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The Promotion and Regulation of Financial Co-Operatives

The Importance of Context

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Abstract

This paper explores a dilemma that development agencies have worried about for the last 50 years; how to build on the advantages of collective self-help for economic development without undermining it. It argues that it all depends on the level of development of the financial co-operative sector and the wider context in which the sector is set. The paper reproduces a chapter of the author's recent report that suggests six scenarios for effective government regulation of the financial co-operative sector, and it makes recommendations concerning the relationship between financial co-operatives and other kinds of development.

In the economically developed countries, the recent banking crisis is leading inevitably to increased regulation of the banking system by government under a tightened 'Basel III' regime. From the point of view of financial cooperatives that have already proved their soundness, there is the threat of too much regulation. In contrast, in developing countries there is often a lack of effective regulation from governments unable to supervise thousands of small societies. Here the threat is of too little regulation. In both scenarios, there is the threat of inappropriate regulation by governments that do not understand the 'cooperative difference'.

In the past the regulators have proved largely unaware of cooperatives. Basel II had no mention of cooperative banking, despite this type having such a large share of the European market. Will Basel III be any more informed? As we have seen, financial cooperatives can be very large, and able to deal with new requirements without their costs increasing too much. They can also be very small, and here inappropriately detailed requirements will impose costs that will damage the competitiveness of smaller banks. In the United States, regulators have recognized this issue by exempting community banks from some of their requirements. In other countries, micro-finance laws regulate small cooperatives while large ones come under the banking system.

In addition to a well-crafted regulatory system, financial cooperatives need a sympathetic environment if they are to reach their potential. They need dedicated promoters to set up new societies, and experts to strengthen them; this is best done 'movement to movement', by cooperative apex bodies in countries where they are already well established. They need employer organizations and trade unions to see the potential benefits of employment-based credit unions. Where NGOs are active in promoting micro-finance they should be careful to nurture sustainable savings-and-credit based cooperatives rather than simply dispensing loans, and they should pay attention to the need for apex bodies that strengthen financial cooperatives as a system. Micro-finance investment funds may find cooperatives an attractive conduit for lending, but there is a danger that they may swamp them with credit that undermines their autonomy.

It is difficult to generalize about what financial cooperatives need. The situation varies from country to country and in the degree of maturity of the cooperative system. Here are some typical scenarios that lead to distinct policy recommendations:

Scenario A: A country with a stable, developed financial cooperative system that has the capacity to expand its support to SMEs

In the aftermath of the banking crisis, governments in the most developed countries are both supporting their banks with massive amounts of cheap credit and beginning to regulate them more closely. When financial cooperatives are offered funding, either for strengthening their capital ratios or for on-lending to SMEs, they should be careful not to allow themselves to be swamped with government money; in the long run they must keep a healthy balance between savings and loans and have an incentive to keep up their own reserves. Government regulators should recognize the differences between financial cooperatives and investor-owned banks both in their capital structure and their corporate governance. They should understand the network type of organization that the European cooperative banks in particular have achieved, and trust the way in which delegated supervision has worked over the last 150 years! They should not over-regulate, otherwise the cooperatives may find it too expensive to serve low-income members with small savings and loan accounts, and be forced to move upwards towards

more affluent clients. It is important for the stability of the cooperative system that local banks are able to make decisions. Without local initiative, the cooperative banking system loses its power to underpin local economies and employment.

Scenario B: A country where an existing financial cooperative sector exists but is not 'aspiring to descend'. Here, promoters of microfinance should engage with the sector to find out why it is not serving the needs of those on low incomes. It may be that there is unfair competition from microfinance NGOs! They should encourage the sector to findways of extending its reach, offering financial and technical support for effective loan appraisal and risk management. If the sector is strong enough, loan guarantees can be offered, and access provided to some wholesale funding. If funds are provided for lending on, these should not overbalance the loan portfolio (25 per cent is a good rule of thumb), and they should be seen as a commercial rather than a political initiative. Only those societies that meet prudential loan repayment criteria should receive funds for on-lending.

Scenario C: A country with a rapidly growing sector that has inadequate supervision. Here, promoters should focus on developing the capacity of government regulators and the national federation to supervise the sector. They can use a grading system that incentivizes societies to become stronger. Where there is a new federation, it is prudent to allow only strong societies to become members (as in Dundulizain Tanzania). Where weak societies are already members they can be incentivized with the offer of economic benefits such as access to electronic networks or guarantee funds if they reach a required threshold. The ones that will not make it might eventually be closed down or merged with stronger societies. Only when they have loan assessment and risk management systems in place can their lending be expanded, and then mainly through use of their own member savings. If the existing law becomes an impediment, the legal framework will need to be updated in consultation with the sector, and using the WOCCU guidelines for credit union law, or the ILO guidelines on cooperative policy and legislation or other guidelines specific to particular types of financial cooperative. A lot of effort should be put into strengthening the national federation to take the lead in promoting and representing the sector. This is what has happened in Poland and Vietnam and is beginning in Tanzania.

Scenario D: A country where a large financial cooperative sector exists and is politically controlled, but there is an effective reform coalition. Here, new laws will be needed guaranteeing the autonomy of financial cooperatives. The regulatory system will need to be reformed, non-viable societies will have to be closed down, corrupt boards removed from office and fresh elections held. Governments can usefully fund the reform process, and in particular a member education programme and the handing over of societies to their members. After all of this has happened, all the usual strengthening measures will be needed to ensure the societies become good at banking! This is the kind of process that is going in China with rural credit cooperatives.

Scenario E: A country where a large financial cooperative sector exists and is politically controlled, but there is NO effective reform coalition. If there is no reform, then nothing can be done. Organizations wishing to promote financial cooperatives should focus on creating an alternative system that might emerge out of existing micro-finance projects. This is what happened in Sri Lanka in the 1970s with the Sanasa movement. It could be an alternative in India, if the current attempts to reform the massive credit cooperative sector are stalled.

Scenario F: A country with no financial cooperatives, or a small number of primary societies. Here, promoters should aim to develop a whole sector, with its own support structures of national federation and a central bank. Nothing less will do. Setting up primary societies on their own will just lead to problems that later on will be difficult to put right. National-level structures follow naturally from demands from primary societies for business services, but they should not have to wait too long! In Poland, for instance, the national federation was set up only a few years after work began to establish primary societies, and it was soon self-sufficient. The aim should be to develop the capacity of the sector largely to supervise itself, and to pay for this out of its profits. That way it will not be vulnerable to cuts in government budgets or changes in policy. Of course, governments will want to regulate and supervise on behalf of savers, but often they do not have the capacity to do this and a lot of delegated supervision will be needed. A law will be needed that regulates the sector, recognizing its unique characteristics as well as what it has in common with other types of bank or micro-finance institution. It is important not to 'reinvent the wheel': there is plenty of guidance provided by The World Council of Credit Unions, the DGRV (German Cooperative and Raiffeisen Confederation) and the ILO.

The relationship between Financial Co-Operatives and Other Kinds of Development

Financial cooperatives can be a base for other kinds of development programmes. Often, they are the only formal organizations available, particularly in remote rural areas. Their members need support, particularly when they borrow money to develop their own businesses; credit carries risks as well as opportunities. Parallel programmes can be provided that cut down the risks to borrowers while not undermining the cooperatives. In particular, they can be a base for supply chain development. This helps primary producers (farmers, fishers, foresters) to make a better return on their business. It is no accident that, as soon as he could, Raiffeisen set up supply cooperatives for farmers, as well as rural credit cooperatives.

They can also be made into a base for small business development, but without swamping them with external funding, or substituting political decisions for commercial ones. Both the financial cooperatives and the SMEs have to survive in a competitive market. Cooperatives often provide micro-insurance in the form of death benefits; as the promoters of the Grameen system found out, if credit is to be used to its full potential, the knowledge that one's surviving family will not be burdened with the debt is essential. Other types of micro-insurance can be added in, but not provided directly by the cooperative; beyond simple death benefits, the linking of insurance and borrowing can create a moral hazard, but if the linkage is not to the loan but to a potential cause of default - ill health or crop failure or natural disaster – the combination of lending and insuring can keep people out of poverty. External funding can be used to subsidize the insurance side, provided this is insulated from the loan product. We should not forget that savings are also a kind of insurance; they smooth out the peaks and troughs of consumer expenditure and to some extent help businesses to survive an economic downturn. Financial cooperatives should always provide savings and credit.

Finally, we should remember that financial cooperatives are not just about financial deepening. Like other types of cooperative, they are 'people-centred' businesses, owned by the people they serve. This makes them more challenging than other types of micro-finance institution to promote, but also much more sustainable.