THE URBAN CO-OPERATIVE BANK:
A CASE STUDY

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Dedication

This book is dedicated to my beloved mother
Preface

The term Urban Co-operative Banks (UCBs) though not formally defined refers to primary co-operative banks located in urban and semi-urban areas. These banks till 1996 were allowed to lend money only for non-agricultural purposes. This distinction does not hold today. They essentially lent to small borrowers and business. Today, their scope of operations has widened considerably.

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

This book cover growth and profile of the origin of urban co-operative banks. The critical evaluation of the performance by taking some financial indicators is made. Suggestions are given based on the research findings for better performance.

Author
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1.1 **INTRODUCTION**

Co-operative emerged into the scene mainly as an offshoot to solve the problems at the grass roots levels, be it in England, Germany, India or any other part of the world. Co-operative first emerged in the 19th century with a view to eliminate the ills of both public and private business and enterprises.

The term co-operatives derived from the Latin word 'co' meaning 'together' and 'opus' meaning 'to work'. A group of people under a common leader form a co-operative body and appoint a managing committee, board of directors and chairman to drive the functional aspects of the co-operative in the right directions. In every nation, co-operative has played an active role in the empowerment of rural areas. Co-operative have contributed there might in the development of the economies all over the world. In India, co-operative are playing a major role in filling the gaps left by the public and private sectors.

The modern day co-operative movement is built a voluntary co-operative where in individual make a deliberate choice to co-operate in some aspects of their life. Co-operative has been...
successful and they have reformed the market place where they have become strong enough in their respective fields.

1.2 CO-OPERATIVE BANKS IN INDIA

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

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

1.3 CO-OPERATIVE STRUCTURE

The Co-operative structure in the country consists of different constituents. At the base of this structure are primary societies which render various types of services. Of this a large number, about 80 per cent, is concerned with agriculture. Most of these societies, about 60 per cent, deal with credit. Thus, a large proportion of primary societies is related to agriculture and credit. This feature of countries, co-operative structure is natural. The reason is that India is an agricultural economy and the problem of credit has all along been a serious one, mostly for farmers. In fact, the co-operative movement in the country was initiated to solve this problem of credit for agriculturists. In the sphere of co-operative credit, there are, over and above the primary societies, central banks at the district level and above them are the banks at the state level, known as apex banks. The function of supplying long-term credit through credit co-operatives performed by separate institutions, called land mortgage or land development banks.

Primary Societies:

- Primary co-operative societies, which form the base of the structure, perform various functions relating to such things as credit, irrigation, marketing, transport, etc. These are generally divided into two groups (1) Credit Societies; and (2) Non-credit societies.

Each one of these two groups is further split up into two sub-groups: (a) agricultural societies, and (b) non-agricultural societies. Agricultural societies, credit and non-credit, are to be found in rural areas and non-agricultural societies, credit and non-credit, in urban areas.

Central and State Banks:

The supply of credit is the most important service being rendered by the co-operative movement. For supervision and financial assistance co-operative credit societies, there are central
banks and state co-operative banks. Central banks supervise the functioning of primary societies of a district or a part of district and offer financial assistance to them. In addition to primary societies, individuals can also become members of these banks. Their capital is drawn from public deposits share capital and loans from other sources. Because of a variety of sources from which these banks draw money, they act as a link between co-operative societies and the money market. By diverting funds of surplus societies to the needy societies, these banks function as balancing centers. Central banks also perform ordinary banking functions such as accepting deposits, transacting through cheques, etc.

**Apex Banks:**

At the top of co-operative credit is the state co-operative bank at the state level, known as the apex bank. It controls the working of the central banks and finances them, and through them helps primary co-operative societies. It also acts as a link between the Reserve Bank of India which it borrows and central banks and primary societies. It direct the co-operative movement in its state.

**Land Development Banks:**

Long-term loans are given by land development banks. In most states, the structure of these banks consists of two parts. At the state level there is central land development bank and below it at the block/tehsil/subdivision levels, there are primary land development banks. Land development banks obtain their funds from share capital, reserves, deposits and issue of bonds, and debentures. However, the major part of their resources is drawn from the floating of ordinary debentures in the market. The investors in these debentures are Life Insurance Corporation, Commercial Banks, the Reserve Bank of India, Co-operative Banks and Central and State governments.

**1.4 URBAN CO-OPERATIVE BANKS IN INDIA**

The term Urban Co-operative Banks (UCBs) though not formally defined refers to primary co-operative banks located in urban and semi-urban areas. These banks till 1996 were allowed to lend money only for non-agricultural purposes. This distinction does not hold today. These banks were traditionally centered around communities, localities workplace groups. They essentially lent to small borrowers and businesses. Today, their scope of operations has widened considerably.

The origins of the urban co-operative banking movement in India can be traced to the close of nineteenth century when, inspired by the success of the experiments related to the co-operative movement in Britain and the co-operative credit movement in Germany such societies were set in India. Co-operative societies are based on the principles of co-operation, mutual help, democratic decision making and open membership.

The first urban co-operative credit society was registered in Kanjivaram in the erstwhile Madras province in October, 1904. Amongst prominent credit societies were the Pioneer Urban in Bombay (November 11, 1905), the No. 1 Military Accounts Mutual Help Co-operative Credit Society in Poona (January 9, 1906), Cosmos in Poona (January 18), Gopak Urban (February 15, 1906) and Belgaum Pioneer (February 23, 1906) in the Belgaum district, the Kanakavli-Math Co-operative Credit Society and Varavade Weavers Urban Credit Society (March 13, 1906) in the south Ratnagiri District. The most prominent amongst the early credit societies was the Bombay
Urban Co-operative Credit Society, sponsored by Vithaldas Tackersey and Lallubhai Samaldas established on January 23, 1906.

The Co-operative Credit Societies Act, 1904 were amended in 1912, with a view to broad basing it to enable organization of non-credit societies. The Meclagan Committee of 1915 was appointed to review their performance and suggest measures for strengthening them. The committee observed that such institutions were eminently suited to cater to the needs of the lower and middle income strata of society and would inculcate the principles of banking amongst the middle classes. The recommendations of the committee went a long way in establishing the urban co-operative credit movement in its own right.

1.5 MARKET SHARE OF UCBS

As on March 31, 2006 there were 1853 UCBS, 84 Scheduled commercial banks and 398 Rural Co-operative Banks in India. An analysis of market share of various banks groups indicates that the share of UCBS in total bank deposits is relatively low. Nevertheless, their market share grew steadily from 3.3 per cent in 1990-91 to high of 6.6 per cent in 1888-2000, but thereafter gradually declined to 4.8 per cent in 2005-06, as shown in the following table:

<table>
<thead>
<tr>
<th>Year ended March 31</th>
<th>Urban Co-op.Banks (UCBs)</th>
<th>Rural Co-operative Banks (RCBs)</th>
<th>Regional Rural Banks (RRBs)</th>
<th>Commercial Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td>4.5</td>
<td>7.2</td>
<td>2.5</td>
<td>85.8</td>
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<tr>
<td>1997</td>
<td>4.9</td>
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<td>2.6</td>
<td>84.9</td>
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<tr>
<td>1998</td>
<td>5.3</td>
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<td>1999</td>
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<td>2000</td>
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<td>7.7</td>
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<td>82.9</td>
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<tr>
<td>2001</td>
<td>6.3</td>
<td>7.2</td>
<td>2.9</td>
<td>83.6</td>
</tr>
<tr>
<td>2002</td>
<td>6.4</td>
<td>7.2</td>
<td>3.0</td>
<td>83.4</td>
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<td>2003</td>
<td>6.3</td>
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<td>3.0</td>
<td>83.7</td>
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<tr>
<td>2004*</td>
<td>5.8</td>
<td>6.6</td>
<td>3.1</td>
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<td>2005*</td>
<td>5.3</td>
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<tr>
<td>2006*</td>
<td>4.8</td>
<td>5.5</td>
<td>3.0</td>
<td>86.7</td>
</tr>
</tbody>
</table>

* Provisional data (Share of RCBs arrived on the basis of projections as their total deposits as on 31.3.2006 is not available.)
1.6 GROWTH OF UCBs

In 1996, when the Banking Regulation Act made applicable to UCBs, there about 11,000 UCBs with deposits and advances of ` 167 crore and ` 153 crore respectively. As at the end of 1996, the member of UCBs increased to 1501 and their deposits and advances rose significantly to ` 24,161 crore and ` 17,726 crore. The UCBs continued to grow at a fast pace till 2003, when their number increased to 1941 and their deposits and advances to ` 1,01,546 crore ` 6,64,880 crore respectively. Subsequently, the number of UCBs declined in 2006 to 1853 with total deposits of ` 1,12,237 crores and advances of ` 70,379 crore. An overview of their growth is given in Table 2 below, the spectacular growth of UCBs in the late nineties and up to 2003, which had resulted increasing their penetration, ironically, also led to certain weaknesses in the sector that adversely affected public perception and thereby, their competitiveness. A major reason for the decline in public confidence was the crisis faced in 2001 by a large multi-state Bank in the state of Gujarat, when the bank witnessed a sudden ‘run’ on its branches, following rumors of its large expose to a leading broker who had suffered huge losses in the share market. The large-scale withdrawal of deposits within short time had resulted in severe liquidity problems for the bank. The bank was also holding about ` 800 crore of inter-bank deposits from a large number of UCBs in the state and from other states, which posed a systematic risk. In order to protect the interests of the general public and also that of the other co-operative banks, RBI had issued directions to the bank restricting certain operations (acceptance of fresh deposits, restricting payments to any single depositor to ` 1000/- and on fresh lending) and requisitioned the Central Registrar of Co-operative Societies, New Delhi to supersede the Board of Directors and appoint an Administrator. The bank was subsequently placed under a scheme of reconstruction with the approval of Reserve Bank of India.

The Gujarat episode was followed by another major crisis in the state of Andhra Pradesh in 2002, when one of the largest banks in the state faced a run, following a newspaper report regarding an enquiry instituted in the affairs of the bank by the State Registrar of Co-operative Societies. The bank was in a weak position, and ultimately, after attempt for its revival failed; its license was cancelled by the Reserve Bank in 2004.

The decline in public confidence in the UCB sector deepened in the aftermath of the crisis in Gujarat and Andhra Pradesh concomitantly, the position of UCBs generally deteriorated. As on 30, 2004, 732 out of 1919 UCBs were categorized in Grade III or IV signifying weakness and sickness. Recognizing the systemic risks and keeping in view the needs of its clientele, Reserve Bank reviewed the entire gamut of legislative, regulatory and supervisory framework for these banks, and in March 2005, brought out a 'vision' document for UCB. The vision document, which was drawn with the main objective of maintaining the viability and competitiveness of UCBs, discussed the characteristics of the sector, analyzed the problems afflicting the banks and proposed strategies for dealing with problems affecting the sector.

1.7 SALIENT FEATURES OF UCB SECTOR

The UCB sector is unique in that there is significant degree of heterogeneity among the banks in this sector in terms of size, geographical distribution performance and financial strength. There is also diversity among the urban co-operative banks in the levels of professionalism,
standards of corporate governance and access to advanced technology. Most importantly, the banks in this sector are under dual control, with a part of the powers vested in the State Government and part with Reserve Bank. The Reserve Bank is, therefore, continuously evolving the regulatory and supervisory framework for UCBs to ensure their soundness without sacrificing their competitiveness.

(a) Heterogeneity

While on the one hand, there are a number of small neighborhood banks functioning for mutual interest of their members, on the other, there are several large UCBs with a wide network of branches, large number of depositors and borrowers, many of whom are medium/large corporate. In the latter kind of UCBs, the co-operative structure remains in organizational arrangement and their business model and goals are more akin to commercial banks.

(b) Dual Control

Urban co-operative banks are regulated and supervised by both, the State Governments, through the Registrars of Co-operative Societies, and by the Reserve Bank of India. The Registrars exercise powers in regard to incorporation, registration, management, amalgamation, reconstruction or liquidation. In case of banks having presence in more than one state, the Central Registrar of Co-operative Societies, on behalf of the Central Government, exercises such powers. The banking-related functions such as issue of licence to start new banks or branches, matters relating to interest rates, policies on loans and investments, prudential norms etc., supervised by the Reserve Bank of India.

(c) Competition and UCBs: Market Scenario

Since 1991, the financial system has seen several reforms. The process of liberalization was set in motion with gradual removal of restrictions on the operation of the pricing mechanism, especially interest rates and statutory liquidity and reserve requirements – a process which is still underway. Enhanced competition both banking and non-banking financial sectors has been gradually introduced – through a dynamic mix of public and private as well as domestic and foreign ownership — along with deregulation and adaptive regulations. Simultaneously, regulation and supervision of banks, financial markets and infrastructure were improved to increasingly align them with international standards and best practices. The market-driven economy, through deployment of more capital, advanced technology and skilled human resources, is posing stiff and increasing completion to all traditional institutions, stiff and increasing completion to all traditional institutions.

1.8 UCB POSITION

Market competition and the need to retain good clientele are affecting to UCBs too leading to squeezing of the margins on many banks, especially the eager ones. The larger private sector commercial banks, with their ability to invest more in technology and offer better remuneration to attract skilled persons, are better off in finding competition. UCBs are targeted by the commercial banks and hence face tough competition.
1.9 CORPORATE GOVERNANCE ISSUES IN UCB

Most of the problems faced by the UCBs are due to governance issues and connected lending. In UCBs, borrowers have a significant say in the management of the banks. This has the potential of influencing the Boards to take decisions that may not always be in the interest of depositors who constitute the most important stakeholders of a bank. Also, unlike the case of institutions the shares of which can be listed in a stock exchange and can change hands without affecting the capital base, in case of UCBs, the shareholders can withdraw their contribution to capital and shrink the capital of the bank and thereby, limit its ability to increase risk weighted assets and expand business. These principles address the challenges of organizational power within credit unions at three separate levels, viz., External Governance, Internal Governance and Individual Governance.

1.10 POLICY INITIATIVES OF RESERVE BANK OF INDIA

Now, let us now take a look at various initiatives taken by Reserve Bank for stabilizing and strengthening the Urban Co-operative Banks. Taking a view on the crisis faced by the sector time and again, the Reserve Bank, in the annual policy for the year 2004-05, announced its decision to stop granting fresh licenses for formation of new UCBs. This was followed with a decision not to grant any fresh branch license as well. It was made clear that this was necessitated pending a comprehensive review of the legislative and regulatory framework governing the sector. It was in this background that a decision was taken to draft a vision document for the sector to outline a framework that would facilitate the strengthening of the sector and enable it to play the assigned role of providing credit to the economically weaker sections.

1.11. VISION DOCUMENT OF UCB

The Reserve Bank eventually formulated a draft vision document, placed it in the public domain in March 2005 and finalized it thereafter, with the following objectives:

(i) To rationalize the existing regulatory and supervisory approach keeping in view the heterogeneous character of entities in the sector.
(ii) To facilitate a focused and continuous system of supervision through enhanced use of technology.
(iii) To enhance professionalism and improve the quality of governance in UCBs by providing training for skill upgradation as also by including large depositors in the decision making process/management of banks.
(iv) To put in place a mechanism that addresses the problems of dual control, given the present legal framework, and the time consuming process in bringing requisite legislative changes.
(v) To put in place a consultative arrangement for identifying weak but potentially viable entities in the sector and provide a framework for their being nurtured back to health including, if necessary, through a process of consolidation.
(vi) To identify the unviable entities in the sector and provide an exit path for such entities.
MOU with State Governments and Constitution of TAFcUBs

In pursuance of the proposals in the draft vision document, state governments having a large number of UCBs were approached for signing memorandum of understanding (MOU). Some of these state governments have since signed MOUs. The memorandum, in fact, provides the basis for the constitution of Task Force for Urban Co-op. Banks (TAFcUB) in with regard to the mechanism for supervision, the smaller banks, which are limited by their size and type of operations, pose lower-systemic risks and therefore, it is envisaged that they would be supervised by a combination of simplified off-site surveillance system of the RBI and on-site audit by the state governments. The dependence on off-site surveillance and on-site supervision by state agencies in respect of small unit) banks, in addition to lowering the supervisory burden of the small entities, would also provide increased flexibility to the RBI to deploy its supervisory resources to the larger and more risky banks.

Emphasis on Corporate Governance and Professionalism

It is being increasingly highlighted that depositors are the most important stakeholders in a bank and therefore inclusion of depositors as shareholders, particularly the large depositors, is an agenda that is being actively pursued independently as also through co-ordination with state government. In order to enhance professionalism, Reserve Bank insists on inclusion of at least two professional directors on the board of each bank, which otherwise is essentially an elected body comprising mainly of persons from the field of cooperation rather than banking. In this directions, ‘Fit and Proper’ criteria for CEOs are also being formulated for implementation through the state governments. Market discipline gradually being increased through rigorous disclosure norms and initiatives like public disclosure of penal action taken against a bank by the RBI. Also in case of gross violation of RBI guidelines/directives where complicity of a director or of the Board is noticed, Reserve Bank of India approaches the Registrar of Cooperatives of the concerned State for removing the director or even for superseding the entire Board, depending upon the nature of the violation. If necessary, RBI also files police complaints for taking action against officials and directors of banks wherever criminal complicity is suspected by the supervisory departments of the RBL State Government through the MOU; agree to take immediate action on requisitions of RBI for supersession of the Board of Directors or for winding up a bank.

In order to ensure that 'arm’s length distance' is maintained between the Board and the day to day operations of the bank, connected lending in terms of loans to directors, and relatives of directors and to firms in which any director may be 'interested', has been banned in India. Further, as the quality of audit is an important aspect of corporate governance, efforts have been made to ensure that statutory audit of banks is conducted by professionals. As per the MOU, the states agree to conduct statutory audit only through Chartered Accountants in respect of banks with deposits over 25 crore, institute special audit by Chartered Accountants at the behest of RBI and enhance the quality of statutory audit by aligning their a system of rating banks with that of Reserve Bank.

Consultative Approach to Regulation

In order to remain sensitive to developments in the marketplace as also for ensuring better coordination between the agencies entrusted with supervision and regulation of UCBs, viz., Central and State Governments and Reserve Bank of India, certain processes and platforms for
regular and structured consultation have been established by us. A Standing Advisory Committee comprising senior representatives of Central and State Government and Federation of UCBs has been constituted, which meets the top and senior management of Reserve Bank once or twice a year, reviews past policies and also gives responses on important policy proposal and other issues of immediate concern.

Non-disruptive Exit Route for Non-viable Banks

The Reserve Bank’s experience with the UCB sector clearly underscored the necessity for providing a non-disruptive exit route for non-viable banks. Accordingly, this aspect has been incorporated in the vision document. TAFCUBs constituted in the States that have signed MOU have been entrusted with the task of identifying potentially viable and non-viable UCBs and suggesting suitable revival path for the former and a non-disruptive exit route for the latter. The exit of non-viable banks would be ideally through merger/amalgamation with stronger banks or conversion into societies that would take deposits only from members without providing cheque facility or ultimately, through liquidation as a last resort.

Merger and Consolidation

The consolidation of the sector through the process of merger of weak entities with stronger ones has been set into motion by providing transparent and objective guidelines for granting no-object to merger proposals as a strategy for providing non-disruptive exit for the weak banks. It also set up a three member Expert Group of outsiders to vet the merger proposals, to provide a transparent mechanism to the process and impartial inputs on such requests. TAFCUBs have representatives of the sector who also provide local level inputs on banks that are on the lookout for taking over other weak banks for expansion of business. The merger process has gathered momentum over the last one year, partly because the stronger banks found this an inorganic growth route. In all, 44 merger proposals have been approved so far, of which no objection has been issued for 23 proposals, Of these, 14 mergers have already materialized.

Liquidation and Settlement of Depositors’ Claims

Banks that are identified as non-viable and as having no scope whatsoever for revival by merger, etc., are taken into liquidation keeping in view the interest of depositors. In liquidation cases, the Deposit Insurance and Credit Guarantee Corporation (DICGC) expeditiously settle the claims of depositors. However, in certain cases, there is a time lag in settlement of claims mainly on account of delay in submission of the claim list by the liquidators. Other factors which affect timely settlement of claims are audit of claim list by Chartered Accountants, court cases, delay in receipt of liquidation order from the RCS, deficiency in claim list prepared by the liquidators etc. DICGC has put in place follow-up and monitoring measures to mitigate the hardship faced by the depositors on account of such delays and facilitate settlement of claim list of failed banks at the earliest.

Technology Initiatives

In order to enhance the access to technology for UCBs, Reserve Bank would consider facilitating acquisition of basic hardware and software for conducting routine operations. Further, software has also been developed to enable the UCBs to prepare and submit all returns to Reserve Bank, electronically. The software has been implemented free of cost in the banks and the officials of banks are also being provided adequate training in using the software, which enables
banks to maintain a database of returns submitted to the supervisor which in turn acts as a MIS for the UCBs. The stronger UCBs also are members of clearing house and of the Real Time Gross Settlement System.

**Skills development/Training, Including Directors and Auditors Training**

To the extent that it does not lead to any conflict of interest, the Reserve Bank of India, in addition to its regulatory and supervisory functions also seeks to play a developmental role for the urban co-operative banks. In this context, in order to improve the skill level of human resources and the technological infrastructure of UCBs, RBI in addition to subsidized programs also provides free of cost training on all important areas of banking operations to the staff and top managements of UCBs through its own training establishments as also through off-shore training establishment at regional centers that have a large network of such banks. As mentioned earlier, software has been developed for banks to help them prepare and submit all the returns to RBI, electronically and the software has been implemented free of cost by RBI, in the banks.

### 1.12 RECENT DEVELOPMENTS

As envisaged in the Vision Document, Reserve Bank approached States having large network of UCBs for signing Memorandum of Understanding (MOU) to ensure greater coordination between RBI and State Government for supervision and regulation of the UCBs. Since June 2005, MOUs have been signed with 8 state governments, viz., Andhra Pradesh (124 banks), Gujarat (296 banks), Karnataka (297 banks), Madhya Pradesh (61 banks), Uttaranchal (7 banks), Rajasthan (39 banks), Chhattisgarh (14 banks) and Goa (6 banks) which together constitute 844 UCBs, i.e., over 45 per cent of total number of UCBs and account for almost 23 per cent of deposits of the sector. As mentioned earlier, upon signing of MOU, as per agreement, RBI constituted State Level Task Force for Urban Co-operative Banks (TAFCUB), which is a six-member body with two representatives each from State Government, UCB sector and Reserve Bank. The TAFCUBs are chaired by the respective Regional Directors of RBI and RCS is the Co-Chairperson. TAFCUBs also have representatives of the sector who provide local level inputs on banks that are on the lookout for taking over other weak banks for expansion of business. As such, the constitution of TAFCUBs and their role in the development of the UCBs in the state on sound lines constitutes a compelling attraction for the state government to sign the MOU with RBI.

### 1.13 CONCLUSION

These initiatives taken by Reserve Bank of India would lead to the evolution of the urban co-operative banking system into a strong and vibrant sector with banks that confirm to all prudential requirements in the medium-term and become at par with the commercial banks in terms of competitiveness and performance. Vision document of RBI is one of the best measures it could take to remove all the hurdles for the UCBs in their way to progress.