bank has to compete in the market with the other institutions for mobilizations. Usually the cooperatives offer a small premium over the rates offered by other banks to attract deposits. But apart from this other methods need to be explored to make cooperative deposits attractive.

One of the most neglected areas in cooperatives is that of deposit mobilisation. Because of the easy availability of resources from higher-tier institution, the Cooperatives have not adequately paid attention to Deposits. However, deposits are the backbone of any banking institution and are a more stable resource for lending.

There is no dearth of deposits in rural areas as can be seen from the CD ratio of Commercial Banks. How do we attract a part of these deposits to the Cooperative Structure? What does a depositor look for when deciding where to park his savings? There are broadly three criteria - safety, profitability and liquidity. Let us examine these three aspects in some detail.

### **Safety**

People desire that their savings should be safe. Several indicators are there such as market reputation of the bank, the outlook of the branch and the experience of the customer with the bank. Much more than what may be the true financial health of an institution, the reputation of the Institution matter is the final sector and needs to be preserved and developed. Therefore, the record of the bank should be highlighted and

every forum should be used to project the positive aspects of the bank. If the financials of a bank are poor, however much they may be concealed, it is difficult to keep it from the gaze of the public. And profitability is a function of good asset management, house keeping and effective business planning. One of the reasons why the cooperative institutions do not attract deposits is their poor financial health.

The other dimension of safety is the feeling of safety that the institutions provide. It is very essential that the DCCB branches match the outlook of commercial banks in the area, as they are the main competitors. All safety measures should be not only there, but visible to customers such as a secure cashier enclosure, a strong room and collapsible gates at the entrance. The depositor should get a feeling that his money will be secure with the bank when he enters the premises.

### **Profitability**

Even though cooperatives in comparison to their peers, deploy money for development in their own area, that in itself would not be reason enough for a depositor to opt to save with the DCCB. The rate of interest offered should be competitive, without being a burden to the bank. Most cooperatives offer a slightly higher interest rate than commercial banks, but unless the rates are fixed after examining the yield on assets, could do more harm than good. The rates of interest should be constantly monitored and periodically reviewed.

### **Liquidity**

Another major factor that depositors look at is the capacity to draw on their money in times of need, irrespective of the maturity period of their deposits. This involves the capacity of the bank to convert the deposit to cash on demand. This becomes a major issue for DCCB branches with low branch level cash limits and no cash/currency chest arrangements. Requesting depositors to wait to get their cash even for a day could adversely impact the reputation of the institution and result in loss of customers and more significantly, word-of-mouth publicity for the bank. The ways to plan for such situations include undertaking data analysis of past trends of cash inflow and outflows and finding patterns, periodically reviewing retention limits of branches and maintaining a "hub and spoke model" with key branches as hubs where cash can be aggregated for transfer in the shortest possible time to the smaller branches, within the day of demand. Maintaining an account with a nearby commercial bank for instant

transfers from Head Offices can also be considered. In the current scenario of shared networks, DCCBs can also enter into arrangements with other banks already having the network to transfer funds on their network, without having to duplicate with their own network.

### **Borrowings**

The second source of resources for DCCBs is borrowings from higher tier institutions. DCCBs have borrowing facilities from their apex level state cooperative banks and from institutions like NABARD. Usually, such credit facilities are provided for a specific purpose and with a fixed tenor. Hence, unlike deposits which in normal course would have a rising trend, while deploying borrowings it is essential to match the tenor of the loan to that of the borrowing so that by the time the borrowings become due for repayment, the loan has come back. The borrowing arrangements of DCCBs are called refinance. DCCBs get refinance from NABARD through the SCBs.

### **Capital and Reserves**

For a banking institution to raise resources either as deposits or borrowings would require that the institution have a capital base consisting of equity and reserves. In a cooperative bank primarily driven by providing credit to its members at a reasonable cost, maximizing return on equity remains secondary. Further, raising capital from the public at large may compromise its mandate. Hence, the equity of the DCCBs is raised from the affiliated member institutions. Normally, as per statute, a borrowing member has to contribute equity in proportion to the borrowings made by the institution from the bank. This does make it difficult for the cooperative banks to have a large capital base and in the present times when capital adequacy is becoming a major issue in banks, cooperatives may in the conventional industry sense be under-capitalized.

To overcome this constraint of capital, State Governments have contributed to the equity of DCCBs to strengthen their capital base, but this has its own pros and cons.

The second source of own capital is the reserves and surpluses created from operations. Operating on small spreads, DCCBs do not accumulate too much surpluses and therefore this forms a small component of the capital base.

**Loans and Advances**

The major business of the cooperative banks is lending. One way of classification of loans is according to the tenor for which the loans are made out.

**Short Term Production Loans**

Short term production loans are extended for raising crops. These are routed through the Primary Agricultural Credit Societies (PACS). For the purpose of extending ST credit, each PACS is required to make an assessment of credit need of its members and forward the same to the DCCB. The DCCB based on the past performance of the society and the resources available with it sanctions funds to the society for disbursement of crop loans to the members. A large portion of the crop loans disbursed by DCCBs is with refinance support from NABARD. The Government of India has introduced an interest subvention scheme whereby loans upto Rs. 3 lakhs are extended to farmers at an interest rate of 7% and Government of India provides a interest subsidy of 2% to the banks.

Short Term Agricultural Credit is a key area of the DCCBs operations and could be considered a mandate of the bank. The needs for short term credit or crop loans have an overriding priority in DCCB loans. Because of the overriding priority that this segment of the lending portfolio of banks attracts, it receives attention from the State Cooperative Bank, NABARD and the Governments both State and Central. The result is that the portfolio is directed and has limited flexibility.

**Scales of finance**

As discussed earlier, the DCCB has a major responsibility in convening the "District Level Technical Committee" on scales of finance (SOF) for the district. These are fixed once a year before the major Crop season in consultation with all the stakeholders. The key inputs in the exercise are identifying all major crops in the district, determining their cost of cultivation and the returns that are coming from the crop and fixing the scale of finance. Since the scales of finance are averages, banks have the flexibility to offer larger loans than the scales fixed for enterprising farmers. The process of fixing a scale of finance is very useful as, it harmonizes the rates across different banks and each bank need not independently arrive at the SOF.

Another major area is the Individual Maximum Borrowing Power (IMBP) fixed by the bank. This limit is based on various factors such as the local valuation of land etc. It is one of the limiting factors that constrain the capacity to lend larger amounts by the DCCBs.

Since crop loan rates are externally pegged and the delivery is usually through the PACS, it constrains the ability for significant innovations in this product.

### **Kisan Credit Card**

Kisan Credit Card is an innovation brought about in the banking system to make short term credit to farmers easy, convenient and flexible. The key features of the scheme are as follows

- One time documentation
- Single limit for whole years requirements
- Requirements for consumption credit are also taken into account
- Any number of drawals and repayments are permitted
- Automatic renewal if the account is regular
- Additional features like personal accident insurance are provided at a small fee in collaboration with insurance companies

The Kisan Credit Card has been a major boon to farmers and has brought in a level of flexibility where the farmer is free to operate the credit limit sanctioned at his convenience.

### **Term Loans**

The cooperatives also offer term loans to farmers. These can be delivered either through the PACs or directly to the farmers by the DCCBs. For such financing, the DCCBs can obtain refinance from higher lending agencies like NABARD, who channelise these funds through the State Cooperative Banks.

Term loans are extended for a wide range of purposes, from excavation of wells, purchase of pump sets to horticulture, animal husbandry and even rural transport like tractors and other farm equipments.

The loan requirement of the project is arrived at based on the aggregate of the cost of various components of investments and then deducting the margin that the borrower will have to provide. The repayment instalment and period is fixed based on the

incremental income that will be derived from the asset and the life of the asset. Usually, for small and marginal farmers, around half of the incremental income is taken for the servicing of the bank loan.

#### **Exercise**

A farmer invested in a well and pumpset costing a total of Rs.100,000. The loan extended by the bank was Rs.80,000.

By creating irrigation facilities the farmer could grow cash crops and his increase in income was estimated at Rs.20,000 per annum.

How would you fix the repayment period for the loan considering the life of the asset as five year and interest on loan at 10% on reducing balance.

#### **Other Loans**

The DCCBs can also extend credit for other activities. One of the major avenues for credit deployment by cooperative banks is extending credit to other cooperative institutions in the district such as Cooperative Sugar Factories, Milk Unions and Cooperative Spinning Mills.

Considering the resources available with the bank and the lending opportunities that emerge, the banks can also deploy credit in other types of loans including jewel loans, consumer durable loans, loans to cooperative credit societies etc. But considering the primary mandate of the bank, these activities can be done only after the agricultural credit demands have been adequately met.

All these potential markets have been well recognized in urban and semi-urban centres, but there is still a vast potential in Rural India where the reach of the Commercial Banks is inadequate and is unfamiliar territory for them. It offers good scope for the DCCBs to build business there.

#### **Portfolio Mix**

What would be the appropriate loan portfolio mix for a DCCB? This question needs to be carefully considered by the bank. For some of the purposes, the resources mobilized are specific and there is no leeway available to the bank except in deciding on whether to undertake it or not and if to undertake, to what extent to go. On the other hand, the bank would have flexibility in deploying its own resources and the considerations that should go into taking a decision would be profitability, safety and the capacity of the bank in handling that portfolio.

**Investments**

Although the investment portfolio of the DCCBs may not be significant in comparison to other institutions, the bank should have a defined investment policy approved by the board, within the boundaries of which the DCCB management can operate.

**Reserves Requirement**

As per Section 18 of the Banking Regulation Act 1949 [As applicable to Cooperative Societies (AACS)] every cooperative society is required to maintain cash reserve ratio (CRR) equivalent to 3% of its demand and time liability. The CRR is to be maintained by the bank by way of cash with itself or by way of balance in a current account with RBI or State Cooperative Bank or by way of net balance in current accounts with SBI/subsidiary/nationalised bank.

In addition to CRR, cooperative banks are required to maintain in cash or in unencumbered approved securities, an amount equivalent to 25% of their demand and time liability as statutory liquidity ratio (SLR) as per the provisions of Section 24 of BR Act 1949 (AACS).

**Cash Management**

Cash is the most liquid asset. However, it is also the most unproductive, as holding cash does not yield any return. Further, holding cash is risky. But then, cash is required to service the day to day needs of the customers. The decision of when the customer will ask for his money is solely in the hands of customers. Based on past trends, it is generally possible to predict the pattern of requirements. Each branch is specified a limit to which cash can be retained, and the balance immediately remitted to wherever there is requirement or to the Head Office for utilization to repay borrowings or invest. Overseeing this process on a daily basis and monitoring it several times a day is essential. This requires both good communication links with all the units as well as appropriate mechanisms for transfer. In some cases, the coop banks tie up with a nearby commercial bank branch to deposit the cash and remit the amount as an instrument instead of cash. In the recovery seasons, the bank requires to monitor the cash balances at the society level and ensure that these balances are transferred to the DCCB as quickly as possible.

### **Customer Service Standards**

Banking being a customer driven enterprise, it is necessary to benchmark oneself by setting performance standards and comparison with the industry standards. The standards should not only be developed by the organization, but also stated publicly through display boards so that customers can know and compare for themselves the quality standards that are provided.

### **House Keeping**

House Keeping in any banking institution is the key to effective working. At each unit of the Bank, the books of accounts need to be written up on a daily basis and reconciled periodically to ensure that there is minimum scope for any irregularities and frauds. The cash book should be closed at the end of each day and the cash balance as per the cash book reconciled with cash on hand. All other ledgers need to be reconciled periodically, preferably every fortnight. With the computerization in banks, these tasks have been greatly simplified and automated.

### **Inter Office Transactions**

Most transactions between the various units in the cooperative credit structure take place through inter-office entries. These need to be regularly set-off as they are one of the most potent areas for frauds and irregularities. Originating and responding to inter office transactions needs to be authorized by a senior officer, and documents supporting the transaction should be maintained at each end. At the head office level, all inter office transactions should be monitored and unreconciled entries tracked. By the end of the accounting year the effort should be to have no unreconciled entries in the books.

### **Sundry and Suspense Account**

Another major area to be monitored and managed very carefully is the sundry and suspense account. This is a temporary head of account where debits and credits are made when the transaction has not been concluded. For example, an advance provided to an officer for undertaking an official tour. In such cases it is expected that the bills are submitted and settled within reasonable time. Often, many such entries remain unresolved and get carried into the balance sheet as an item of asset. At the beginning of the next accounting year, the aggregate amount gets reflected as an opening

balance, and unless closely monitored may become loss assets of the bank. A periodic review of Sundry/Suspense balances at every accounting unit is a must.

### **Internal Checks and Controls**

The internal checks and controls is an integral part of the management of any business organisation. The methods of operations adopted have to be guided by standardized procedures and practices so that there is uniformity across different branches/offices of the organisation. Such checks and controls are necessary to prevent and irregularities of omission and commission duly the course of daily business. The internal checks and controls presupposes the occurrences of human error as a natural phenomenon and tries to obviate them. It also prevents and dissuades employees and clients from willful perpetration of frauds and malpractices.

Sound checks and controls are critically important for the banking system as not only do they deal in money, but are the repositories of public savings held in trust. The goodwill and public confidence are crucial elements for the survival and growth of banks. The internal checks and controls play a vital role in maintaining the reputation of banks and is key to a string financial sector in the economy. A loss of public confidence in banking system can severely retard growth.

### **Objectives of Internal Control System**

The objectives of Internal Control System are to ensure that :-

1. Business of the bank is conducted a prudent and orderly manner in accordance with pre-laid out, established policies.
2. All transactions in the bank are conducted only under specific or general authority given to specific staff.
3. All assets of the banks are properly and adequately safeguarded and all liabilities are controlled.
4. Accounting norms and uniformity in practices are followed.
5. All records are systematically maintained to provide complete, accurate and timely information.
6. Risks associated with the business are identified and assessed.

The elements of Internal Control in a district central cooperative bank are :

1. Accounts control

2. Administrative control
3. Concurrent audit
4. Internal Audit / Inspection
5. Vigilance cell and fraud monitoring arrangements
6. Review by Board of Directors

### **1. Accounts Control**

Proper maintenance of accounts, upkeep of appropriate ledgers, supporting subsidiary ledgers, other registers are important in the context of accounts control. The bank follows standard practices of accounts and the basic books in uniform formats are maintained by all offices/branches of the bank. The internal and ongoing control mechanism include daily posting of the ledgers, verification of entries by offices from the vouchers. The officers who verify the entries and the clerks who make primary entries are specifically allotted such work and are personally responsible. The books are periodically balanced which ascertains the accuracy of maintenance of books. The balancing is carried out at specific periodic intervals and a subsidiary balancing ledger is maintained. The books of the bank is certified as tallied and the balances in the subsidiary balancing ledger tallies with the balances in the General Ledger.

### **2. Administrative Control**

Various administrative measures are followed to ensure the soundness of internal checks and controls. These include rotation of the staff engaged in sensitive accounting and cash handling activities, periodic transfer of staff etc. These controls also include delegation of financial powers in respect of sanction of advances post sanction monitoring etc.

### **3. Concurrent Audit**

Concurrent audit in district cooperative banks is usually carried out in larger branches. This is to ensure that the vouching and accounting is done appropriately and that the delegated powers are used properly.

### **4. Internal Audit / Inspection**

Audit is carried out periodically by the internal auditors of the banks. The audit on the one hand helps to ensure that the accounts are correctly reflected in the books. On the other, it also gives valuable feedbacks to the management about systemic lacunas, and risk areas. The internal audit essentially ensures that the books are properly maintained and that the annual accounts reflect the true and honest financial position of the bank. Audit deals with financial transactions of the organisation.

The banks also carry out internal inspections. The inspections are broader in its coverage and content than audit. Typically the internal inspection of a DCCB include the review of loan decisions, documentation, use of delegated powers, adherence to internal checks and controls, and branch management aspects. It also critically review the books of accounts and various other housekeeping aspects. Inspection, in fact, can be stated to be a qualitative review of the affairs of the organisation.

### **5. Vigilance Cell and Fraud Monitoring Arrangement**

Frauds often occur in banks due to criminal deception of persons singly or in collusion with others. Unfortunately, there is a rising trend of misappropriations, embezzlements, defalcations etc. in the Central Cooperative Banks. Such frauds in banks are perpetrated through encashment of forged documents, manipulation of accounts, operations of fictitious accounts. Unauthorised credit facilities granted for reward or illegal gratifications, facilities provided to close relatives without proper appraisal, complicity in manipulation of records and documents while granting excess loan, etc. are also types of frauds prevailing. These frauds have multiplicity of negative effects in banks. The first and most important is the injustice to the depositors. It is a criminal breach of trust towards them and results in the loss of goodwill among the present and potential clients. In rare cases, if frauds of such large intensity or very frequent in occurrence can result in a run on the banks. The second fallout is the weakening of the morale and ethical value system in the bank. Frauds occur mostly due to laxity in internal checks and controls. It is often seen that the internal staff come to know of frauds much before auditors and management become aware of these. The pecuniary gains resulting from frauds may draw more persons to commit such acts. The third impact on the bank is the actual physical loss of money. This will impact the profitability of branches/banks as provisions may have to be made.

It is the primary responsibility of the management to prevent frauds. The management counters the situation essentially in two ways. The first by preventive vigilance. This include the review of existing systems, periodically ascertaining that laid down procedures are followed, staff is rotated as desirable, officers use delegated powers appropriately, examine that security items, records etc. are properly maintained. Insistence on regular reporting by branches to head office; and identification of any exceptions to normal trends in the business of branches, analytical review of such trends etc. are carried out. The management also insists that fraud prone areas are identified by internal auditors and special efforts are taken to

tighten checks and controls in such areas. Usually, the District Cooperative Banks insist upon the Branch Managers to issue a monthly certificate to the head office. The branch manager certifies that the cash balances are correct, books are balanced, that important accounts are checked by specific officers with names; returns are verified and submitted to higher authorities on time. Such certification makes the branch managers and other verifying/authenticating officers personally accountable for the proper compliance with laid down systems, procedures, checks and counter checks. Surprise checks are also conducted in branches as a measure of preventive vigilance.

The second approach is to initiate investigations/enquiry against all cases of fraud. Both internal enquiries as well as criminal investigation by the police are preferred. It is important to note that the investigations must be conducted diligently so that deterrent punishment is meted out to the perpetrators. In certain cases, the bank management has shown reluctance to prefer police complaints fearing the loss of confidence of the general public. But this is neither the right practice nor the right rationale. Frauds can have outsiders involved in it, may be committed due to extortion, outside pressure, external criminal nexus etc. It may be committed with the help of powerful elements within the bank. Such ramifications shall be exposed only outside, neutral agencies. It is, therefore, insisted that frauds are reported to higher agencies like NABARD and RBI and that cases are immediately registered with the police. The modus operandi of frauds are subjected to detailed scrutiny to understand the weaknesses in the existing systems and introduce newer checks and controls as well as modifying the method and periodicity of checking and reporting as the case may be.

## **6. Review by Board of Directors**

The management reports the status of the compliance with internal checks and controls in head office departments and branches to the board. The delays in reporting by branches, improper monthly certifications, deviations between certification and actual verifications etc. are reported. Reports on any frauds detected and progress in ongoing enquiries are also reported. The board is apprised of the status of housekeeping and accounts. The board generally appoints an audit committee which goes into the details of such reports, call for clarifications etc. The reports of internal audit and inspections are also reviewed by the board.

## **Human Resources Management**

Managing Human Resources in a DCCB is one of the greatest challenges of senior management. The geographical area of operation being limited and the staff local, intimate relations with the clients develop short-temporary postings in which works to the advantage of the DCCBs as compared to the Commercial Banks. The recruitment and promotion policies are generally approved by the cooperative department, (Registrar of Cooperative Societies) entry level positions in DCCBs such as field supervisors are filled both by the promotion of secretaries of PACS and by open market recruitment. For the officer cadres also, the vacancies are filled from both the feeder cadre and by direct recruitment. In view of the precarious financial position of many DCCBs there was a freeze on recruitment. This has caused impediments in filling up vacancies arising from retirements and depletion in staff further aggravating the problems of the CCBs. Fresh recruitment of professionally qualified staff and increasing use of technology can ease the situation considerably.

As DCCBs do not have the opportunity to recruit staff on an ongoing basis, it is essential that the capacity building of the available staff is given a high of attention. The banking industry like the Indian economy is moving very fast, and to keep pace with the changes, the cooperatives will have to provide continuous exposure to their employees the best and the latest happenings through participation in training, seminars and workshops.

## **Audit and Inspection**

It is mandatory for all banks to undergo periodic audit and inspection. Audit is the verification of the books of accounts of the bank to confirm that they present a true and fair picture of the financial position of the bank. This process if done on an ongoing basis is called concurrent audit. Normally, the audit of the DCCBs is conducted by the auditors of the cooperative department. In some states, this work can also be undertaken by Chartered Accountants. One of the points of note is that a large part of the portfolio of DCCBs comprises the outstanding to farmers at the PACS. Hence, the financial health of the DCCB will be impacted by the health of the PACS. As of today, the financial statements of the DCCBs do not reflect the aggregation of the financials of the PACS, as they are fully autonomous entities.

The inspection of the DCCBs is undertaken by NABARD on a periodic basis to confirm that the bank is working in a manner that is not in detriment to the interest of the borrowers. Inspection goes beyond the domain of Audit and sees several aspects including policies, procedures and their operations.

### **Inspection of District Central Cooperative Banks**

All District Central Cooperative Banks are registered under the Banking Regulations Act and are under the regulatory control of the Reserve Bank of India. The banks are expected to follow the various relevant provisions of the Banking Regulations Act and are subjected to periodical supervision to ensure that they function as per the provisions of law and with prudence. In the case of the DCCBs, National Bank for Agriculture and Rural Development has been designated as the supervisor along with Reserve Bank of India. However, as a matter of convention, Reserve Bank usually do not exercise its powers to inspect these banks. The supervision of banks are carried out by on-site inspection as well as by offsite surveillance. The offsite surveillance is carried out by scrutinising statements submitted periodically by the banks. These statements and their periodicity are prescribed by the supervisors. The statements relate to the position of non-performing assets, the

The onsite inspection is carried out by supervisors at the premises of the bank. The supervising officers scrutinise the books of accounts, decision making processes, internal checks and controls, management practices, policies, funds management etc. of the bank. The onsite inspection is considered to be the main platform of supervision in the Indian context so far.

### **Objectives of On-site Inspection**

The objectives of the on-site inspections are several. The first objective is to ensure that the bank conducts its business in such a manner that the interest of all present and future borrowers is protected. It must be remembered that the banks collect deposits from the public and hold it in trust with the promise that it will be returned to the depositors, either on demand or at the end of specific terms. The second key objective is to ensure that the business of the bank is conducted in conformity with the relevant acts, rules, regulations, bye-laws and various other directives issued by the Reserve Bank of India. There are several provisions of the BR Act and the State Cooperative Societies Act that are required to be followed by the banks. These includes continuously maintaining minimum prescribed cash balances, maintaining

balances in investments in government bonds, deposits with higher tier agencies at prescribed ratios to the total deposits held by the banks, submitting regular returns to RBI & NABARD, etc. The inspections also look at the various rules, guidelines etc. prescribed by the Government, RBI, NABARD, etc. from time to time and the adherence of the bank to these. The fourth important objective of the on-site inspection is to examine the financial position of the bank, assess the financial soundness and the correctness of maintenance of the books of accounts. It also looks at the managerial soundness of the bank. This includes the review of the process of decision making, the delegation of power and its use, the policies laid down by the management and adherence to it etc.

The on-site inspections also is a tool used by the supervisors to understand the weaknesses in the banks and to develop an action plan to take care of such weaknesses as well as to help the bank to grow. Thus the supervisors examine the various aspects of the bank with a view to understand the bank in its totality. This would mean that the inspection also takes into account the potentials, the strengths and weaknesses and the risks to which the specific bank is exposed to in its business environment. In other words, it is not an exercise to locate only operational deficiencies and find faults.

### **Coverage**

The on-site inspection focus on the core areas of the bank's functions. These include the analysis of the financial position, management, internal checks and controls and the compliance with regulatory and policy requirements.

The basic approach of Inspection of the DCCBs is called the 'CAMELSC' approach.

This stands for

1. **Capital**
2. **Asset Quality**
3. **Management**
4. **Earnings**
5. **Liquidity**
6. **Systems &**
7. **Compliance**

The coverage of the inspection is designed such that the process concentrates on the more important areas of supervisory concern broadly the three key areas are the

financial position and performance, the management and operating systems and the compliance review. The key elements under each of these broad areas are briefly discussed below.

## **I. Financial Position and Performance**

The following areas are reviewed critically:

- i) **The Asset Quality:** The two most important assets of the bank are the loans and advances and the investments. During inspection the quality of the banks portfolios under these two categories are critically analysed. The policies of the bank in building its assets, the adherence to various laws, rules and prudential practices and quality of the portfolios are analysed. Any deviations from norms, suspicious trends, concentration in any specific sector etc. are reviewed.
- ii) **Solvency and Capital Adequacy:** The solvency of the bank means, as in the case of any other business, that the net worth of the bank is positive. This means after taking into consideration all losses, provisions required for bad loans, investments, frauds etc., the bank has a positive capital base. The capital adequacy is a concept which ensures that the bank has a minimum positive net worth to take care of its normal business risk. The capital adequacy ratio is stipulated by the Reserve Bank of India. Though a specific stipulation has not yet been prescribed in the case of DCCBs, the inspection computes the capital adequacy to ensure that the bank's overall financial position is healthy.
- iii) **Liquidity:** The liquidity position is one of the most critical aspects of banking in general. Liquidity of the bank ensures that the depositors can be paid their money either on demand or when the term of their deposits expire. The liquidity is assessed in two aspects. The first is the compliance to statutory requirements. All DCCBs are required to maintain 3% of their total Demand and Time Liabilities (DTL) as liquid cash either with them or as current account balances with the State Cooperative Banks. Similarly, they are also required to invest 25% of their DTL in fixed deposits with State Cooperative Banks or other investments approved by the Reserve Bank of India. The second critical analysis is about the term for which bank has built up assets and liabilities. The bank must ensure that the total volume of its loans/advances and investments

that gets repaid/matured in one year's time is equal to the volume of deposits are borrowings that it has to repay during one year's time. Such analysis can be done for different buckets of time, like two years, more than two years etc.

- iv) **Borrowings:** The bank often has to borrow from higher financing institutions to provide adequate funds for loaning. The borrowings are always made either from or through the State Cooperative Bank. The bank is eligible for refinance from higher financing agencies like NABARD, NHB, NCDL etc. These borrowings are made through the SCB, while direct borrowings are also made from them. The terms and conditions of such borrowings, the actual need for borrowing, rate and the proper utilisation and timely repayment etc. are evaluated during inspection.
- v) **Earning Performance:** The two most important parameters that is reviewed during inspection to assess the earning performance of the bank are (a) the Net Interest Margin and (b) the Net Margin. The Net Interest Margin (NIM) is the difference between the total interest paid by the bank on its deposits and borrowings and the total interest earned on its loans/advances and investments. The Net margin is arrived at after deducting all the other expenses from the NIM and then adding all other income of the bank to it. It is usually expressed as a percentage to total assets.

## **II. Management and Operating System**

The inspection reviews through major aspects in this area. There are the management quality at the level of the Board, the CEO and the supervisory staff of the bank, the various management systems and the informal checks and controls. The soundness of the manage decisions, the adherence to various systems, internal checks and controls are reviewed.

## **III. Compliance Reviews**

The bank is expected to meticulously follow the various policy guidelines issued by the Reserve Bank of India, NABARD, State Cooperative Banks, State Government etc. from time to time. It is also required to follow various statutory provisions and said periodical statements and reports to RBI & NABARD. The banks' adherence to these is reviewed and critical comments made during the inspection.

### **Prudential Norms**

Sweeping reforms are taking place in the world economies and the financial systems. One of the major fall-outs of these reforms is that there is a high degree of cooperation and integration among world economies. The Indian Economy and the financial system is no exception to this. As a result, one global understanding is that all financial institutions shall follow similar systems while representing their financial positions. One approach to achieve this is to adopt prudential norms. Prudential norms mean the use of prudent benchmarks and common yardsticks to understand the financial position of financial institutions. Thus, the position of a bank in India using prudential norms can be compared with a bank in another country. It will also reflect the real position of the bank.

The major prudential norms adopted in Indian Banking system are:

1. Income Recognition and Asset Classification
2. Exposure Norms
3. Capital Adequacy

Such norms were used in Indian banking system for a long time, but the benchmarks and norms varied from institution to institution. In the case of the District Cooperative Banks the first two norms have been adopted till now.

### **Income Recognition and Asset Classification (IRAC) Norms**

The income recognition and asset classification relates to transparency. The international practice in banking is that a loan account is treated as 'Non-Performing Asset' (NPA) if either the interest or an instalment is overdue for a specific period of time. All income that accrues in such accounts is not recognised as income. Simultaneously, all loan accounts which are classified as NPA are required to be provided for in anticipation of possible losses. These loans are classified into three categories:

- i) Sub Standard Assets
- ii) Doubtful Assets
- iii) Loss Assets

Loans in which either interest or instalments are overdue for more than 90 days to 36 months are classified as sub-standard assets. 10% of the outstanding loan amount has

to be provided for towards anticipated losses by charging the Profit and Loss account of the DCCB. If the loan is overdue for beyond a period of 36 months, it is classified as doubtful assets. The doubtful assets itself is further sub-classified into three viz:

- i) Doubtful Assets I if it is overdue for a period of 36 to 48 months
- ii) Doubtful Assets II if it is overdue for a period of 49 to 72 months
- iii) Doubtful Assets III if it is overdue for a period more than 72 months

As per the existing norms, the DCCBs are required to provide 20%, 30 % and 60% of the outstanding amount respectively for the above three sub-classifications. The provisions shall be increased to 100 % by 31 March 2010 for the third category of doubtful assets.

The last category is the loss assets which are loan accounts identified by the banks, or its auditors or supervisors (NABARD/RBI) as unrecoverable for any reason. 100% of such loans shall have to be provided for certain relaxations, however, have been allowed for loans for agricultural purposes. In this case, loan is considered as NPA only if it is overdue for two crop seasons and the 90 days norm is not applicable.

Apart from the provisions for the delinquent loan assets, the banks are required to provide 0.25 % of all outstanding standard loan assets to provide cover for any normal business losses that may arise in future.

### **Recovery**

In any banking operation, the profit comes not only from lending but from the ability to recover the money lent out. This is a function of not only a proper appraisal system that makes correct assessment of the capacity of the project to generate cash flow for the borrower to repay. In the agricultural sector, the crop harvests are seasonal and so it is essential to track the operations of the farmer and trap the cash flows before they disappear. The cooperative structure has its own recovery mechanisms. As explained above, the timely recovery of the loans lent both by the DCCB directly as well as through PACS will determine if the loan assets are performing or non performing. The longer the loans remain unrecovered, the quality of loans become that much worse. Apart from this, poor recovery of loans will also impair the ability of the DCCB to get funds from the State Cooperative Banks as well as refinance from higher financing agencies like NABARD, SIDBI, NHB etc. These institutions usually

stipulate that unlimited amount of refinance is available; depending on actual requirements, if the NPA levels of the DCCB is low at 25% or less and beyond certain percentages no refinance would be available.

The approaches for recovery of loans can be classified into three. These are preventive steps, corrective steps and coercive steps. Some elements of these are indicated below:

#### 1. Preventive steps

- (i) Proper scrutiny and appraisal of loan proposals.
- (ii) Proper assessment of the borrower regarding his/her ability to utilise the loan and willingness to repay.
- (iii) Regular and effective follow up
- (iv) Proper documentation
- (v) Regular monitoring of the loan portfolio at the bank level to catch early warning signals.
- (vi) Raise demand notices in time to remind the borrowers about prompt repayment.

#### 2. Corrective Steps

- i) Personal visit to houses/business centres of defaulting clients.
- ii) Joint visits by DCCB and PACS officials.
- iii) Special recovery efforts by members of the board, particularly the elected Directors from PACS.
- iv) Motivate staff for regular follow up through acknowledging performance, monetary incentives etc.
- v) Adopting innovative strategies like using Self Help Groups to encourage villagers to repay, holding recovery camps, organising farmers clubs, facilitating marketing of crop produce at right prices, promoting contract farming etc.

#### 3. Coercive Steps

- i) Repeated visits to the member
- ii) Sending legal notices
- iii) Attaching security of available through legal process.
- iv) Using Lok-Adalats for quick settlement.
- v) Conducting public auction of previously attached properties.
- vi) Using revenue recovery act.

However, it must be remembered that very often external factors also contribute to loan defaults, particularly in agricultural and allied activities. These include the occurrence of natural calamities like drought, floods etc. which are beyond the means of the borrowers to cope with. Similarly, market/economic reasons can also adversely affect recovery. Lower prices, lack of demand for produce during particularly year etc. will affect the cash flow of borrowers negatively and result in loan defaults. It is necessary to take a sympathetic view towards such reasons and allow loans to be rephased or rescheduled. This will provide longer period for the borrowers to repay providing fresh loans to carry on the activity during the next academic season is also recovery.

### **Cooperatives and Microfinance**

The self help group movement in India has by now established strong roots all across the country. A typical group comprises 15 – 20 women who come together to do savings and internal lending and in due course obtain access to resources from the banks. The linkage of the SHGs was mainly with the commercial banks and regional rural banks, due to the difficulty of the cooperative banks in dealing with an unregistered body. This matter has since been addressed by several states by carrying out necessary amendments to the state acts to enable SHGs to become members of the DCCBs and borrow funds. Some of the DCCBs have recognised the unique potential that microfinance business has and have established special cells for the purpose.

The role that can be played by DCCBs in microfinance has been demonstrated by Bidar District Central Cooperative Bank Ltd, Karnataka. Bidar DCCB has involved all its 44 branches and 171 PACS in promoting SHGs. Almost all the economically poor families have been covered under SHG movement. More than 10,000 SHGs have been formed and 80% of them enjoy bank linkages which include SHGs of artisans, physically challenged and even beggars. Bidar DCCB has sponsored an NGO, Sharada Rural Development and Self Employment Training Institution for imparting skill development and up-gradation trainings for the interested members of groups free of cost.

#### **Member Education**

Although member education remains in the domain of the Cooperative Union, it is essential that the Executives of the DCCB remain in continuous touch with their clientele of borrowers. This helps in better understanding of each other and develops

a level of trust that provides sustaining support in adverse conditions. It also helps the management to continuously have their ear to ground and get direct feed back on the impact of their work and the perception of the grassroots and their expectations. Therefore, it is essential that every executive of the DCCB as a matter of rule should be out in the field to the maximum extent possible. He should convey to the members the various policies and priorities of the bank and the financial position of the bank and the need for responsible conduct by the members and their active involvement in the affairs of the bank.

### **Restructuring of Cooperatives**

As discussed above, the three tier Cooperative Banking structure in India plays a vital role for providing production credit to the agricultural sector in the India. It is also the most important source of financial support to other primary cooperative societies. But, unfortunately this sector is besought with several weaknesses. The Government of India has felt the need to revamp the three tier cooperative banking network and constituted the committee to "Restructure and Revitalise the Cooperative Banks", under the chairmanship of Professor Vaidyanathan. This Committee is also popularly known as the Vaidyanathan Committee.

The Committee has identified several major weaknesses in the system. Some of these are :

The cooperative credit system is impaired key areas of Governance, Management and Financial Stability.

The system has submerged in a high degree of politicisation affecting prudence in Governance.

Poor governance has led to poor management of the banks and the adoption of poor policies. The cumulative effect have been huge losses in all the three tiers, particularly the DCCBs and PACS.

The state government interference in the governance is often rampant with the boards often superseded for flimsy reasons. Inordinate delays have been noticed in conducting elections auditing etc. Quite often there is both political and administrative interferences in the operations of the banks and societies.

Weaknesses are observed in housekeeping, particularly reconciliation of books, balancing of books recovery follow up etc.

Political and administrative interference in the most vital aspect of recovery of loans is seen to be rampant.

Various forms of loan waiver schemes announced by government of the time have adversely affected both the credit discipline among members as well as the overall financial stability of these institutions.

The Vaidyanathan Committee has, therefore, recommended the implementation of a revival package covering three broad areas :

Financial Assistance.

Legal and Institutional Reforms and

Measures to improve quality of management.

#### 1. Financial Assistance

The Cooperative Banks and PACS shall be provided financial assistance under a revival package so as to make them strong to serve the credit needs of the rural people, particularly the small and marginal farmers. Such revival package shall include assistance to wipe out accumulated losses also. The financial package shall also increase the capital base of the banks/societies and reduce the government share of equity to 25% of the total subscribed share capital of the society. Cost of training and capacity building to improve the financial management skills of the staff and board of directors is also envisaged. Financial support shall be made available for installation of uniform accounting and monitoring systems and computerisation of PACS.

#### 2. Legal and Institutional Reforms

Full membership rights to all users, including depositors

Wider access to all institutions for borrowing and investment

Ensuring elections before end of tenure of Boards

Exit of State equity and consequent withdrawal from Boards

Empowering RBI to directly exercise full regulatory authority in financial matters

#### 3. Measures to improve Quality of Management

Co-option of professionals on Boards

Reduction of State intervention in administrative and financial affairs

Limiting powers of State to supersede Boards

Introduction of Prudential norms and audit by CAs

**Implementation**

The Government of India has accepted the Vaidyanathan Committee recommendations and rolled out the programme for Revival of the Cooperative Credit Structure. NABARD is the nodal implementing agency for the programme. By April 2008, 19 states had accepted the package and commenced implementation.

**Conclusion**

Efficient management of the DCCB requires multi-dimensional approach. On the one hand the Board of Directors have to provide direction and leadership by giving adequate operational autonomy to the functional managers. The depositors at the DCCBs see it as a banking institution and expect service on par with other commercial bank while borrowing members expect timely adequate and low cost credit. Balancing these expectations requires the DCCBs to be very efficient in its operations and up-to-date in its housekeeping. The management of DCCBs therefore requires understanding of these multiple dimensions and performing accordingly to match the expectations of the stakeholders.

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