

Legislative Brief

The Banking Regulation (Amendment) Bill, 2020

The Banking Regulation (Amendment) Bill, 2020 was introduced in Lok Sabha on September 14, 2020. It amends the Banking Regulation Act, 1949. The Bill replaces the Banking Regulation (Amendment) Ordinance, 2020 promulgated on June 26, 2020.

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Highlights of the Bill

- ◆ Co-operative banks are exempted from several provisions of the Banking Regulation Act, 1949. The Bill applies some of these provisions to them, making their regulation under the Act similar to that of commercial banks.
- ◆ Co-operative banks may raise equity or unsecured debt capital from the public subject to prior RBI approval.
- ◆ RBI may prescribe conditions on and qualifications for employment of Chairman of co-operative banks. RBI may remove a Chairman not meeting 'fit and proper' criteria and appoint a suitable person. It may issue directions to reconstitute the Board of Directors in order to ensure sufficient number of qualified members.
- ◆ RBI may supersede the Board of Directors of a co-operative bank after consultation with the state government.
- ◆ The Bill allows RBI to undertake reconstruction or amalgamation of a bank without imposing a moratorium.

Key Issues and Analysis

- ◆ Co-operative banks provide banking facilities to people of small means. However, absence of regulatory oversight by RBI on par with commercial banks has contributed to the poor performance of co-operative banks. The Bill seeks to extend RBI regulation of co-operative banks with respect to management, capital, audit and winding up.
- ◆ 'Banking' is a Union List subject in the Constitution and 'incorporation, regulation and winding up' of co-operative societies' is in the State List. The question is whether regulation of management, audit, capital and winding up of co-operative banks are essential to regulating the activity of banking, and therefore whether the Bill falls within the legislative competence of Parliament.
- ◆ The Bill enables co-operative banks to issue equity shares to members and to persons residing within the banks' area of operation. Since co-operative societies raise capital from members, it is unclear what it means to raise equity capital from the public. Further, restrictions on redemption of share capital by members may limit their option to exit.

PART A: HIGHLIGHTS OF THE BILL

Context

The banking sector in India consists of scheduled commercial banks, regional rural banks, small finance banks and co-operative banks. Co-operative banks provide banking facilities to persons of small means thereby fulfilling the objective of financial inclusion.¹ As of 2015, nearly 90% of loans made by co-operative banks were of less than five lakh rupees each, accounting for 33% of total lending by these banks. Co-operative banks are those co-operative societies whose principal business is banking. These societies are owned, promoted, controlled and managed by their members and seek to provide support to them.

As per the Constitution, states can legislate on the incorporation, regulation and winding up of co-operative societies.² States regulate co-operative societies under their respective Co-operative Societies Acts, through the Registrar of Co-operative Societies (RCS). In 1965, certain provisions of the Banking Regulation Act, 1949 (BR Act) were made applicable to co-operative banks.³ This gave Reserve Bank of India (RBI) some powers to regulate co-operative banks. This was done to protect the interests of depositors and extend deposit insurance coverage to these banks.

RBI regulates state co-operative banks, district (central) co-operative banks and primary co-operative banks (also called urban co-operative banks). It regulates banking-related activities of these banks such as issuance of licenses for new banks/branches and investment and loan policies. RBI also prescribes norms for capital adequacy, asset classification, liquidity requirements and exposure norms.⁴ The RCS in each state regulates incorporation, registration, management, recovery, audit, supersession of Board of Directors and liquidation of co-operative societies registered with it.

The Banking Regulation (Amendment) Bill, 2020 amends the BR Act to expand RBI's regulatory control over co-operative banks in terms of management, capital, audit and liquidation. The Bill was introduced in Lok Sabha on September 14, 2020. While introducing the Bill, the Finance Minister discussed the need for the Bill to protect depositors' interest, highlighting the crisis in the Punjab and Maharashtra Co-operative (PMC) Bank. The Bill replaces the Banking Regulation (Amendment) Ordinance, 2020 promulgated on June 26, 2020.⁵ A Bill, seeking to make similar changes, was introduced on March 3, 2020 and withdrawn on September 14.⁶

Key Features

The Bill makes two kinds of changes: (i) extending previously omitted provisions of the BR Act to co-operative banks, and (ii) amendments to certain provisions of the Act that apply to all banks.

Co-operative Banks

- **Prescription of qualifications for management:** Co-operative banks are excluded from provisions of the BR Act with respect to conditions on employment and qualifications for the Chairman and Board of Directors. The Bill provides that co-operative banks cannot employ as Chairman, someone who is insolvent or has been convicted of a crime involving moral turpitude, among other restrictions. It empowers RBI to remove the Chairman if he is not fit and proper and appoint a suitable person if the bank does not do so.
- The Bill provides that the Board of Directors must have not less than 51% of members who have special knowledge or practical experience in areas such as accountancy, banking, economics or law among others. It allows RBI to direct a bank to reconstitute the Board if it does not conform to the requirements. If the bank does not comply, RBI may remove individual directors and appoint suitable persons.
- **Supersession of Board of Directors:** Under the BR Act, RBI is empowered to issue an order to supersede the Board of Directors of multi-state co-operative banks for a maximum period of five years and appoint an Administrator. Multi-state co-operative banks are co-operative banks with operation in two or more states, and are registered under the Multi-State Co-operative Societies Act, 2002. For other co-operative banks, RBI may approach the RCS to supersede the Board. The Bill extends RBI's power to supersede Board of Directors to all co-operative banks. In case the bank is registered with a state RCS, RBI may issue the order in consultation with the concerned state government, seeking its comments within such period as specified by RBI.
- **Audit and winding up:** Under the Bill, audit of co-operative banks would be conducted on par with scheduled commercial banks. Accounts would be audited by a qualified person and RBI approval would be required before appointing, re-appointing or removing an auditor. RBI may order a special audit for such transactions and such periods as specified in the order. Previously, RBI could issue an order for an additional audit for co-operative banks, in addition to the audit required under Co-operative Societies Acts.
- The Bill makes applicable certain provisions relating to winding up and special provisions for speedy disposal of winding up proceedings of banks will now be applicable to co-operative banks.
- **Issuance of shares and securities:** Co-operative banks are excluded from the provision on issuance of shares and securities under the BR Act. Other banks are allowed to issue equity or preference shares and

RBI is empowered to impose conditions on issue of preference shares. Voting rights are typically allotted on the basis of one share one vote. The Act (read with RBI Directions) imposes a ceiling of 15% on voting rights exercised by an equity shareholder.

- The Bill modifies the relevant provision of the BR Act to provide that co-operative banks may, with prior approval of RBI, issue equity, preference or special shares at face value or at a premium to members or other persons residing within the banks' area of operation. Banks may also issue unsecured debentures or bonds with maturity of not less than 10 years. Banks cannot withdraw capital without permission from RBI. Further, members are not entitled to payment from the bank against the surrender of shares.

Formulation of scheme for reconstruction or amalgamation without moratorium

- Under the BR Act, RBI may, after placing a bank under moratorium, prepare a scheme for reconstruction or amalgamation of the bank. This may be done to secure proper management of the bank, or in the interest of depositors, general public, or the banking system. Banks placed under moratorium do not face any legal action for up to six months. Further, banks cannot make any payment or discharge any liabilities during the moratorium. The Bill allows RBI to initiate a scheme for reconstruction or amalgamation of a bank without imposing a moratorium.

PART B: KEY ISSUES AND ANALYSIS

Role of co-operative banks

In a discussion paper on the Banking Structure in India (2013), RBI envisioned a four-tier structure for banks, consisting of international, national, regional and local banks.⁷ The fourth tier of local area banks and co-operative banks were envisioned to serve the credit requirements of small borrowers. Urban co-operative banks (UCBs) cater to the financial needs of the local community, serving persons belonging to lower income groups in urban and semi-urban areas. RBI (2013) had considered the commercialization of UCBs by converting them into local area banks. However, they observed the importance of the cooperative spirit in the banking sector in channelling credit to people of small means. The High Powered Committee (HPC) on UCBs, in 2015 recommended that RBI issue fresh licenses to UCBs to serve in unbanked/ underbanked districts, noting the role these banks play in facilitating financial inclusion.

However, RBI (2013) had also noted that UCBs have performed poorly due to challenges such as low capital base, lack of sources to raise capital (UCBs raise equity capital only from members), poor credit management and lack of professional management.⁷ The 2013 paper had suggested that converting UCBs into local area banks to free them from dual control (of RBI and RCS) and improve their ability to raise capital could improve their performance. Several RBI reports have highlighted the absence of certain regulatory and supervisory powers of RBI over UCBs as one of the reasons for their poor performance.^{8,9,1}

While RBI regulates licensing and loan policy, prescribes prudential norms and conducts inspection of UCBs, it requires the assistance of RCS to act against the management, or undertake restructuring or liquidation of these banks. For effective regulation of UCBs, the HPC (2015) had suggested that RBI be given powers to constitute and supersede the Board of Directors, remove the Chairman, conduct audits, and wind up UCBs. RBI exercises these powers with regard to all other banks regulated under the BR Act. The Bill empowers RBI to exercise control over co-operative banks in terms of management, capital, audit and winding up.

Note that such additional powers may increase pressure on the supervisory capacity of RBI. Currently, RBI regulates and supervises 86 scheduled commercial banks, 45 regional rural banks and 10 small finance banks. The Bill extends RBI's regulation and supervision to 1,544 UCBs, 363 district (central) co-operative banks and 33 state co-operative banks.

Legislative competence of Parliament

Through the Bill, Parliament extends RBI's regulation of co-operative banks to cover matters pertaining to the management, capital, audit and winding up of such banks. The question is whether Parliament has the jurisdiction to legislate on these matters for co-operative banks. These entities are registered as co-operative societies under various state Co-operative Societies Acts and perform the activity of banking.

Parliament has the power to legislate on 'banking' through entry 45 of the Union List in the Seventh Schedule to the Constitution. Matters pertaining to 'incorporation, regulation and winding up' of co-operative societies are covered under entry 32 of the State List. Further, entry 43 of the Union List excludes from the purview of Parliament, matters pertaining to incorporation, regulation and winding up of co-operative societies.

A question may be raised about whether regulation of management, capital, audit and winding up is essential to regulating 'banking' and therefore falls within the purview of entry 45 of the Union List, or whether it is

Act: Sections 10, 10A, 10B, 10BB, 12, 12A, 30, Part IIA, III, IIIA

Bill: Clauses 4(F), 4(G), 4(J), 4(L), 4(M), 4(N)

primarily related to ‘incorporation, regulation and winding up’ of a co-operative society under entry 32 of the State List. When co-operative banks were brought under the purview of the BR Act in 1965, provisions related either directly or indirectly to the incorporation, management and winding up of co-operative banks were omitted.¹⁰ The Statement of Object and Reasons of that Bill noted that these provisions are not in pith and substance within the scope of any entry (including ‘banking’) in the Union or Concurrent List.¹⁰

A recent judgement of a Constitution Bench of the Supreme Court may be relevant.¹¹ It considered whether Parliament had the jurisdiction to allow co-operative banks to recover debt under SARFAESI Act, 2002. It held that recovery of debt was an essential facet of ‘banking’ and therefore it is within the purview of Parliament to enable co-operative banks to recover debt under the SARFAESI Act. The judgement noted that a co-operative bank’s entire operation and activity of banking are governed by the BR Act. As banking in pith and substance is covered under entry 45, incidental trenching upon a subject reserved for states (entry 32) is permissible. It added that on matters of ‘incorporation, regulation and winding up’ which are unrelated to entry 45 of the Union List, co-operative banks will be governed by state legislation. Therefore, the question is whether regulation of management, audit, capital and winding up are essential to the activity of banking and the operation of a (co-operative) bank, and thus, whether the Bill falls within the legislative competence of Parliament.

Provisions on capital may violate principles of co-operative societies

Treatment and rights of equity capital raised from the public is unclear

Act:
Section 11

Bill:
Clause 4(G)

The Bill enables co-operative banks to issue (with prior approval from RBI) equity, preference or special shares, at face value or at a premium by way of public issue or private placement. Co-operative societies are set up on the principle of member control with (equity) shares issued to members. Since co-operative societies raise capital from members, it is unclear what it means to raise equity capital from the public, how it will be treated and regulated. Further, issuance of equity shares may violate principles of co-operative societies if they carry proportional voting rights. Co-operative societies grant voting rights only to members based on the principle of ‘one member one vote’ irrespective of shareholding. Note that the Vishwanathan Committee (2006), set up to study ways to augment capital of UCBs, recommended issuance of preference and special shares, both of which would be non-voting.¹²

Restriction on demanding payment against the surrender of shares by members may limit exit options

The Bill prohibits members from demanding payment against the surrender of their share capital. This may contravene provisions contained in certain Co-operative Societies Acts. The Karnataka Co-operative Societies Act, 1959, for example, provides for refund of shares to a member if there are no outstanding dues.¹³ This provision of the Bill raises concerns for existing members of co-operative societies whose option to exit by surrendering their share capital will be restricted.

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2. Entry 32, List II, Schedule VII.
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