

**NATIONAL FEDERATION OF URBAN COOPERATIVE BANKS  
AND CREDIT SOCIETIES LTD. (NAFCUB), NEW DELHI****PRE BUDGET MEMORANDUM (2018-19)**

National Federation of Urban Cooperative Banks & Credit Societies Ltd. (NAFCUB) incorporated in 1977 is an apex level promotional organization of urban cooperative banks and credit societies in the country. NAFCUB is one of the designated 21 national cooperative societies included in the second schedule of the Multi State Cooperative Societies Act, 2002, providing a forum for discussion and follow up issues relating to Urban Cooperative Banks (UCBs) and Credit Societies with the concerned authorities/regulators.

**Background**

Urban co-operative credit societies, in their formative phase were organized on a community basis to meet the credit needs of their members. From its origin then to today, the thrust of UCBs, historically, has been to mobilize savings from the middle and low income urban groups and purvey credit to their members – majority of which belong to weaker sections. In 1966 there were about 1106 UCBs with deposits and advances of Rs.167 cr. and Rs.153 cr. respectively. Since then urban cooperative banks have shown phenomenal growth in terms of their numbers, size and scale of operations.

Urban Cooperative Banks play an important role in meeting the credit requirements of low and middle income groups of the society both in urban and rural areas. In 2005, Reserve Bank of India envisaged a road map for growth and development of UCBs through its Vision Document. To revive the Urban Cooperative Banking Sector, RBI's multi-layered regulatory and supervisory strategy has led to a gradual reduction in the number of UCBs through mergers/amalgamations of viable urban banks and the exit of unviable ones. As on 31.3.2017, there were around 1562 urban cooperative banks in the Country with 11,000 branches spread across the Country serving 5 cr. customers belonging to poor and marginalized sections of the society. The deposit mobilization by UCBs as on aforesaid date was Rs.4,43,000 Cr. and extended loans & advances of Rs. 2,61,200 cr. Urban cooperative banks have been categorized into Scheduled and non-scheduled banks. There are only 54 scheduled UCBs, which are specified in the Second

Schedule of RBI Act and are transmitting 46% business of the Sector. Most of the non-scheduled UCBs are unit banks or with less than 5 branches that are meeting credit needs of poor and marginalized sections of the society.

There are around 50000 credit societies in the Country. While majority of credit societies are state specific, there are around 300 credit societies registered under provisions of Multi State Coop. Societies Act.

The Urban Cooperative Credit Sector is playing unique and efficient role in financial inclusion and inclusive growth of the country. They are participating voluntarily in Prime Minister's Pet Scheme of "Jan Dhan Yojna" (PMJDY) in a big way.

### **Issues Concerning Urban Cooperative Banks**

#### **1. Deletion of Sec.80(P)(4) & Restoration of tax benefits under Sec.80(P)(2)(a)(1) of Income Tax Act 1961**

Cooperatives have historically been given some concessions in income tax for the reason that cooperatives are organized by people of limited means and that they are essentially mutual organizations. Sec 80(P) of the I.T Act 1961 was carefully conceived provision for deductions in respect of cooperatives doing certain types of business. The credit cooperatives, including cooperative banks were also included in the provision and as per Sec 80(P)(2)1, income derived out of banking business was exempt from income tax. Although the entire income tax foregone by the exemption to the 2000 odd cooperative banks (1600 urban cooperative banks, 31 St. coop. banks, 370 DCCBs and 20 St. ARDBs), with membership of over 25 million of urban banks alone, would not have exceeded Rs. 1000cr. then (now it could be Rs.2000cr.) the deduction was however withdrawn in 2006-07, with insertion of a new sub section 80(P)(4) to the Act.

The entire sector pleaded with the then Finance Minister to continue the deduction provision as the cooperative banking sector catered almost entirely to agriculture, small business in unorganized sector of economy, and to small housing loans and had many constraints of raising capital besides being predominantly mutual entities where profits were considered surplus that were indivisible and were ploughed back into the system, thus giving no advantage to share holders (read members) individually, in terms

of appreciation of value of their shares( unlike in case of the shareholders of companies).

Over 90% of the urban cooperative banks are very small entities providing basic banking services to the people of very limited means. These banks make very small surplus which need to be ploughed back to shore up their CRAR requirement in order to stay afloat. It was not fair to decide to impose income tax on the entire sector on the basis of profits earned by a few of the largest cooperative banks, which they did despite many constraints.

We have to submit that the sector has clarified to the Ministry all the points raised by them. They were with regard to adherence to concept of mutuality, the claim of the Dept., that only a small percentage of banks(2%) were brought under tax net when actually all the cooperative banks are covered, that cooperative banks were making huge profits, that bringing the cooperative banks under tax net would improve their governance, and that leaving the cooperative banks untaxed would be economically inequitable, and that some relaxations were provided to cooperative banks in the next budget etc.

It would therefore not be fair to look at the cooperative banks from certain technicality of the "principle of mutuality" alone. It needs to be accepted that they are, in effect, mutual entities for all practical purposes. While it needs to be acknowledged that they are overwhelmingly mutual in their operations, it must also be kept in mind that these banks are social sector financial institutions and they deserve tax breaks to survive and compete.

A large number of cooperative banks could get progressively wiped out over a period of time because they will not be able to retain enough surpluses, as a third of it has to be given as income tax, and at the same time they will also not be in a position to raise required capital, on account of inherent constraints of cooperatives in going to the markets. The consequent reduction in number of coop. banks will definitely affect a sizeable portion of vulnerable sections of the society who will be forced to go back to the folds of the local moneylenders.

**The issue of taxing income of cooperative banks needs to be viewed from the overall perspective of importance that the Government is attaching to the role of the cooperative banking sector in the financial system in its larger scheme of ensuring 100% financial inclusion to be the foundation of its stated objective of inclusive growth.**

**It is therefore requested to kindly delete the Section 80(P)(4) which was introduced in 2006-07 and restore the pre 2006 position in respect of deductions to cooperative banking institutions .**

**It is suggested that the pre 2006 position is brought back into the statute book for the following strong reasons:-**

- Avenues of raising capital for cooperative banks are limited to increase in shares from their members which cannot be tapped beyond a level. The only other way of augmentation of owned funds is retained earnings.
- Concept of "one-member-one-vote", absence of any co-relation of net worth of the cooperative bank and its share value, absence of any trading platform for transfer of shares at their market value, and above all, the non-perpetual nature of shares of co-operatives, negates the presumption that the "retained surplus" of cooperatives are to be termed as "profits" in spirit and be taxed. It is for this reason that the earnings of credit cooperatives are not taxed in two thirds of the countries of the world.
- A strong reason attributed by World Council of Credit Union, for exemption of retained earnings of cooperative banks from tax is the fact that these amounts increase the lendable resources of the cooperative banks who extend credit to the needy sections of society, providing value addition to the economy.
- Localised institutions like urban cooperative banks ensure that funds mobilized from a particular area are utilized for the benefit of people of that area in contrast

to the commercial banks, who use a good portion of funds mobilized in rural areas or less developed states in metros and other well developed areas.

This is all the more relevant in the Indian context. The amount that is collected as income tax from the cooperative banking sector every year, if left in the hands of cooperative banks, would augment their capital base to help them increase their deposits and provide loans to the tune of about 10 times of the tax amount. These loanable funds would go primarily to marginal farmers, artisans, urban poor, petty traders, self employed and lower middle class sections of the society.

Tax from cooperative banks is not very significant and it could easily be foregone in the larger interests of the cooperative banking sector and the underprivileged sections of the society. This is particularly important when viewed from a very valid assumption that the customers that are not accommodated by the cooperative banks turn to private money lenders and very rarely they approach the commercial banks.

- Out of less than 2500 cooperative banks that are liable to pay income tax, nearly 1600 are urban cooperative banks. Most of these urban cooperative banks are very small. In fact, mere 2% of the urban banks account for 40% of the resources. It, therefore, does not stand to reason to tax 98% of such small socio-economic entities, particularly when they have very few avenues of raising capital.

**Thus, taking the following factors into consideration i.e.:**

- † **international practice of leaving out retained surplus of cooperatives from taxation;**
- † **“retained earnings” strictly not in the nature of “profits” in the cooperative system;**
- † **absence of any market value being attributable to the shares of cooperatives;**
- † **absence of alternative avenues of raising capital for cooperative banks and their requirement to maintain certain minimum levels of CRAR;**

- † **nature of the client profile of cooperative banks and direct benefits that the cooperative banks can pass on to these clients, if their retained earnings are not taxed;**
- † **extremely small size of over 90% of the urban cooperative banks and the nature of clients they cater to;**
- † **the direct impact on marginal farmers/urban poor; no flight of resources from less developed regions to affluent regions.**

**It is submitted that the issue of imposition of income tax on cooperative banks be kindly revisited and the applicability of Sec.80(P)(2)(i) of the Income Tax Act be restored for cooperative banks by deletion of Sec.80(P)(4) that was introduced through Finance Act 2006.**

**Further, there are certain deductions which are available to commercial banks and cooperative banks have been denied those on account of the construction of the relevant sections.**

**2. Sec.80(c)(xxi) of the Income Tax Act 1961 – Inclusion of deposits with non-scheduled cooperative banks for eligibility**

The clause (xxi) was introduced to Sec.80(c) of the Act in 2006 to include term deposit for a fixed period of not less than 5 years with a scheduled bank to be included as investments eligible for deduction for the purposes of Sec.80(c). Of the 1800 urban cooperative banks, only 53 are scheduled banks. The non-scheduled urban cooperative banks are disadvantaged on account of the discrimination against them. Deposits are being shifted from non-scheduled cooperative banks to scheduled commercial banks, since very few centers in the Country have scheduled cooperative banks.

It is submitted that the clause (xxi) be amended to

- i) include “and a cooperative bank” after “scheduled bank”;
- ii) replace “for a fixed period of not less than 5 years” by “for a fixed period of not less than 3 years”;
- iii) add in the explanation “and a cooperative bank means a State Cooperative Bank, a Central Cooperative Bank and a Primary Cooperative Bank, as defined

in Sec.5 (as modified by Sec.56(AACS) (cci) of the Banking Regulation Act 1949".

### **3. Extension of jurisdiction of Debt Recovery Tribunals to hear the cases of recoveries of cooperative banks debts**

At present the Debt Recovering Tribunals do not accept the recovery cases of non multistate cooperative banks as the Debts Due to Banks and Financial Institutions Act 1993 is not applicable to the cooperative banks. The number of loan accounts of over Rs.10 lacs have increased manifold even in the cooperative banks, over a period of 10 years.

It is submitted that the cooperative banks may also be kindly brought under the purview of the Debts Due to Banks and Financial Institutions Act 1993, so that they become eligible to approach DRTs for recovery of their dues.

**We request the Hon'ble Finance Minister to kindly include the amendment to the Act to make cooperative banks eligible to take advantage of DRT.**

### **4. Loans to Directors of UCBs and their relatives**

Consequent to the collapse of MMCB, and the stock market scam in 2001, as per the Report of JPC, RBI had prohibited urban cooperative banks from sanctioning of loans to its directors and their relatives. This was partially modified later to permit loans against own FDs and LIC policies. ***The Federation has been requesting RBI to at least treat directors of urban banks on the same footing as directors of commercial banks in this regard and permit them facilities from their banks that are allowed as per B.R. Act. There is a case for full restoration of loan facilities to directors with a cap on the aggregate of such loans.*** At present the directors of urban banks, many of whom are traders/owners of MSMEs/professionals are largely handicapped on account of the fact that their proposals for business loans of relatively small amounts are not entertained by commercial banks, since they have to be sanctioned by the boards of commercial banks, (as they are

directors of banks). Thus, many persons in the town are disinclined to continue as directors of urban banks. This issue needs to be addressed.

## **5. Financial Resolution and Deposit Insurance Bill 2017**

The Financial Resolution and Deposit Insurance Bill 2017 is based on the Report of the Committee constituted by the Central Government for the purpose. The legislation is a sequel to the Insolvency and Bankruptcy Code 2016, as it was decided that financial service providers were different from other companies and a special legislation covering their insolvency and bankruptcy was needed to be enacted. It was also recommended in the report that the law should provide for formation of a Corporation that will take over deposit Insurance function from DICGC. All types of financial service providers are included under the new entity.

Chapter XVII containing Sections 120 and 121 have apparently been included on account of the fact that cooperative banks are the only financial service providers that are in the List II i.e. the state list in the Constitution and the powers to make laws regarding resolution is with the states, while the existing DICGC Act has been made applicable to them with specific provisions having been introduced in the cooperative societies acts of all the states. Therefore some specific steps are needed to be taken for the cooperative banks to be brought under the purview of Financial Resolution and Deposit Insurance Bill.

Section 120 refers to "eligible cooperative banks" in the context of deposit insurance cover to be provided by the new Corporation as per provisions of this Bill.

Section 120 states

*"(1)On the commencement of this Act, an eligible co-operative bank as defined under clause (gg) of section 2 of the Deposit Insurance and Credit Guarantee Corporation Act, 1961, shall, be deemed to be an eligible co-operative bank for the purposes of this Act for a period of two years which may be extended by a further period not exceeding one year, as may be notified by the Central Government or until the law governing such eligible co-operative bank meets with the requirements of this Act, whichever is earlier.*



*(2) If on the expiry of the period specified in sub-section (1), the law for the time being governing the co-operative bank fails to meet the requirements of this Act the cooperative bank shall cease to be an insured service provider under this Act.*

**The Federation feels that subsection (2) as above is highly unjust towards cooperative banks who could be deprived of the insurance cover for no fault of theirs. Some states may be reluctant or may take more than the prescribed 3 years to make necessary amendments to the cooperative societies acts. It is for the Centre to convince or compel the states to amend the acts to fall in line with Financial Resolution and Deposit Insurance Bill and transfer the resolution powers in respect of cooperative banks to the Corporation.**

**We therefore request that Section 120(2) may kindly be dropped.**

Section 121 states

*"121 (1) An eligible co-operative bank may be wound up in the following circumstances, namely:—*

- (a) the co-operative bank has failed to comply with the requirements specified in section 11 of the Banking Regulation Act, 1949;*
- (b) the co-operative bank has by reason of the provisions of section 22 of the Banking Regulation Act, 1949 become disentitled to carry on banking business in India;*
- (c) the co-operative bank has been prohibited from receiving fresh deposits by an order under sub-section (4) of section 35 of the Banking Regulation Act, 1949 or under clause (b) of sub-section (3A) of section 42 of the Reserve Bank of India Act, 1934;*
- (d) the co-operative bank having failed to comply with any requirement of the Banking Regulation Act, 1949 other than the requirements laid down in section 11 thereof, has continued such failure or, having contravened any provision of that Act has continued such contravention beyond such period or periods as may be stipulated in that behalf by the Reserve Bank of India, from time to time, after notice in writing of such failure or contravention has been conveyed to the co-operative bank;*
- (e) the co-operative bank is unable to pay its debts; or*
- (f) in the opinion of the Reserve Bank of India,—*

*(i) a compromise or arrangement sanctioned by a competent authority in respect of the co-operative bank cannot be worked satisfactorily with or without modifications; or*

*(ii) the continuance of the co-operative bank is prejudicial to the interests of its depositors.*

*(2) Without prejudice to the provisions of any other law for the time being in force, a co-operative bank shall, for the purpose of clause (e) of sub-section (1), be deemed to be unable to pay its debts—*

*(i) if, on the basis of the returns, statements or information furnished to the Reserve Bank of India in pursuance of the provisions of the Banking Regulation Act, 1949, the Reserve Bank of India is of opinion that the co-operative bank is unable to pay its debts; or*

*(ii) if the co-operative bank has refused to meet any lawful demand made at any of its offices or branches within two working days, if such demand is made at a place where there is an office, branch or agency of the Reserve Bank of India, or within five working days if such demand is made elsewhere and, in either case, the Reserve Bank of India certifies in writing that the co-operative bank is unable to pay its debts”*

**The MSCS Act 2002 and the cooperative societies acts of all the states presently have provisions regarding winding up of cooperative banks and appointment of liquidator. The provisions empower the Registrar of cooperative societies to order winding up and to appoint Liquidator, invariably at the instance of the RBI.**

**In order for the process of winding up of a cooperative bank to be initiated under the above provision and other relevant sections of the new act, the cooperative societies acts of states and the MSCS Act will have to be extensively amended and until such time, the existing provisions will apparently continue.**

**In the event of delay by the states in the carrying out all the required amendments, the cooperative banks should not be put in difficulties or kept under uncertainties.**

Apart from the above observations, it is felt in general, that cooperative banks were till now handicapped by having to comply with diktats of two regulators, i.e. the RBI and the Registrar of Cooperative Societies of the State where a cooperative bank is registered . Now in having to be answerable to a third authority also will make the working of cooperative banks that much more difficult.

## **6. Issues concerning DICGC**

### **a.) Enhancement in coverage limit**

There is a genuine case for increasing the limit of coverage from Rs.1 lac to Rs.5 lac as the last time the limit was hiked was over 20 years back. This will help the smaller urban banks as there is a tendency to keep deposits only to the limit of insured amount with these banks, even though most of them are healthy banks. The argument that of some PSBs that they do not need deposit insurance is not well conceived as they are trying to flex their muscles on account of the implicit sovereign guarantee they have, being owned by Govt. The other argument for linking increase in cover limit to risk based premium is also unfair to all cooperative banks. Risk is based on the sectors the banks have exposure to. While St.coop banks and DCCBs have majority of exposure to agriculture, the urban banks have high exposure to small business, micro enterprises and their 90% advances are of below Rs5lac value. These are relatively higher risk sectors and the beneficiaries the loans are those whom the commercial banks generally do not actively solicit. The cooperative banks who fulfill a social purpose should not be penalized with higher premium for carrying higher risk. ***Therefore the limit of insurance cover should be increased appropriately without an increase in rates of premium.***

### **b) Claims of depositors with deposits above Rs1lac to be at par with claim of DICGC**

The DICGC Act provides for first claim of the Corporation on any amounts realized by liquidation of assets to the extent of payments made by the DICGC to the depositors on cancellation of license of a bank. This needs to be reviewed. There are number of cases

where depositors having deposits of over Rs.1 lac would be deprived of their amount while the insuring Corporation that has only met its obligation as insurer in the normal course after taking the insurance premium, gets the first charge. ***Claims of the depositors whose deposits are not covered are should at least have parsi passu status with that of DICGC on the proceeds of recoveries of the banks whose licenses have been cancelled by RBI.***

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