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Unused cooperative potential in microfinance

Rabobank

'Access to financial services for all' has been the mantra of development organisations, since the UN declared 2005 as the International Year of Microcredit. Microfinance Institutions (MFIs) are often mentioned as a way to achieve more access to finance for all. But what about savings and credit cooperatives, credit unions and other financial cooperatives? Does their track record in rural areas of Western Europe not warrant more attention for this type of organisation? The main characteristics of financial cooperatives look promising. However, some obstacles pose a challenge to fully benefit from the advantages.

Access to finance as driver of economic growth

In 2000, the UN formulated eight Millennium Development Goals (MDG), to be achieved in 2015. The UN promotes financial sectors that give access to all income levels, as a way to reach the MDGs. Economic research shows that greater access to financial services indeed is one of the important drivers of economic growth. A requirement is that financial institutions offer more than just (micro) credit. The possibility to save, insure and handle remittances is also important to help households rise from poverty. Moreover, with full access, households are less likely to fall back into poverty.
Access to financial services is lagging behind in developing countries. While the Netherlands has more than 34 branches per 100,000 people, developing countries have, on average, 8.5 branches per 100,000 (table 1). However, these ratios do not include unofficial providers of financial services, such as moneylenders, family and traders. New developments, such as banking with mobile phones, can also change the meaning of the ratio. Even so, they still give a clear indication of how much progress can be made in developing countries. Especially the rural regions are not well supplied with financial services, as most banking concentrates in urban areas. This also holds for most MFIs, as it is more efficient to reach the poor in urban areas. It is unfortunate that most attention from the financial sector goes to urban areas, because the level of poverty is higher in rural areas – some 70% of the poor in developing countries live in rural areas[1]. Moreover, the development of rural areas could prevent mass migration to the cities and, furthermore, enhance food security, with positive effects on the country as a whole.

Table 1: Bank branches per 100,000 people

High income countries (OECD)	33.1
High income countries (nonOECD)	12.3
Middle & low income countries	8.5
- Eastern Europe & Central Asia	12.6
- Middle East & North Africa	8.7
- Latin America	6.8
- Asia & Pacific	6.2
- Sub-Saharan Africa	2.9

Source: Beck, Demirguc-Kent & Martinez Peria, 2005, *Reaching out: Access to and use of banking services across countries*

Access problems in rural areas

Many financial institutions see rural areas as unprofitable due to the high transactions costs that result from low population density, limited technological advancement and poor infrastructure. Difficulties in assessing the creditworthiness of a client and the limited possibility to ask for collateral add to the high transaction costs. Moreover, agricultural finance is, in general, perceived riskier than financing urban activities. However, it is not just the financial sector that hinders the development of access. Even if people are given access to financial services, it is no guarantee that they start using it. People exclude themselves because they do not trust the financial system, they do not understand the way it works in the official financial institutions – made harder by the high illiteracy rates in some developing countries – or the products they seek are not offered. To weigh down costs, in many cases standardised products are offered with strict repayment schemes, but in rural areas the seasonality of production and diversified incomes demand more customised financial products. The main problem that hinders the provision of financial services in rural areas differs per country. In

[1] Pingali, P., K. Stamoulis & R. Stringer, 2006, *Eradicating extreme poverty and hunger: Towards a coherent policy agenda.*

Table 2: Access problems

Services are not offered (supply inefficiency)
- High costs, low return (limited economies of scale, high transaction costs, risk of financing agriculture)
- Information asymmetry (no collateral, no credit registration)
- Unfavourable environment (poor infrastructure, instability)
People do not use services (self-exclusion)
- Desired products are not offered
- (Financial) illiteracy
- Lack of knowledge and/or awareness
- No need for financial products (trade in kind)
- No trust in financial sector

the global discussion about possible solutions, financial cooperatives are only mentioned occasionally. However, history shows that financial cooperatives in Western countries have played an important role in providing financial services in rural areas. This raises the question whether there should not be more attention for financial cooperatives[2].

Cooperative advantages to access problems

The principles that F.W. Raiffeisen formulated in the nineteenth century (table 3) are seen as the starting point of the financial cooperatives in Western Europe. Although the principles are too specific in time and situation to be held as general principles for all financial cooperatives for eternity, the basics are still used today in many forms.

The main difference between financial cooperatives and other business forms is the ownership by members of the cooperative. Other important characteristics are the local orientation of cooperatives and their ability to mobilize savings.

Table 3: Raiffeisen's principles

1. Local character
2. Local autonomy and affiliation to central organisation
3. Solidarity/unlimited liability
4. Full reservation of all profits
5. Unsalaried board

Member ownership

Ownership by members of the community gives the community the possibility to influence the direction of the cooperative. In small cooperatives, this means that members can determine which products are offered or how a cooperative is run. In a large cooperative, members may not vote on the products, but they are in general more involved than 'traditional' clients. A cooperative should, therefore, be able to offer products that are better suited to the needs of the community. Moreover, a cooperative should also be able to increase the knowledge about cooperative processes and about the advantages of financial services. It is much easier to ask your neighbour than go to a bank. Trust in cooperatives also benefits from local ownership, especially if the attitude towards everything from the city is sceptical.

Local presence

Local presence gives cooperatives a head start in the assessment of clients. As the lack of information about creditworthiness constitutes a serious problem in rural areas, local knowledge can significantly decrease the cost of doing business. Information available in a society is free to those who are part of this society - think about the informal talks at the market or at family gatherings -, but very costly to collect from outside.

Local involvement also gives cooperatives more means of assuring that loans are repaid and used for the agreed purpose. Contracts can often not be used, because people are illiterate or the legal system limits enforcement. Moreover, it is often difficult to ask for collateral in the form of land or housing. Many clients do not own the land they work on, the registration of property does not work well or the piece of land is just too small to be of value in case of default. Instead of contracts or collateral, a cooperative has the ability to use peer pressure or 'informal' collateral[3], such as social status, to stimulate repayment.

Savings mobilization

One of the basic ideas behind financial cooperatives is that everybody saves – even the poor. Cooperatives

[2] Savings and credit cooperatives, credit unions and cooperative banks are all seen as financial cooperatives.

[3] Formal collateral is valued by both the borrower and the lender, such as land rights. Informal collateral includes those things that are valued by the borrower, but are relatively worthless to the lenders. It protects the lender against strategic default, but not against involuntary default (Ray, D., 1998, *Development Economics).*

can use the resources that are created by savings to offer loans to its members. For a cooperative, this has several advantages. First, it provides cooperatives with a relatively cheap and secure way of acquiring funds, thereby lowering the costs of operating in a rural area. However, a downside to this system is that a local cooperative's activity is limited to the amount that they can attract in savings. A central organisation therefore often has the task to balance the surpluses and deficits of the different regions. Second, using member's savings as funds reduces the dependence on subsidies and loans from donors and/or governments. This dependency is one of the main issues in the discussion around the sustainability of MFIs. Third, resource mobilization gives a boost to peer pressure. If your neighbour is borrowing your savings via the cooperative, you will pay extra attention to what he is doing with his loan.

Obstacles remain

Overall, financial cooperatives have several assets that could make them valuable in the effort to make financial services available to everybody. Research shows that the most progress in solving access problems can be expected in the area of information asymmetry, followed by the familiarity with financial services. However, before getting too enthusiastic about the possibilities that financial cooperatives offer, some obstacles that prevent the full use of the possibilities have to be taken into account. Note that the following list is by no means an exhaustive overview that applies to all financial cooperatives, but there are several issues that show up in many cases.

'Traditional' weaknesses

In research literature on cooperatives, several weaknesses are mentioned that find their roots in the way cooperatives are organised. A weak governance structure is seen as the most important weakness, followed by the limited scale of operation. As a result of inadequate control systems, mismanagement and accounting flaws, but also corruption and conflicts of interest can arise. Internal control mechanisms should be backed up by external supervision, such as a central organisation or the government.
Unfortunately, in many developing countries the government does not provide adequate regulation and supervision. Financial cooperatives are often supervised by the same department as other (non-financial) cooperatives instead of the banking supervisor[4].
A central organisation or network of cooperatives can help to overcome the problems related to governance structure and economies of scale. Joint resources can provide the necessary knowledge and ability to invest in accounting and/or ICT systems that ease the process of monitoring. CamCCUL, the central organisation of a network of credit unions in Cameroon (West-Africa), visits local credit unions to audit the books and offers training to improve the level of the bookkeepers. The central organisations of cooperative networks in developing countries are often supported by western organisations with money and technical assistance. For example, Rabobank Foundation has paid for courses in agricultural credit for personnel of CamCCUL in the past. Currently, it supports CamCCUL in its effort to run a bank owned by the credit unions.

Conservative attitude towards investments

The conflicting interests of members and management can delay the decision to invest in new products or technologies. Members may put priority on keeping the reserves secure, while management feels that they should invest in new developments. Investing in new technologies may sound like a bridge to far in rural economies where many are still subsistence farmers. Nevertheless, technology and new types of banking are expected to play a large role in developing countries in the coming years. For example, banking with mobile phones is booming in several developing countries. Currently, the number of people with a mobile phone has already surpassed the number of people with a bank account in many developing countries. In South Africa and Botswana, for instance, one-third of people who do not have a bank account, do own a mobile phone or have access to one[5]. Thus, cooperatives will need to keep up with the new technologies, if they want to offer their members the products they demand. Otherwise they risk to reinforce their reputation of being a

[4] Branch, B., 2005, *Working with savings & credit cooperatives, CGAP Donor Brief No. 25.*

[5] CGAP, 2006, *Mobile phone banking and low-income customers. Evidence from South Africa.*

'graduation' institute - as soon as you reach a certain wealth level you are able to move on to commercial banks offering more complex and innovative products. Moreover, new technologies will help cooperatives to lower their costs created by the large distances in rural areas. The limited scale of operation, which may deter the ability to invest in new technology, can be overcome by joining a network. However, the conservative attitude of members is hard to change.

Government influence

Government influence in cooperatives has a historical background. During colonisation, cooperatives were set up after European models. After independence, the new governments -supported by western donors- used the cooperatives as a way to achieve their development goals, such as rural development and agricultural (soft) loans. Many state cooperatives failed because nepotism and low repayment ratios were daily business. Despite the current awareness that cooperatives should be market-driven, independent and member-based organisations, cooperatives in many developing countries still have a reputation of state influence and are often used to target specific groups. As illustration, Sanasa, a network of thrift and credit cooperatives in Sri Lanka, granted housing loans as part of the government's Million Houses Program. Problems in the repayment rates for housing loans triggered the government to write off all outstanding loans, which meant a major loss for Sanasa. It also had a negative effect on the repayment morale of clients. Many did not see a difference between Sanasa and the government and expected remission of other debt owed to Sanasa as well. Another way in which government influences cooperatives is through legislation. Many countries have a restrictive, government controlled legislation for cooperatives. For example, in Sri Lanka, cooperatives are only allowed to grant loans to members and external lending requires the approval of the Ministry of Cooperatives. This ministry also has to approve the purchase of assets over Rs. 5,000 (about USD 45). The restrictive government policies hamper financial cooperatives in their ability to expand. In the long run a change in government attitude and in legislation will be necessary. However, as with any government change, this will take time. For now, a more pragmatic solution can be used: start an organisation that is based on the principles of financial cooperatives, but works under a different name. For example, UN's Food and Agri branch FAO uses synonyms like 'farmer-owned businesses' and 'rural people's organisations' in order to avoid the restrictions for financial cooperatives.

Conclusion

Access to financial services is one of the important drivers of economic growth. Financial cooperatives in developing countries, offering a broad range of financial services, have a huge potential in providing financial services to those excluded in rural areas.
To reach this potential it is important that everybody who is involved with cooperatives, including members, management and the government, sees and treats financial cooperatives as independent business organisations.
Governments should avoid restrictive cooperative legislation and create appropriate supervisory bodies or put cooperatives under supervision of the central banks, just as other financial institutions. Improved financial supervision would stimulate cooperatives to install control mechanisms, although the limited knowledge and experience could pose serious limitations. Technical assistance from western development organisations will therefore remain essential. Loans and monetary subsidies, on the other hand, can create a dependency on donors and is therefore that is not encouraged.
Increased awareness of cooperatives as business by both management ánd members will also create a better environment for investments in new developments. Working together with other cooperatives will probably be necessary to obtain the required resources. Although financial cooperatives are no panacea to access for al, financial cooperatives could certainly help developing countries to achieve their development goals, especially in rural areas.

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