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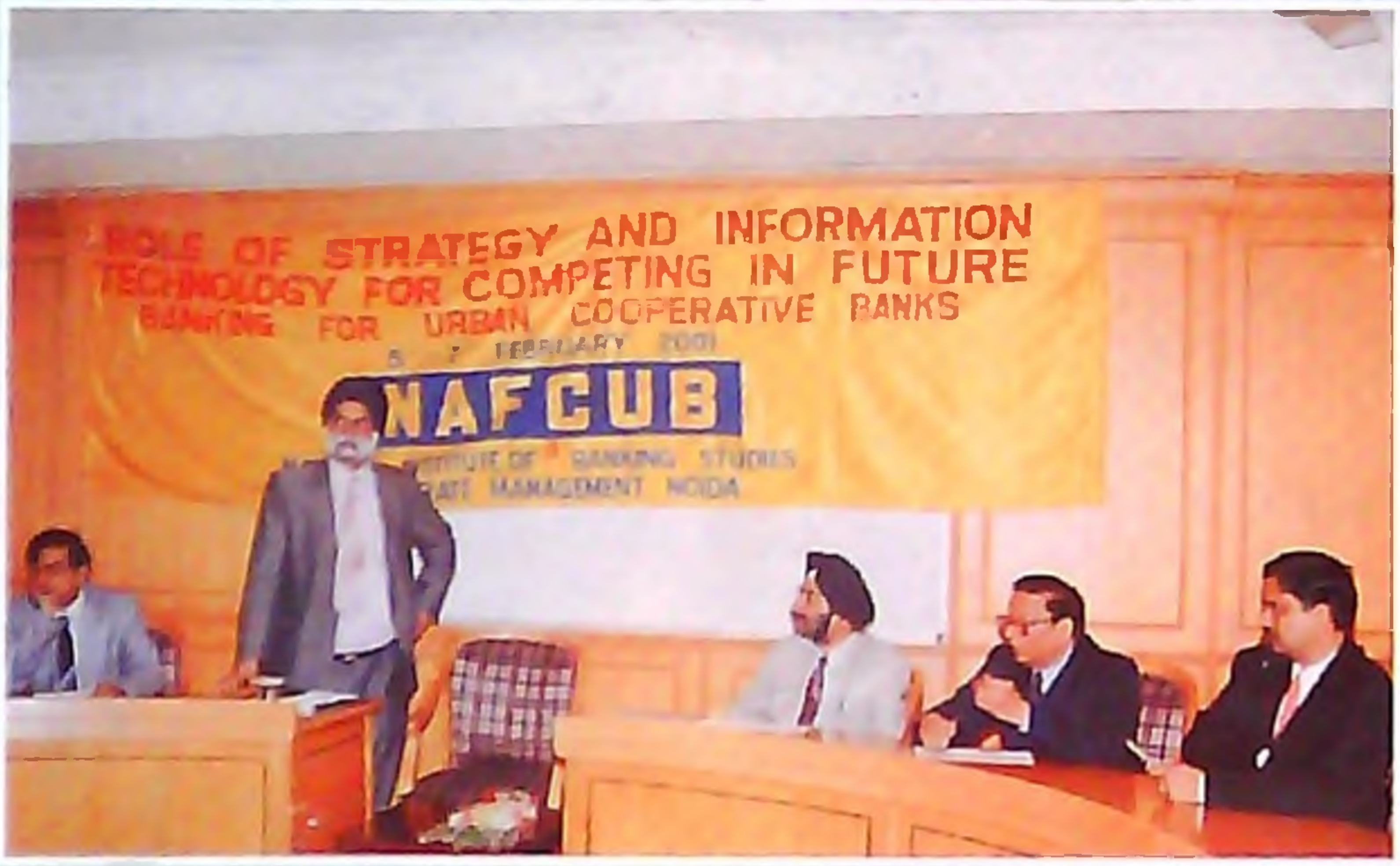

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Reserve Management in Urban Co-operative Banks : A Case Study

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Introduction

In the past, banks, in an urge to maximise profit, used to lend all their funds without keeping any reserves for liquidity. Later on banks realised the danger of this aggressive credit policy and started maintaining reserves based on their own wisdom. Still some banks disregarded reserve requirements and continued with aggressive credit practices overlooking liquidity. This tendency ultimately necessitated the need for imposing certain norms regarding reserves on the banking sector by the Central Bank. The instrument of statutory cash reserve requirement was first experimented by the Federal Reserve System of America in 1933. In India reserve requirements were first tested as a tool to safeguard the interest of the depositors but subsequently it was used as an instrument of credit control.

The Reserve Bank of India Act, 1934 introduced statutory provisions regarding reserve requirements for the first time. According to section 42(1) of the Act Scheduled Commercial Banks are required to keep minimum three per cent of their demand and time liabilities as cash reserve. The Act also empowers the RBI to vary the ratio between three to 15 per cent depending upon the circumstances. As on date the CRR of commercial banks is 8.5 per cent and co-operative banks 3 per cent. The cash reserve requirements of non-scheduled banks are governed by Section 18 of the Banking Regulation Act, 1949. According to Section 24 of the B.R. Act, 1949, banks are required to maintain not less than 25 per cent of their demand and time liabilities as liquid assets properly known as Statutory Liquidity Ratio (SLR).

According to the Banking Regulation Act, 1966 (as applicable to Co-operative Societies) a co-operative institution doing banking business with a share capital and reserves of Rs. one lakh and above is eligible to be treated as a co-operative bank. The Act which came into force on 1st March 1966 had empowered the RBI to have the same control over the banking business of the Co-operative banks as it has over the commercial banks coming under the Banking Regulation Act. According to the BR Act (as applicable to Co-operative Societies) a Co-operative bank is required to keep 25 per cent demand and time liabilities as statutory liquidity ratio over and above the cash reserve of three per cent since 1st March 1961.

Cash reserves constitute a zero return investment for the banks. Similarly the return on statutory liquidity reserves is below the mean cost of funds. Hence any reserves kept over and above the statutory requirements will impair the profitability of the banks.

Here an attempt has been made to examine the extent of excess reserves maintained by the Palaghat Co-operative Urban Bank Ltd. and to estimate the opportunity cost of excess funds kept by the bank.

Excess Cash Reserves of Palaghat Co-operative Urban Bank (PCUB)

The excess cash reserve is estimated at three levels, namely, three per cent, four per cent and five per cent. The opportunity cost of excess cash reserves is calculated at minimum interest rate. The excess cash reserves of PCUB is given in Table 1.

From the table it is clear that the bank had kept excess cash reserves at 3 per cent level in all the years and at 5 per cent level in the initial year. The aggregate excess cash reserves kept by the bank at 3 per cent level was Rs.87.51 lakhs. However it is heartening to note that the excess reserves gradually declined over the years indicating improved reserve management efficiency.

The excess cash reserves naturally would have undermined the profitability of the bank. Hence an attempt was made to estimate the opportunity cost of excess reserves kept at all the three levels. The opportunity cost was calculated at three alternative interest rates namely, minimum lending rate, mean lending rate, and maximum lending rate. The opportunity cost

Table 1. Excess Cash Reserves of PCUB (From 1994-95 to 1998-99)

(Rs. in lakhs)

Year	DTL	CRR	3% of DTL	4% of DTL	5% of DTL	Excess at 3%	Excess at 4%	Excess at at 5%
1994-95	894.74	49.94	26.84	34.78	44.73	23.10	15.16	5.21
1995-96	1177.46	55.20	35.32	47.10	58.87	19.88	8.10	-
1996-97	1486.64	65.08	45.54	59.38	74.23	20.54	5.70	-
1997-98	1849.03	65.34	55.47	73.96	92.45	9.87	-	-
1998-99	2623.84	92.83	78.71	104.95	131.19	14.12	-	-
		Total				87.51	28.96	5.21

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Table 2. Opportunity cost of excess cash reserves of PCUB

(Amount in lakhs)

Year	Excess CRR at 3%	Excess CRR at 4%	Excess CRR at 5%	Minimum Interest Rate (%)	Mean Interest Rate (%)	Max Int. (Gold loan) Rate (%)	Opportunity Cost: Excess CRR at 3% At Min Int	Excess CRR at 3% At Mean Int.	Excess CRR at 3% At Max Int	Excess CRR at 4% At Min Int	Excess CRR at 4% At Mean Int	Excess CRR at 4% At Max Int	Excess CRR at 5% At Min Int	Excess CRR at 5% AtMean Int	Excess CRR at 5% At Max Int
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8) (2x5)	(9) (2x6)	(10) (2x7)	(11) (3x5)	(12) (3x6)	(13) (3x7)	(14) (4x5)	(15) (4x6)	(16) (4x7)
1994-95	23.10	15.16	5.21	14.0	16.16	17.0	3.23	3.73	3.93	2.12	2.45	2.58	0.73	0.84	0.89
1995-96	19.88	8.10	-	14.0	16.79	18.0	2.78	3.34	3.58	1.13	1.36	1.46	-	-	-
1996-97	20.54	5.70	-	17.5	18.51	19.0	3.59	3.80	3.90	1.00	1.05	1.08	-	-	-
1997-98	9.87	-	-	16.5	18.04	19.0	1.63	1.78	1.87	-	-	-	-	-	-
1998-99	14.12	-	-	16.0	16.76	17.5	2.26	2.37	2.47	-	-	-	-	-	-
TOTAL	87.51	28.96	5.21				13.49	15.02	15.75	4.25	4.86	5.12	0.73	0.84	0.89

of the excess reserves at the three alternative lending rates is shown in Table 2.

The table indicates that if the bank had lent the excess reserves at 3 per cent level at the maximum, mean and minimum lending rates it would have made an additional aggregate income of Rs.15.75 lakhs, Rs.15.02 lakhs and Rs.13.49 lakhs during the reference period. The marginal difference in the opportunity cost of excess funds was due to the narrow difference in the minimum, mean and maximum lending rates. The aggregate estimated revenue loss was Rs.5.12 lakhs, Rs.4.86 lakhs and Rs.4.25 lakhs at 4 per cent cash reserve for maximum, mean and minimum lending rates respectively.

Excess Statutory Liquidity Reserves

The PCUB is legally bound to maintain 25 per cent of its demand and time liabilities as statutory liquidity ratio (SLR). The bank used to invest the statutory liquidity reserves in the Palakkad District Co-operative Bank, Kerala State Co-operative Bank and in unencumbered eligible securities. For the purpose of this study any investment made over and above the statutory requirement of 25 per cent is treated as excess SLR. It was observed that the excess cash reserves was transferred to statutory liquidity ratio. So for computing the opportunity cost of excess SLR, the excess CRR was deducted from the actual SLR kept by the bank. The excess reserves under SLR is indicated in Table 3.

Table 3. Excess Statutory Liquidity Reserves of PCUB

(Amount in lakhs)

Year	DTL	SLR Actually kept	SLR computed	25% of DTL	Excess of SLR
(1)	(2)	(3)	(4)	(5)	(6) = (4-5)
1994-95	894.74	268.93	245.83	223.68	22.15
1995-96	1177.46	416.86	396.08	294.36	102.62
1996-97	1484.64	575.42	554.88	371.16	183.72
1997-98	1849.03	734.54	724.67	462.25	262.42
1998-99	2623.84	1353.89	1399.77	655.96	683.81
			Total		1254.72

Table 4. Opportunity cost of excess SLR kept by PCUB

(Amount in lakhs)

Year	Excess SLR kept	Maximum Interest rate (%)	Mean Interest rate (%)	Differential Interest rate (%)	Opportunity cost of excess SLR
(1)	(2)	(3)	(4)	(5)=(3-4) (5)	(6)=(2x5) (6)
1994-95	22.15	17.0	16.16	0.84	0.19
1995-96	102.62	18.0	16.79	1.21	1.24
1996-97	183.72	19.0	18.51	0.49	0.90
1997-98	262.42	19.0	18.04	0.96	2.52
1998-99	683.81	17.5	16.76	0.74	5.06
			Total		9.91

From the table it can be seen that the bank was keeping huge excess statutory liquidity reserves. The excess of SLR steadily increased from Rs.22.15 lakhs in 1994-95 to Rs.683.81 lakhs in 1998-99. The aggregate excess statutory liquidity reserves amounted to Rs.1254.72 lakhs during the reference period. Eventhough the bank fetched some return on the investment of SLR, the yield would have been more if the excess reserves were converted into high yielding loans. Hence the opportunity cost of excess SLR was estimated at differential interest rate and given in Table 4.

Opportunity cost of excess SLR

Table 4 reveals that the estimated aggregate loss due to excess SLR kept by the bank for the entire period of the study was Rs.9.91 lakhs. The opportunity cost of excess SLR kept by the bank steadily increased from Rs.0.19 lakhs in 1994-95 to Rs.4.06 lakhsin 1998-99. *(Contd. on p.33)*