India’s Co-operative Banks on the Route to Financial Inclusion

Prasanna S H[1] **Rajunaik S**[2]

1. Assistant Professor
   Department of Commerce and Management
   Govt First Grade College
   Rippanpet, Shimoga (Dist)
   Email: haladappaprasanna@gmail.com
2. Librarian
   Govt First Grade College
   Holehonnur, Shimoga
   E-mail: rajunaik_sb@yahoo.com

Abstract: *Financial inclusion has increasingly attracted attention of the global community in recent years. The importance of financial inclusion can be explained in terms of maximizing the proportion of population covered by the formal financial sector, to enable the chanelling of funds for productive investment, controlling inflationary tendencies, and monitoring and widening the tax base among other things. This paper looks at the role of the cooperative banking system in promoting financial inclusion. It discusses the genesis of the credit cooperatives supported by the district central cooperative banks (DCCBs) in enabling the provision of financial services to low income families. These institutions are currently the subject of reform programmes intended to make them more efficient and effective as providers of financial services if not necessarily as promoters of inclusion.*

Key Words : *Financial Inclusion, Cooperative Banks, Financial Services.*

1. Introduction:

Financial inclusion has increasingly attracted attention of the global community in recent years. The Blue Book on inclusive finance, a UN publication of 2006, raises the question fundamental to financial inclusion “why are so many bankable people unbanked?” A look at the efforts aimed at financial inclusion worldwide: a Financial Inclusion Task Force and a financial inclusion

fund in the UK, a civil rights law, Community Reinvestment Act (CRA) in the United States, and a host of initiatives like the Committee on Financial Inclusion in India leading to the establishment of a Financial Inclusion Fund – indicates that financial inclusion has been recognized as an issue of central importance in both developed and developing countries.

What is financial inclusion? Put simply, financial inclusion means giving people access to relevant financial services at an affordable rate. The ambit of financial inclusion can differ depending on how policy makers define it. The definition, in turn, depends on the evolution of banking services in a country and the ambition of the policy makers. In a country where a large proportion of the population is unbanked, a characteristic of many developing countries, financial inclusion has a different meaning compared to a developed country where only a small minority does not have a bank account. In the case of the former, opening a basic bank account might amount to financial inclusion whereas in the case of the latter financial inclusion might imply making available a gamut of financial services such as credit, insurance and pension plans

The importance of financial inclusion can be explained in terms of maximizing the proportion of population covered by the formal financial sector, to enable the channeling of funds for productive investment, controlling inflationary tendencies, and monitoring and widening the tax base among other things. The nature of financial exclusion and the reasons for it could vary between countries and within a country but the consequences of such exclusion are uniform.

While financial inclusion may have gained currency internationally in recent times, in India the process of financial inclusion has been on the radar of policy makers for at least four decades. The key mechanisms through which the Government of India has attempted to address the issue of financial inclusion has been through;

1. *Maximizing the spread of the commercial banking system*
2. *The development of the co-operative banking system including primary cooperatives as well as cooperative banks, and*
3. *The creation of an extensive network of Regional Rural Banks (RRBs).*

This paper looks at the role of the cooperative banking system in promoting financial inclusion. It discusses the genesis of the credit cooperatives supported by the district central cooperative banks (DCCBs) in enabling the provision of financial services to low income families. These institutions are currently the subject of reform programmes intended to make them more efficient and effective as providers of financial services if not necessarily as promoters of inclusion.

2. A Huge Effort to Reform the Cooperative System

The performance of the cooperative credit system has been the subject of ongoing debate, not just in recent years, but over many decades. Some of the early efforts to develop and build a strong cooperative credit system have been well summarized in the report of the most recent study group to suggest ways to improve its functioning, the Vaidyanathan Committee of 2004. Within the past ten years, however, there have been three other committees

1. Capoor Committee, 1999: Task Force to study the functioning of the Cooperative Credit System and suggest measures for its strengthening.
2. Vyas Committee, 2001: Expert Committee on Rural Credit.
3. Vikhe Patil Committee, 2001: Joint Committee on Revitalization Support to Cooperative Credit Structure.

The Vaidyanathan Committee documents the deterioration in the functioning of the cooperative credit system, particularly in the 1980s. "The State gave primacy to cooperatives as the sole means of delivering institutional credit to rural areas and injected large and increasing amounts of funds directly. Upper tier cooperative banks were encouraged to accept public deposits and borrow from other financial institutions." The cooperative credit system was also used by the state to channel its development schemes, especially subsidy programmes for the poor. The committee's report notes that "As the financial involvement of the government in cooperatives increased, its interference in all aspects of the functioning of cooperatives also increased…often compelling them to compromise on the usual norms for credit worthiness, [which] ultimately began to affect the quality of the portfolio of cooperatives." In short, the cooperatives "became a conduit for distributing political patronage."

The Vaidyanathan Committee made a comprehensive set of recommendations for the revival of the cooperative credit system. These included;

1. Special financial assistance to wipe out the accumulated losses and to strengthen the capital base of the cooperative credit institution. Responsibility for funding these losses was divided amongst the Government of India (agricultural loans of cooperative banks and all credit businesses of PACS), the state governments (non-credit businesses of PACS, credit guaranteed by them and other receivables from them) and cooperative credit societies and banks themselves (return of state government equity and direct loans made by them voluntarily).

2. Radical changes in the legal framework to empower the Reserve Bank of India – as the banking regulator – to take action directly to ensure the prudent financial management of cooperative banks. This entailed the enactment of legislation at the state level for facilitating an appropriate governance and supervisory structure including provisions to be incorporated in existing Cooperative Societies' Acts to enable this process.

3. Improvement in the quality of personnel at all levels of the cooperative credit system through capacity building and other interventions that would lead to an improvement in efficiency. This would include improvements in efficiency through the establishment of a new and enhanced common accounting system, management information system, internal controls and audit mechanisms, enhanced credit appraisal and risk management, business diversification, product development and HR as well as financial literacy and awareness of rights and responsibilities amongst PACS members.

Thus, the measures recommended required the state governments first to sign up to the Government of India's scheme including legal and regulatory changes to be followed by the enactment or amendment of appropriate legislation. The release of funds to the states for this reform process would then be linked to a number of administrative measures;

3.1 Reconstitution of boards of management, elected with no state government nominees.

3.2 Cooperative banks accept criteria of eligibility for board membership

3.3 Professionally qualified (as prescribed by RBI) persons are appointed as CEOs of banks and properly trained personnel as secretaries of PACS.

3.4 All employees are answerable to the boards of cooperatives and CEOs and staff is appointed by them.

3.5 Boards are limited to policy decisions and reviews while the CEO and staff screen, appraise and decide on loan applications and take actions necessary to ensure recoveries.

3. Will Cooperative Reform Enable Inclusion?

After nearly two years of the reform process for financial cooperatives, one of the key lessons that has emerged is that the lack of a common accounting system and ineffective audit procedures over the years have resulted in a chaotic financial picture. Lacking appropriate accounting for non-performing assets (NPAs), no accounting for depreciation and other similar problems have made it impossible to determine the correct aggregate financial status of the cooperative credit system. In some cases the accounts have been found to be incorrect by as much as 90% of the total size of the balance sheet of a primary cooperative. As a result, the initial focus of the reform programme has been on using the new common accounting system (CAS) to calculate a corrected figure for accumulated losses so that recapitalization can be expedited. It will become easier to determine the true financial position of the DCCBs to facilitate, in turn, their recapitalization.

The use of CAS to calculate the true financial position of PACS clearly has potential to be reasonably accurate and the subsequent recapitalization of the societies is likely to create reasonably clean balance sheets. However, the possibility of this process being seen by some PACS as a "bonanza" to extract extra recapitalization funds on the basis of massaged balance sheets cannot be ruled out. Nevertheless, the reasonably clean balance sheets of most societies resulting from this exercise would (subject to the conditions set out below) provide the PACS and DCCBs with a new opportunity to revitalize and provide their services to members in an effective and efficient manner. If this were to happen, it would encourage the members to make better use of the cooperatives' financial services. In practice, however, this will only happen if a number of conditions are met. These conditions include

3.1 Professional governance free from political partisanship.

3.2 PACS seen as the members' own institutions and not as an extension of the historical system for extending state subsidies.

3.3 Competent financial management undertaken professionally at both the society and DCCB levels.

Here in lies the challenge; in a politically charged environment where public elections are held virtually every year to select representatives for different levels of government – national parliament, state assemblies, local government – the re-activation of the PACS and DCCB governance structures is more

than likely to reinforce considerations of political patronage. Ensuring that such considerations remain subdued and subordinate to the overall goal of cooperative revitalization will take a concerted effort at restraint at all levels of the political system; something that has not been in evidence in recent years.

In a tradition of lack of competence and discipline in financial management combined with rent-seeking by PACS managers, the likelihood of improved management resulting from training alone is not high. However, a focus on rigorous audits and inspection along with repeated efforts at follow up training could start to create some impact in the long run. It is a decadal rather than a short term programme which will work well only in tandem with improved local governance. Small wonder then that the credit-deposit ratios of cooperatives in India are high resulting from the reluctance of their members themselves to trust their savings to such shaky financial management. the credit deposit ratios of DCCBs have actually risen from less than 80% to over 100% during the current decade. Regrettably, it is most likely that the present effort at reviving the cooperatives will see a sharp, but temporary, improvement in the functioning of the cooperative credit system before a gradual decline again sets in. Periodic improvements of this type have become the norm since the creation of the cooperative system in 1904; there is little in the latest programme to give hope of any better results this time around. The only silver lining is that the high economic growth of recent years has provided the central government with more resources to repay the debt it is incurring for this purpose from the international development agencies – the ADB and the World Bank. To the extent that this latest attempt will inject the cooperative credit system with the resources to continue to provide large numbers of people with at least partial financial services – before another capital injection is required – this exercise is worthwhile; that it will provide a major, long-lasting impetus to the process of financial inclusion is unlikely.

Conclusion

It is apparent from the discussion above that the amalgamation and reform process has lost touch with the original objective of promoting cooperative banks as an instrument of financial inclusion. Though that goal is increasingly being force-fed to the banking system as a whole through the mechanism of "no-frills" accounts and implemented through under-paid business correspondents, it is unlikely that this strategy is sustainable. The purpose of this is to assess the recent operational experience of cooperative banks to

determine their contribution to financial inclusion and to document the constraints such banks face in furthering that process. The results of these assessment will throw further light on some of the issues referred to devise a comprehensive set of recommendations on ways in which the co operative banking system can be supported in maximizing its contribution to providing financial services to low income clients.

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