



THE WORLD BANK

Providing Financial Services in Rural Areas

A Fresh Look at Financial Cooperatives



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Providing Financial Services in Rural Areas: A Fresh Look at Financial Cooperatives



THE WORLD BANK
AGRICULTURE AND RURAL DEVELOPMENT DEPARTMENT

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1818 H Street, NW
Washington, DC 20433

Telephone 202-473-1000
Internet www.worldbank.org/rural
E-mail ard@worldbank.org

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Executive Summary

This report demonstrates that financial cooperatives can be sustainable providers of financial services in rural areas and development assistance needs to consider supporting them as a means to enhance access to rural finance. It does not suggest that financial cooperatives are the only providers or the preferred channel in all circumstances. For financial cooperatives to function as sustainable institutions, governments need to provide an enabling environment, not exercise excessive control that restricts growth and consolidation, and not use them as channels to provide subsidized credit. Integration into networks has wide-ranging benefits for financial cooperatives, ranging from improved governance to the ability to provide a wide range of services.

BACKGROUND

In recent years, there has been a renewed understanding of the vital role in rural economic growth that can be played by access to financial services. In many countries, both developed and developing, financial cooperatives bring financial services to a broad rural clientele. Financial cooperatives are private, locally-based, member-owned organizations. The institutional and business model of successful financial cooperatives has evolved over the years.

Financial cooperatives in developing countries have not always been successful. There have been many failures: financial cooperative systems in many countries are unsustainable, subject to political influence-taking and used by governments for their own purposes.¹ However, there are examples where they provide access to financial services to large population groups, especially in rural areas, with very little support from governments or donors. Hence, there is a renewed interest among rural development stakeholders in financial cooperatives as a means to enhance access to financial services in rural areas.

In order to assess prospects for supporting further outreach by financial cooperatives to the rural poor and to identify deter-

¹ International Labour Office 1999.

minants of success of such endeavors, the World Bank's Agriculture and Rural Development Department (ARD) commissioned four country case studies² and organized four regional workshops in 2004 and 2005.³ The case study countries were chosen purposively as countries with financial cooperatives that have: substantial operations with a broad range of services and a relatively large rural outreach; a mature federation or network with a significant number of members in rural areas; been functioning for relatively long time; and were not being explicitly subsidized by the government.⁴ The workshops and case studies clearly suggested that financial cooperatives are a major provider of rural finance in many countries, and that some of them are already sustainable or have high potential of becoming sustainable with some external technical assistance.

This report "Providing Financial Services in Rural Areas: A Fresh Look at Financial Cooperatives" is based on the findings of these studies and workshops and international experience evidenced in the literature.⁵ The target audiences of this report are staff and management of international development agencies, policy makers and regulators in developing countries, and the financial cooperative sector and other rural finance practitioners both in developing countries and worldwide.

CASES AND THE LESSONS OF EXPERIENCE

Burkina Faso is one of the poorest countries in the world. In the difficult conditions this entails, financial cooperatives are the largest providers of rural financial services. *Reseau de Caisses Populaires du Burkina* (RCPB), the largest network of financial cooperatives, offers several financial products and reaches about one fifth of the nation's households, including many poor people. The cooperatives in this network are extending their outreach through innovative mechanisms, linking to women's groups and opening informal service points. The cooperatives in the network, and the subset of those situated in the rural areas, are profitable as a group, however, more than half of the rural cooperatives are not profitable. This limits further expansion of outreach. The primary reason for the losses appears to be the low uniform interest rates

applied on all loans, which are significantly lower than that applied by microfinance institutions (MFIs) in the region.

In Brazil, financial cooperatives serve over a quarter of the rural population and their outreach is growing fast among poorer Brazilians. The case studied—*Sistema de Cooperativa de Crédito* (SICREDI)—is a large and fast growing network, offering a large range of financial and other products. Low costs and lower profit expectations keep services priced below those of competitors. The sound financial situation has permitted rapid expansion and should permit SICREDI to increase its outreach further. Links to rotating savings and credit groups are one entry point for expanding the membership base as are the ability to offer a full range of financial products and services, and the strong balance sheet is an excellent basis for further growth and outreach.

In Sri Lanka, the Sanasa network has the largest rural outreach of all financial institutions, serving over 20 percent of the population, almost 90 percent of them in rural areas and nearly 60 percent of them women. However, most of the financial cooperatives remain very small and offer limited services, and there is a growing problem of overdue loans. A principal factor behind these problems appears to be lack of autonomy: the government restricts the growth and consolidation that is required to achieve sustainability. The supervision responsibility, which is exclusively held by the cooperative department, is also ineffective.

Kenya has a long history of cooperative development. Financial cooperatives, backed by the cooperative bank, reach 30 percent of the rural population with a broad range of products. Recent regulatory changes have allowed the financial

2 Burkina Faso, Brazil, Kenya, Sri Lanka

3 Washington, March 2004; Brazil June 2004; Azerbaijan; November 2004; Tanzania, June 2005.

4 Lessons from a study of some of the troubled systems of financial cooperatives would certainly also provide valuable lessons. However, it was not necessary for the scope of ARD's objectives and was left for future work.

5 A separate paper synthesizes lessons from the four case studies: Nair and Kloeppinger-Todd 2007. Cuevas and Fischer 2006; a recent World Bank Working Paper, discusses some of the key issues in the legal, regulatory, and supervision framework, and governance in financial cooperatives.

cooperatives to open to a wider clientele and to broaden the range of products offered. Outreach has been further increased by links to informal savings groups, and by running mobile banking services and “payment points.” Although the overall financial position of the sector appears sound, the regulatory framework and supervision by government is not adequate.

BUILDING GOOD GOVERNANCE IN SUPPORT OF SUSTAINABLE GROWTH AND OUTREACH

A **sound legal framework** is key to sustainable growth and expanded outreach of financial cooperatives. Whether laws are specifically drawn up for financial cooperatives or not, or whether one law or several apply does not appear to make a difference to the growth of financial cooperatives. What is needed is clarity on the powers and duties of financial cooperatives as member-owned financial institutions, on governance and supervisory responsibilities, and on protection of depositors. Also important is the legal framework for the financial sector as a whole: for example, the laws on collateral, the judicial process, and enforcement mechanisms. Legal frameworks can—and often should—evolve with the growth of the financial cooperative sector.

Regulation and supervision are essential to the growth of a healthy and sustainable financial cooperative sector. The regulatory framework for financial cooperatives needs to address the unique nature of financial cooperatives, as both financial institutions and cooperatives. Initially, regulatory requirements can be relatively light, but as financial cooperatives grow into broader financial institutions, they should progressively come under financial sector regulations based on best practice prudential norms and ratios. Two of the four case study countries do not have a regulatory framework adequate to enable the growth and development of financial cooperatives.

Supervision of the implementation of these regulatory requirements varies enormously. Supervision tends to be more effective for the larger financial cooperatives, while in many countries smaller financial cooperatives are little supervised. Some regions, particularly Eastern Europe

and Central Asia, have a particularly large “supervision gap.” In general, indirect supervision (auxiliary or delegated) works best for smaller “closed” financial cooperatives, but where financial cooperatives are large and open and essentially offer banking services, they are best placed under banking authority supervision. Supervision by ministries of cooperatives may deal inexpertly with prudential regulations, and also impose unnecessary administrative constraints on the growth of financial cooperatives. Where financial cooperative networks are made responsible for supervision, they need to be empowered with a clear legal mandate and capacity building.

Internal governance is a key challenge for financial cooperatives. The case studies for this report suggest that there is significant room for improvement in the governance of financial cooperatives in at least three of the four countries. Access to network support can help to build governance structures and capacity. Integration into a federated structure necessarily strengthens governance further, especially where there is access to pooled funds. Strong leadership is a great help and cooperatives do best when they have such leadership. Developing, motivating, and training human resources is a massive challenge. The networks play a big role here and this is one area where public or external support can certainly make a contribution.

DEVELOPING A STRONG BUSINESS BASIS FOR EXPANDED OUTREACH

As **businesses**, financial cooperatives meet a significant gap in the market with a sustainable institutional and business model. This is based on a member-owned service organization reaching an unserved but bankable clientele with products determined by demand, and with prudent financial management based on members’ resources and a “savings first” approach to credit discipline.

Successful financial cooperatives have followed a cautious, step-by-step approach to expanding the product range and the client base. Most financial cooperatives continue to base their lending on members’ resources, with some call on financing from elsewhere within the cooperative network. The virtues of financial self-reliance and savings

first, that serve financial cooperatives well in their early stages, do not appear to limit growth. Indeed, they underwrite a strong financial discipline within broader networks and help the financial cooperative sector grow to a scale where it may even compete with the banking sector. However, it is important that the common bond that is considered one of the most important features of a successful small primary financial cooperative be reinforced or replaced by other mechanisms that encourage financial discipline and good governance.

CROSS-CUTTING ISSUES

The cooperative sector has always drawn strength from its capability to work upwards from grass roots institutions towards **network arrangements**. Through vertical integration and with an increasing array of services and products over time, financial cooperatives can become as advanced as any other type of financial institution. For financial cooperatives, the benefits are strongest within federated models which help build governance at all levels, improve financial capacity, often enable primary financial cooperatives to offer more sophisticated products than they could on their own, reduce risk, and open up many other important economies of scale. Cooperative banks, too, have been successful in many countries in spreading risk and pooling liquidity and in linking financial cooperatives into the wider financial market. Many financial cooperative sectors have also developed other products such as insurance and leasing.

Political economy issues have great bearing on the governance of financial cooperatives. Governments have an essential role in setting up the enabling environment for financial cooperatives, but they often go well beyond that. Although the record is mixed, financial cooperative sectors on balance grow faster and more sustainably by handling their own promotion and supporting the strengthening of their own governance as far as possible and by keeping government intervention to the minimum. Where governments do intervene, a sustained open dialogue with an independent cooperative sector is essential. In any case, safeguards have to be written into financial cooperative governance against inappropriate or corrupt political interference.

Many financial cooperatives are very successful in achieving a large **rural outreach**. However, the historical pace of growth of financial cooperative sectors has varied considerably. In the case of Sri Lanka, it was a combination of institutional change (from savings clubs to financial cooperatives) and the growth of demand which triggered a rapid expansion. In the case of Brazil, a change in the law triggered growth. In Kenya, it was the link to the successful produce processing and marketing cooperatives that set off early growth. A second wave was triggered when the law changed to allow broader membership.

There are three factors that suggest that in many countries there is good market potential for financial cooperatives: a large population of poor rural people unserved by other financial institutions; a lack of fast growing alternatives; and a growing rural economy. Many countries have particular potential for increased outreach. In Sub-Saharan Africa, the potential is high, because of the poverty in rural areas and the lack of alternative providers. In Eastern Europe and Central Asia, there has been limited growth of financial cooperatives to date, but there is considerable potential, including in rural areas. In Latin America, financial cooperatives reach a significant number of households, but there is enormous scope for expanding membership and deepening financial outreach—and the networks have the needed financial capacity.

Expanding outreach requires the will and the endorsement of a growth strategy by the unions and primary financial cooperatives and their members. Failure to observe these conditions would undermine the democratic foundation of the financial cooperative sector.

TOWARDS AN AGENDA FOR EXTENDING OUTREACH SUSTAINABLY

There is a long track record of **external intervention**, much of it positive in its impacts. Long-term partnership approaches have brought sustainable institutional growth in many countries, and sector-to-sector partnerships have been particularly successful. In several countries, external partners have even helped to **initiate** a sustainable financial cooperative sector by supporting new central organiza-

tions and financial cooperative networks. The most successful external interventions have focussed on developing institutions to the point where the sector can stand on its own feet. Donors have also promoted innovation and helped develop new products for financial cooperatives. There are risks, however. *No assistance should undermine the financial profitability and savings-based business model of financial cooperatives.*

Entry points for external support can be identified at three levels: in the enabling environment; at the network level; and at the level of grass roots financial cooperatives. Support to the enabling environment can be a highly-g geared area where external agencies have a comparative advantage: policy dialogue; support for the development of an appropriate legal, regulatory and supervisory framework; strengthening of regulation and supervision capacity; and the development of prudential norms and standards. External partners can also support development of new products, particularly those of practical value to financial cooperatives.

External intervention is also highly geared at the network level. Here activities are best implemented through a long-term, technical assistance relationship, notably sector-to-sector twinning, with the agenda driven by demand from the national financial cooperative networks. Some possible externally financed activities could include helping with design of programs to safeguard customers' funds, developing information technology, supporting education and training programs, and helping to set up apex institutions such as a cooperative bank or insurance company.

Improving the outreach of the financial cooperatives is the final objective of external assistance. Much of the strengthening needed at this level will come through the network-level support provided. This support could include help in conducting demand assessments and preparing a strategy for outreach, support for the establishment of new financial cooperatives, support for expanded physical outreach of existing financial cooperatives, underwriting the costs of outreach for poorer or more dispersed clients, aiding informal groups to grow into financial cooperatives, and supporting the diversification and broadening of the product offering.

Unless carefully designed, any external support can undermine the very sustainability and outreach it is designed to support. Assistance has to be crafted to avoid distortions and the possibility of dependence. One area where external assistance is usually not necessary—and may even be harmful—is credit lines.

CONCLUSION: KEY LESSONS AND MOVING TO ACTION

Financial cooperatives are significant providers of financial services in rural areas, in both developed and developing countries. In the successful cases, this success is based on a tried and tested institutional and business model: democratic, bottom-up, autonomous, self-financing, and savings-based. Vertical integration has brought strength and efficiency to most financial cooperative sectors.

Many financial cooperative sectors have driven and financed their own growth. In some countries, however, governments and donors have intervened to promote, often using inappropriate instruments, and to control. In other cases, there have also been heavy influence-taking by political actors. There has been a history of government and donor interventions—largely unsuccessful and sometimes fatal to the concerned financial cooperative—of using these institutions to channel funding to specific target groups, without regard to the sustainability of the financial institution in the long run. Therefore, wherever possible, the sector should depend on itself for its own institutional strengthening and growth.

There is enormous growth potential for financial cooperatives in rural areas in many countries. However, expanding outreach spells risk, and sectors have to build their growth strategies on solid governance structures and a sound financial situation. Extending outreach has to be decided on by the sovereign instance—the membership.

External agencies committed to rural development and poverty reduction may explore ways to help the financial cooperatives in developing countries to grow and increase their outreach, particularly to the rural poor. Next steps might be to *link to the international financial cooperative sector* to identify particular windows of opportunity. Based on this, partnerships could be set up to carry out *regional*

and country analyses to pinpoint the areas for potential growth and the likely catalysts. Where external support is indicated, areas and the catalytic inputs could be identified in *country action plans*, and *country agreements for sustained partnerships* could be set up. In all this, *mechanisms for coordination between external partners* are critical.

A CALL FOR CAUTION

Reform or restructuring of such systems is very complex and difficult and needs to be carefully

considered. Examples of systems of financial cooperatives and cooperative banks that are considered for restructuring are found in India, China, and Turkey,⁶ among others.

⁶ For example, the World Bank in May 2007 approved a \$600 million loan to India for the purpose of restructuring its system of financial cooperatives. Some of China's districts are considering reforming their systems of Rural Cooperative Banks (RCBs) in order to make them sustainable and Turkey is analyzing its financial cooperatives for possible reforms.

OBJECTIVES OF THE REPORT

In recent years, there has been a renewed understanding of the vital role in rural economic growth that can be played by accessible financing. In many countries, financial cooperatives have provided this accessible financing, bringing financial services to a broad rural clientele, “breaking the market failure”, as a 2006 World Bank working paper puts it.⁷

What is the scope for financial cooperatives to scale up and to further expand their rural outreach without increasing risks or undermining their sustainability? What are the characteristics of financial cooperatives that have such potential? What are the supporting conditions that need to be in place? Finally, what can the World Bank and other development agencies and countries do—or not do—to promote further outreach?

These are the questions which will be answered by this report. The report complements the 2006 World Bank working paper cited above. Where the working paper focused on the governance framework—and in particular on the regulatory and supervisory framework and on the rules regarding financial cooperative and federation management—this report focuses on development potential of financial cooperatives, particularly as sustainable providers of financial services in rural areas. A separate Discussion Paper synthesizes lessons from the four case studies commissioned as background papers for this report.⁸ The full case studies are available on request.

The target audiences are management and staff of international development agencies, policy makers and regulators in developing countries, and the financial cooperative sector and other rural finance practitioners both in developing countries and worldwide.

⁷ Cuevas and Fischer 2006.

⁸ Nair and Kloeppinger-Todd 2007. This report is available in French and Portuguese also. All case studies are available in English. The Brazilian case is available in Portuguese and the Burkina Faso case is available in French.

Table 1: Some Examples of Outreach by Cooperative Networks

Desjardins (Canada)	609 local cooperatives (985 service outlets) in 3 Canadian provinces serving 5.6 million members
RCPB (Burkina Faso)	108 local cooperatives providing national coverage
Kenya	Cooperatives mobilize 31 percent of domestic savings
People Credit Funds (Vietnam)	930 cooperatives serve over one million members
RCC (China)	Over 37,000 cooperatives throughout the country
Russia	1,200 cooperatives
ALKU (Lithuania)	56 cooperatives serving 55,000 individuals
Mexico	1,800 entities serving over 2.5 million members
Cyprus	Cooperatives deliver 30 percent of the country's banking services
Rabobank (Holland)	288 local cooperatives (1,299 service outlets) serving 1.5 million members
India	112,309 primary agricultural cooperatives reaching 120 million members

Source: Gaboury and Quirion 2005.

THE IMPORTANCE OF FINANCE TO RURAL DEVELOPMENT

The vital role of rural finance derives from its contribution to the three strategic goals of rural development and rural poverty reduction: (i) rural economic growth; (ii) inclusion and participation of all rural people in development; and (iii) reduction of vulnerability to economic, physical, and other shocks (World Bank 2005III).

Regarding *rural economic growth*, access to financial services helps small farmers to improve productivity through investment in irrigation, production equipment, inputs or hired labour, and also to invest in post-harvest handling, processing, and marketing. Substantial agricultural development—and development of related processing and marketing facilities in rural areas—and real increases in the incomes of rural families have happened almost nowhere without access to financial services. Rural finance can also help create opportunities for non-farm enterprises, in businesses ranging from handicrafts to commerce and telecommunications.

Where rural finance has been able to *include the rural poor*, as with the “microfinance revolution” or financial cooperatives, it has helped to resolve a key constraint to poverty reduction by providing resources that allow the poor to invest and so pursue new economic opportunities.

Rural finance *reduces vulnerability* through savings and access to credit which help rural house-

holds manage seasonal liquidity shortages, and meet planned life events such as marriage and childbirth and unplanned life events such as a health emergency and death. Access to insurance services helps the poor directly mitigate some of these risks. Well-functioning rural financial systems can also help poor families receive remittances reliably and at low cost.

For most rural people, commercial banks do not provide these services. As a result, most economically active rural people depend on family support or on high-cost informal sources like traders or money lenders. Financial cooperatives provide financial services to a significant part of the rural population, thus filling an important gap on the continuum of financial service providers from commercial banks to the informal providers such as village moneylenders and friends and relatives.

WORLD BANK APPROACH TO RURAL FINANCE

Until the early 1990s, World Bank support to rural finance was largely through credit lines managed by parastatal banks. Impacts on rural livelihoods proved limited, largely restricted to the better off, and low recovery rates, high costs, and a “credit only” approach inhibited the development of these banks as sustainable institutions.

Based on this disappointing experience, the donor community and governments reassessed their approach and developed a new market-based

paradigm characterised by a broad range of financial services (rather than just credit) offered to all rural people (not just farmers) at market interest rates. Institutionally, the emphasis shifted to an insistence on operational efficiency and financial viability of rural financial institutions.

From these changes, the World Bank has adopted five guiding principles in its approach to rural finance:

- *Demand responsive approach*, serving rural people with the products they need and including savings, insurance, and payment and remittance facilities, as well as credit.
- Priority to *sustainable institutions*, with emphasis on savings not only as a product demanded by rural people but as a key factor in financial discipline and in the financial sustainability of intermediaries.
- Clearly defined but *limited role for government*, essentially in establishing good macroeconomic policies and a conducive legal and regulatory framework.
- Financial support to rural finance institutions to be restricted primarily to *technical assistance* and *capacity building*; loanable funds to be provided only when liquidity is the primary constraint and are accompanied by actions that address this market failure.
- *Holistic approach*, supporting improved access to financial services within the whole range of measures that promote rural economic development.

Based on these principles, the Bank has invested in analytic work in a number of countries and a number of rural finance projects. In FY 2004, for example, the Bank provided US\$288 million under 20 projects, including both exclusively rural finance projects and rural finance components in multisector projects. These projects variously financed improvements in service provision, demand development, market facilitation, and the enabling environment. Four of these projects directly supported the development of financial cooperatives, and three supported the development of savings and credit groups that could link into the financial cooperative sector. Other types of service providers supported by this rural finance lending were microfinance institutions (five projects) and banks and non-bank financial institutions (three projects).

FINANCIAL COOPERATIVES AND OTHER PROVIDERS OF RURAL FINANCIAL SERVICES

Financial cooperatives are among institutions with the largest outreach in rural areas, both in the developed world and the developing world.

Credit Agricole in France and Rabobank Netherlands provide a major share of rural financial services in these countries and are among the biggest banks in the world. In countries such as India, China, Sri Lanka, Burkina Faso, and Kenya financial cooperatives are among the largest providers of rural financial services. However, in many developing countries the high level of outreach has come at the expense of profitability.

Financial cooperatives are not the only financial institutions with important rural outreach. Other financial institutions that provide services in rural areas include commercial banks, microfinance institutions (MFIs), postal savings banks, agricultural development banks, and community-based organizations.

MFIs have proved very successful in many countries but their focus is typically urban and limited to a few products. The origin of MFIs was the need to serve people typically excluded by other financial institutions—i.e., the poor, women, and the handicapped. MFIs seek to build creditworthiness and incomes among their clients through very small loans, which may progressively increase in size over time. Many of these MFIs have been successful and some are now transforming themselves into regulated, deposit-taking institutions. Up to now, their main focus has been on the more concentrated—and therefore easier to manage—urban clientele, but many are now seeking to expand their outreach to rural areas. However, their focus on a limited range of small-scale products and their inability to reach remote rural areas leaves much of the demand unmet.

Which form of organizations can play a leading rural finance role depends on local economic, social, and historical circumstances. MFIs can play an important role in rural areas where they are present, and can reach an otherwise neglected part of the population. They can play a significant role in areas with very large numbers of poor people, such as Bangladesh, or in areas such as Afghanistan where economic activity and mutual trust have eroded.

Financial cooperatives target a population that is very much broader—and perhaps better off, hav-

ing at least some liquidity and a capacity to save, and a need for a relatively broad range of financial services. Cooperatives do better in areas with well-established market economies and a tradition of mutual self-help.

Post offices can meet only a part of the demand for financial services. Postal savings banks can be an efficient way to provide savings, payment, and money transfer facilities to rural populations but they do not extend credit. Therefore, their role can at best be complementary to other full-service financial institutions.

Agricultural development banks can transform into broad-based rural financial institutions—but examples are few and far between. For many years, government-owned agricultural development banks were the institution of choice for rural finance. Their credit-only, subsidized approach, often acting as agents for lines of credit, proved unsustainable: repayment rates were low and poorer people rarely benefited. Many of these banks have been liquidated, while others have been restructured to respond to the new, liberalized market situation.

Some of these transformed banks have successfully turned themselves into broad-based rural financial institutions. For example, the Agricultural Bank of Mongolia privatized and renamed Khan Bank provides services to rural populations throughout Mongolia and indeed is the sole provider in most cases.

Commercial banks reach significant rural population only in very few countries. In the past, commercial banks have been encouraged—or even obliged—to open rural branches and to run smallholder lending programs. The encouragement has diminished with liberalization, and many banks have closed down smallholder lending and reduced their rural branch network. Nonetheless, in some countries such as India and Indonesia, public commercial banks play a major role in providing rural financial services.

Community-based financial organizations can reach the poorest and can be complementary to financial cooperatives. Community-based financial organizations, such as self-help groups in India and village savings and loan associations in Africa, are beginning to demonstrate that they can provide viable financial services to large numbers of poor people who live in sparsely populated rural areas. In India, vertically integrated networks of self-help groups linked to banks are now providing financial ser-

vices to hundreds of thousands of poor women who previously had no access to financial services. Essentially, these organizations practice a very simple form of cooperative banking, and there is clearly scope for synergy to improve financial cooperative outreach and to scale up the groups' access to services.

Summary. None of the institutional types mentioned above should be ignored when promoting increased access to financial services in rural areas. Several of them can, under the right circumstances, be complementary to the development of financial cooperatives.

Since the unmet demand for financial services in rural areas is large in most developing countries, there is plenty of scope for expansion of all organizations that have a mandate or interest in serving rural areas and have products, processes, and systems that allow them to do so sustainably.

METHODOLOGY AND ORGANIZATION OF THE REPORT

This report is based on a major review exercise organized by ARD in 2004–2006 that comprised four regional conferences and four in-depth case studies.

The four regional conferences—on the theme *Strengthening Financial Cooperatives*—were organized between March 2004 and June 2005 in: Bagamoyo, Tanzania; Baku, Azerbaijan; Recife, Brazil; and Washington DC. Over 200 rural finance specialists took part. The objective was to create a forum for key stakeholders of financial cooperatives and for resource persons from the international network to share experiences and ideas about how to sustainably expand the outreach of financial cooperatives.⁹

In addition, ARD commissioned case studies on well-established financial cooperative networks in four countries. The selection criteria for the case study countries (Box 1) were designed to ensure that substantive lessons could be drawn. Based on these criteria, Burkina Faso, Brazil, Sri Lanka, and Kenya were purposively selected, field work was carried out, and the cases were written up.¹⁰

⁹ See Annex IV for a summary of the conference findings.

¹⁰ The case studies are summarized in Chapter 3 of this paper and details can be found in Annex IV.

Box 1: Criteria for the Selection of the Case Study Countries and Networks

- The scale of operations of financial cooperatives had to be substantial, with a broad range of products and services, and with a large rural outreach.
- The country had to have a mature federated or network structure with a substantial number of member institutions in rural areas.
- The financial cooperatives have been functioning for a relatively long period of time.
- The financial cooperatives should be operating without explicit government subsidies.

Source: Authors.

Drawing on the wealth of knowledge and insights generated from these exercises, this report first identifies the unique characteristics of cooperatives in general and financial cooperatives in particular, as well as their histories (Chapter 2). Chapter 3 summarizes the lessons from the case studies. Chapter 4 focuses on legal and regulatory issues and a supervision framework. Key issues for building good governance and the business

basis in support of improved outreach and sustainability are discussed in Chapter 5 and 6. The final chapters first review cross-cutting issues and the experience of external support for development of financial cooperatives and then discuss how and when to intervene, and entry points for donor support. The report concludes with a summary of key lessons and a discussion of how to move forward to action.

Characteristics and History of Financial Cooperatives

COOPERATIVES: A BRIEF INTRODUCTION

Originating in Europe, the cooperative model has been successfully transplanted to many developing countries. Cooperatives originated in Europe during the 19th century as mutual self-help organizations for poor people. In England, the “Rochdale Pioneers” established consumer cooperatives on principles that are still broadly adopted by cooperatives today.

The cooperative model was first taken to the developing world when Sir Frederick Nicholson, the “father of Indian cooperatives”, adapted the model to the Indian situation. Many cooperative sectors in developing countries followed.

Where governments tended to play a larger role. In contrast to the autonomy and self-reliance that characterized the early cooperative sector in Europe, cooperatives in developing countries were often promoted and closely regulated by governments which saw them as instruments of both control and development. Many cooperative systems became dependent on monopoly situations: many were little more than distribution channels for state-subsidized inputs or monopoly marketing agents for crops. Often they were dependent on various forms of subsidies, and they were open to manipulation and corruption.

The liberalization of the 1980s and 1990s forced a move back towards more autonomy for cooperatives. In many countries, this controlling and protectionist approach persisted after independence, and even intensified where centralizing or socialist governments ruled. However, the economic and political liberalization of the 1980s and 1990s created serious challenges. Cooperatives in developing countries were ill-prepared, and some failed. As a result, cooperative laws were rewritten in many countries to recognize that cooperatives are private, self-help organizations belonging to their members, and to reduce the power of the government to intervene. In many countries, governments transferred their former support functions to the cooperative sector.

Cooperative law in most countries now reflects the basic cooperative principles. In most countries where cooperatives operate, the law reflects most or all of the principles codified by the International Cooperative Alliance (Box 2). Laws also recognize cooperatives as businesses,

Box 2: Cooperative Principles

1. *Voluntary and open membership.* Cooperatives are voluntary organizations, open to all persons able to use their services and willing to accept the responsibilities of membership, without discrimination based on gender, social, racial, political, or religious affiliation.
2. *Democratic member control.* Cooperatives are democratic organizations controlled by their members, who actively participate in setting their policies and making decisions. Elected representatives are accountable to the membership. Members have equal voting rights (one-member, one-vote).
3. *Member economic participation.* Members contribute equally to and democratically control the capital of their cooperative.
4. *Autonomy and independence.* Cooperatives are autonomous, self-help organizations controlled by their members. If they enter into agreements with other organizations, including govern-ments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their cooperative autonomy.
5. *Education, training, and information.* Cooperatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their cooperatives. They inform the general public—particularly young people and opinion leaders—about the nature and benefits of cooperation.
6. *Cooperation among cooperatives.* Cooperatives serve their members and strengthen the cooperative sector by working together through local, national, regional, and international structures.
7. *Concern for community.* Cooperatives work for the sustainable development of their communities through policies approved by their members.

Source: Authors.

licensing them to act as commercial enterprises, able to retain their surpluses and to build up their capital base to a level that enables them to compete in a market-oriented economy.

FINANCIAL COOPERATIVES: THEIR ORIGINS AND DEVELOPMENT

Financial cooperatives originated as local savings and loan organizations in developed countries, where they have matured into nationwide financial institutions. The first financial cooperatives were agricultural credit cooperatives set up in Germany under the guidance of Friedrich Raiffeisen, initially in response to the potato blight of 1848.¹¹ Their original purpose was to provide small loans to poor farmers or small entrepreneurs. From these humble beginnings, financial cooperatives in Europe and parts of North America have progressed steadily from village-based organizations to full-scale

banks. In most developed countries, these banks are now under central bank supervision and are full-fledged participants in financial markets, providing a wide range of financial services. Cooperative banks are especially strong in collecting savings, which are the principal source of their funds for lending operations. In some countries they manage 20–40 percent of the funds in the deposit market (i.e., Germany, Netherlands, Ireland, and Finland).

Cooperative banks in developed countries are nearly always federated under an apex bank such as DZ Bank in Germany, Rabobank in the Netherlands, Crédit Agricole in France, and Desjardins in Canada. These mature cooperative banks belong to the International Cooperative Banking Association, based in Switzerland.

¹¹ For more about the origins and early history of financial cooperatives (and of cooperatives in general), see Annex II.

In the developing world, the origins and development path of financial cooperatives parallel those in developed countries. Primary-level financial cooperatives typically start as small organizations, based in a village or workplace. In the beginning, they are usually managed by members on a voluntary, part-time basis, and provide only savings and loan basic products. Lending is financed by the pool of members' savings. The organization is registered as a cooperative, is owned by its members, and follows a one-member, one-vote principle. The members' liability is limited to the value of their shares. The financial cooperative may also be subject to a voluntary or statutory code regulating the governance and management of financial cooperatives in the country.

As membership expands and the business grows, the financial cooperative may take on salaried managers and staff. The financial cooperative at this stage may follow several growth strategies:

- Enlarge the membership criteria beyond the village or work place.
- Move away from "closed", members-only status, to open its services to non-members.
- Join a higher-level network—a union, federation, or a cooperative bank—in order to benefit from common services and access to additional financial resources.
- Extend the range of products and services, with mature financial cooperatives often of-

fering a very wide range of products, both financial and non-financial.

However, financial cooperatives in different countries follow different paths and rates of development. Financial cooperatives may range from informal village-based savings and loan organizations to semi-formal financial cooperatives, right up to large credit unions and formal cooperative banks. The path and pace of growth varies across countries. For example, India, Brazil, and Kenya have large financial cooperative sectors. While the growth in India and Kenya was led primarily by the government, in Brazil growth was primarily led by federations. The level of integration of the sectors also varies. For example, the Kenyan and Sri Lankan financial cooperative sectors are much less integrated than those in Brazil and Burkina Faso.

Credit unions are essentially financial cooperatives that emerged from work places. A credit union is a closed institution offering services only to its members who have a common bond—typically a place of employment or profession.

Financial cooperatives have national and global alliances. Financial cooperatives belong through their national organizations to one or more international alliances. These international institutions (Box 3) report membership of national organizations with over 950,000 financial cooperatives and credit unions, and a staggering 636 million members worldwide.

Box 3: The International Financial Cooperative Sector and Support Structures

At the international level, there are two global organizations with different functions which represent financial cooperatives: the International Cooperative Banking Association (ICBA) and the International Raiffeisen Union (IRU). ICBA provides and promotes technical cooperation, whereas the IRU is an advocacy organization dedicated to maintaining and spreading the financial cooperative spirit and reputation. IRU has member organizations from 100 countries, nearly all of them national federations or banks,

and represents 900,000 financial cooperative societies and 500 million individual members.

Credit unions subscribe to the World Council of Credit Unions (WOCCU), which represents more than 43,000 credit unions and through them 136 million individual members.

The international apex organization for all types of cooperatives is the International Cooperative Alliance (ICA), which has 226 member organizations from 91 countries, representing more than 800 million individual cooperative members.

SPECIAL RELEVANCE OF FINANCIAL COOPERATIVES TO RURAL AREAS

Providing financial services in rural areas is challenging for several reasons. Costs are high, the risks are great, and the overall returns low and uncertain. Over the last 100 years, financial cooperatives in many countries have demonstrated the ability to achieve a broad outreach in rural areas. Three characteristics of financial cooperatives have marked the growth of financial cooperatives as rural finance providers in developed countries. Although these characteristics are not applicable to the history of financial cooperatives in many developing countries—where they were set up by governments and used as channels to provide rural credit—the characteristics remain relevant to initiatives that seek to revitalize and strengthen financial cooperatives as rural finance providers.

Financial cooperatives grew in response to a felt need, and their capacity developed along with their services. Cooperatives are locally established by members for members. By definition, their services correspond to members' expressed needs and the range of services and financial volume expands as a direct function of performance. Good performance stimulates demand, deposits finance products, management skills develop, and the cooperative and its capacity grow step by step.

Financial cooperatives have a business model which is anchored in their characteristics as locally-based, member-owned organizations. Credit discipline comes from the fact that their financial resources depend, at least initially, on member savings. The need for a savings first approach imposes disci-

pline on members to develop sound financial habits. It also creates a culture of responsibility and prudence throughout the institution, based on the knowledge that resources belong to the members and not, for example, to the government.

Costs are typically lower than those for commercial banks. Salaries are modest and monitored by members. Premises are simple. Profits are usually tax exempt. Deposit rates are usually low. Margins reflect objectives of mutual self-help and institutional sustainability rather than profit maximization.

Risks are also typically lower than for commercial banks. Most or all borrowers are member shareholders, whose financial history, enterprise, and character are usually well known to the credit committee. The savings first approach will usually have established financial discipline, and a balancing deposit account, and the payment of receipts into the cooperative account, will usually be required. In case of difficulty, mutual solidarity and peer pressure will make repayment a social obligation.

Financial cooperatives are private organizations established by people for their own benefit and based on an institutional model that has evolved over the years which embodies long experience of success. The institutional model is "bottom up", based on grass roots initiatives. Rural people can acquire this model and adapt it to their purposes at very low cost, and often with support from a local, national, or international agency that will help with institutional development. This avoids costly trial and error. As financial cooperatives grow, they usually federate at regional and, ultimately, at national levels, and so represent an important private sector economic force.

This chapter gives a brief summary of the four case studies commissioned as background studies for this report. As was mentioned in section 1.3, these countries were selected because they had financial cooperatives that: have been in operation for a relatively long time; have substantial operations with a broad range of services; have a large rural outreach; are part of mature network; and do not receive explicit subsidies from the government. A caveat in drawing conclusions from the cases: all data reported in the cases are self-reported. Wherever some changes have been made to the data provided by the institutions, they have been to correct for totaling. No adjustments have been made to financial statements. Table 2 gives select economic development indicators for these countries. Indicators for South Korea and the United States (USA) are included for comparison with more developed countries.

BURKINA FASO

One of the poorest countries in the world, with low and erratic rainfall and scant natural resources, Burkina Faso has almost half (46 percent) of its population below the poverty line. Banking services are very limited outside towns, and only half of the country's provinces (23 out of 45) have any bank branch at all.

Financial cooperative sector has achieved remarkable outreach in a very difficult environment. The Réseau de Caisses Populaires du Burkina (RCPB) is by far the most important financial intermediary in the rural sector, especially for poor people (Box 4). There are four regional unions, which have a network of 124 independent caisses populaires in the country, spread over 32 of Burkina Faso's 45 provinces. The total number of members and clients at the end of 2005 was 430,000, approximately one-fifth of Burkina Faso's 2.3 million families.

RCPB has developed women's solidarity groups to increase its outreach. Despite its substantial outreach, RCPB is still concerned that it has too little penetration in rural areas—most of the country's 8,000 villages have no close access to a caisse populaire or to any other formal or semi-formal financial institution. RCPB has therefore developed two innovations to expand its outreach into less populated areas.

First since 1990, RCPB has been adding small, village-based women's solidarity groups. The groups are linked to the closest caisse populaire, which also organizes education and training for the

Table 2: Case Countries—Select Economic Development Indicators

Country	Estimated Population (million) 2005	Human Development Index Rank (out of 177 countries) 2003	Life expectancy at birth, total (years) 2004	GDP per capita (PPP, US\$) 2005	Poverty Head-count Ratio (% below US\$1 PPP) 2004	Rural Population (%) 2005	Agriculture Value Added (% of GDP) 2005
Brazil	186.40	63 (0.792)	71	8,730	8	16	10
Sri Lanka	19.58	93 (0.751)	74	4,569	6	85	17
Kenya	34.26	154 (0.474)	48	1,165	23*	79	27
Burkina Faso	13.23	175 (0.317)	48	1,222	27	82	31
South Korea	48.29	28 (0.90)	77	21,868		19	4
USA	296.50	10 (0.94)	77	41,854		20	1

* 1997

Source: World Bank 2006, UNDP 2006.

women, especially in health care. Subsequently, the *caisse populaire* provide small loans to these solidarity groups, thus extending outreach substantially. Some 3,215 village solidarity groups were granted loans in 2005.

A second popular innovation has been the establishment in rural areas of small service points. In many cases, a community has asked to get a *caisse populaire* in its area but a feasibility study has shown that this would not be financially viable. Instead, RCPB helps the closest *caisse populaire* open a “service point” in the interested community to provide basic savings and credit services. In this way, RCPB reaches the widely-dispersed population without the high cost and risk of setting up a new *caisse populaire*.

A wide range of products and services are provided. Despite the poverty of the country, a surprisingly wide range of financial services are available in typical *caisses populaires*, including a large number of savings products (sight and term deposits, savings from salary, special savings accounts for education, funerals, retirement, etc.). Loan products are equally diverse, including salary advances and social loans (for marriages, funerals, etc.); loans for furniture, transport, and housing; agricultural loans for farm inputs, equipment and labor; and commercial credit including loans for inventory, prefinancing of produce, and equipment purchases. Other financial services offered include salary transfers to home area and check cashing. In

addition, RCPB offers advisory services through subsidiary firms, including evaluation of commercial projects.

Low lending interest rates have left many rural financial cooperatives insolvent and make RCPB's finances vulnerable. As a network, the RCPB is profitable. Its surplus grew from FCFA 659 million (US\$1.3 million) in 2002 to FCFA 1.2 billion (US\$2.3 million) in 2005. Rural *caisses populaires* as a group have shown an improving trend in profitability, reducing losses from 2002 to 2004, and becoming profitable in 2005. However, less than half of the rural *caisses populaires* were solvent. The combined accumulated deficit in the insolvent *caisses* in 2005 was FCFA 710 million ((US\$1.4 million). Interest rates and yields are too low—the interest rate for most types of loan is only 10 percent on a declining basis and actual gross yield is only 7 percent on the total portfolio—to cover all risks and costs.

This constrains increases in rural outreach. Low spreads and inadequate risk premia inevitably make the cooperatives reluctant to expand outreach to a riskier clientele.

Summary. RCPB is a profitable network offering a solid range of products and reaching a large rural population, including many poor people. The cooperatives are extending their outreach through innovative mechanisms, linking to women's groups and opening informal service points. However, further outreach is constrained by losses in many rural cooperatives, caused primarily by reluctance

Box 4: Cooperative Financial Institutions in Burkina Faso

- There are three major networks of financial cooperatives in Burkina Faso, with a total of 276 offices.
- The largest of the networks is the RCPB. It has a federated structure, with the Fédération de Caisses Populaires du Burkina (FCPB) at the national level, regional unions, and FCPB branches (*Antennes techniques*) at the regional level, and 124 local financial cooperatives (*caisses populaires*) at the local level.
- The *caisses populaires* have 430,000 individual members, representing about one-fifth of the country's 2.3 million families. Membership is open to all persons living within the area of a *caisse populaire*.
- The RCPB network is profitable as a whole.
- Financial cooperatives are regulated under a law called PARMEC that is common to most Francophone countries in West Africa.
- By law, financial cooperatives within the West African Monetary Union, which includes Burkina Faso, are supervised by the Banque des Etats de l'Afrique de l'Ouest and by the monitoring units of the ministries of finance in each member country. In practice, the supervision in Burkina Faso has been undertaken mostly by FCPB.

Source: Aeschliman 2007.

to charge higher interest rates that cover all costs and risks involved in rural lending.

BRAZIL

Brazil, the largest country in South America, is a middle-income country but with very wide income disparities. The banking sector is large and sophisticated, yet outreach is limited: only one-third of adult Brazilians have a bank account. Financial cooperatives have only 6 percent of the rural financial market in money terms but serve over a quarter of the rural population and are growing fast among poorer Brazilians who do not otherwise have access to financial services.

Commercial banks and subsidized rural finance programs are major providers of credit in rural areas. The main financial actors in rural areas are: the federal bank Banco do Brasil; the private bank Bradesco; a variety of regional development financial institutions; and financial cooperatives. Government subsidizes rural credit and channels it through public financial institutions, either directly or by an on-lending agreement with private entities. A separate subsidized government program, Programa Nacional de Fortalecimento da Agricultura Familiar (PRONAF), provides credit to small agricultural producers.

More than a quarter of rural households access financial cooperative services. Financial cooperatives' volume of rural lending accounts for only 6.2 percent of total financing but is relatively important in terms of outreach. Of the five financial cooperative networks, the largest are the Sistema de Cooperativas de Crédito do Brasil (SICOOB), with 1.2 million members and SICREDI, with about 1 million members. The three others have fewer than 200,000 members together and limited rural outreach. The Cooperative Bank estimates that about half of the memberships in these cooperative networks are rural. Thus, about 27 percent of the 4.1 million rural households in Brazil benefit from cooperative financial services.

The case studied—SICREDI—is a large and fast growing network. SICREDI was selected for the case study because it is rapidly expanding its outreach and about half of its members are from rural areas (Box 5). One-third of its individual members are women, and women are also often the joint owners of savings and loan accounts. In the rural areas, SICREDI's main competitor is Banco do Brasil, which is often the only other financial services provider.

It is a highly integrated network. Financial cooperatives that are part of the SICREDI network are horizontally and vertically integrated. The cooperatives are responsible for each other's operating re-

Box 5: The SICREDI Financial Cooperatives

The SICREDI financial cooperatives have a vertically integrated structure that includes:

- At the base level, 130 primary savings and credit cooperatives, with 890 branch offices and service points.
- At the secondary level, five “Centrals” (regional unions), owned by the primary cooperatives. The Centrals have branches for groups of two or more primary cooperatives.
- At the tertiary level, a Confederation and a Cooperative Bank, owned by the Centrals and primary cooperatives.
- Individual membership at the base level of more than 1 million in 2006.

- A democratically constituted General Assembly as the highest decision-making body at all levels.
- Since 2005, supervision of all financial cooperatives and all non-bank financial institutions by a specialized department within the Central Bank—Departamento de Supervisão de Cooperativas (DESUC)—and in the case of primary cooperatives, auxiliary supervision by the Centrals.

The SICREDI cooperatives have maintained a very satisfactory financial and operating performance over the past five years. The profits for the network as a whole have grown steadily from R\$61.2 million (US\$ 29.9 million) in 2001 to R\$149.4 million (US\$ 72.9 million) in 2005.

Source: Brusky 2007.

sults and must absorb losses in any cooperatives in the network. Operational manuals are elaborated by the apex institutions and enforced by the Centrals. Administrative processes, credit policies, auditing procedures, human resource and remuneration policies, and product offerings are standardized across the cooperatives. A key feature that makes such standardization possible is the networked Management Information System.

As a result, its range of products is very broad. SICREDI offers a remarkably broad range of products and services, similar to that obtainable through banks, including some 64 loan products, 11 savings products, and 22 insurance products. If all the variations are counted, SICREDI has close to 160 products. Not all these products are available everywhere but a typical primary savings and credit society in the SICREDI network might offer: a variety of savings products, including passbook savings and time deposits; up to 28 forms of credit; and many non-banking products, including basic forms of life assurance, car and accident insurance, property and equipment insurance, and several forms of agriculture insurance (hail damage, crop failure). Outreach is enhanced by offering deposit facilities to informal rotating savings and credit clubs. In addition, a primary cooperative could also offer access to mutual investment funds through

the regional unions and the Cooperative Bank. Other services include facilities for check cashing, salary transfers to home area, access to credit cards, and foreign exchange services.

The SICREDI cooperatives have maintained a very satisfactory financial and operating performance over the past five years. Savings interest rates are slightly above the market rates and lending interest rates are slightly less than those practiced by banks because of the lower costs and risks and lower profit targets that characterize financial cooperatives. However, the network’s policy is not to emphasize low interest rates or fees in order to gain new members but rather to present this aspect as just one of the many advantages of member-owned cooperatives.

The strong balance sheet is an excellent basis for further growth and rural outreach. Profits for the global network have grown steadily over the past five years (Box 5).¹² Profits are distributed inside the system: 50 percent is added to the members’

¹² SICREDI has been profitable despite PRONAF, the publicly subsidized credit program, being the source for three-fourths of rural credit provided by its member financial cooperatives. There seems to be adequate mark-up available on these funds. SICREDI management estimates profitability on these loans to be around 3–5 percent. No analysis was done of the broader effect of these subsidies on the rural finance market.

shares; 45 percent goes to reserves; and 5 percent to a technical assistance and educational fund. The portfolio quality of the network as a whole is excellent, with default rates at less than 1 percent. The network's financial strength would allow it to finance further increased rural outreach.

Summary. Brazil's financial cooperatives have considerable outreach, serving over one-quarter of rural households. Nearly half the financial cooperatives in the SICREDI network, with nearly half of the total membership, are in rural areas. Yet the network is fully profitable with a high quality portfolio, offering a very large range of financial and other products. Low costs and risks and lower profit expectations keep services priced below those of competitors. The sound financial situation has permitted rapid expansion in rural areas and should permit SICREDI to increase its outreach further. Links to rotating savings and credit groups are one entry point for expanding the membership base.

SRI LANKA

Although incomes in Sri Lanka are the highest in South Asia, almost one-quarter of the population live below the poverty line. The country is densely populated, with almost three-quarters of the pop-

ulation living in rural areas. Literacy rates are very high.

Over three-quarters of Sri Lankans have access to basic financial services, but the range of products is very limited. State banks dominate the commercial banking sector and one—Ceylon Bank—has branched out into rural lending using a Grameen Bank approach. There are many other institutions involved in rural finance, including the multipurpose cooperatives, many of which have rural finance branches. As a result of this extensive rural financial outreach, over three-quarters of Sri Lankan households, excluding those in conflict-affected areas, have access to some form of savings account and short-term credit. However, the range of financial services to which these households, especially poorer households, have access is limited.

The Sanasa network has the largest rural outreach among all financial institutions. The Sanasa network of financial cooperatives (Box 6), with its 8,840 primary societies (PTCCS) located throughout Sri Lanka, has the largest rural outreach of all financial institutions in the country, serving about 20 percent of the population. The only financial service provider with a larger outreach is Samurthi, the government's social welfare program that provides credit to households that receive welfare payments.

Box 6: Sanasa Cooperatives in Sri Lanka

- The Sanasa sector, an organization that dates from 1906, is based on independent Primary Thrift and Credit Cooperative Societies (PTCCS) at the field level.
- The secondary- and tertiary-level structures consist of 25 district unions, a national federation and five companies, of which the Sanasa Development Bank Ltd. (SDBL) and the Sanasa Insurance Company are the most successful.
- The others are the Sanasa Educational Campus, the Sanasa Engineering and Development Company (SEDCO), and the Sanasa Producer Consumer Alliance (SANEEPA).
- The Sanasa sector has 8,840 PTCCS and a total individual membership of 855,000, of whom 58 percent are women.
- The PTCCS are supervised by the Ministry of Cooperatives. Although the Sanasa structure is nominally vertically integrated, the federation and district unions are not permitted to supervise the PTCCS due to their "independence" (This independence is doubtful, because the Ministry of Cooperatives can intervene at any time).
- The cooperative bank, SDBL, is licensed and supervised by the Sri Lankan Central Bank.
- There are no consolidated statistics available on the financial performance of the PTCCS, but consolidated past due loans total 23.5 percent of the portfolio in 2004.
- The SDBL and the Sanasa Insurance Company are profitable, whereas the other companies owned by the sector make small losses.

Source: Owen 2007b.

The vast majority—an estimated 90 percent—of PTCCS operate at the village level and they are present in all of Sri Lanka's 27 districts. Sanasa's 855,000 members are largely middle- to low-income entrepreneurs, farmers, workers, and civil servants from all ethnic communities. Some 58 percent of members are women.

The range of products available can be very broad. The Sanasa cooperatives offer a range of banking and other financial and non-financial services. Financial services available in a typical PTCCS include: savings and fixed deposit accounts; consumer loans; social loans (for marriage, funerals, etc.); micro loans (for salary advances, furniture, transport, etc.); and agricultural loans (credit for equipment and labor). The PTCCS also offer loans to community organizations for rural infrastructure, such as solar energy, biogas, and sanitation. Non-financial services are available on an agency basis, including life insurance, loan insurance, and vehicle and property insurance. Some PTCCS also offer other revenue-raising services such as post office and phone services.

But two-thirds of financial cooperatives remain very small and offer very limited services. Despite this wide range of potential offerings, two-thirds of the primary-level financial cooperatives are very small, have no paid staff, and offer no financial products other than the basic savings and credit accounts.

Beyond these services, Sanasa also functions as a social institution. PTCCS are involved in community activities such as transportation; farm input supply and marketing of produce; preschools; welfare services; and children's clubs.

Despite the success in extending rural outreach in a competitive market, there are signs of major financial problems in the network. A major weakness is the absence of a standardized accounting and reporting framework, and a centralized system of collecting and consolidating financial information. As a result, it is not possible to correctly estimate the financial health of the network. Nevertheless, even going by the consolidation of the self-reported figures of overdue loans, 23.5 percent overdue loans suggests that many basic societies are in trouble. The problems are reflected at the level of the district unions, where 7 of the 25 unions are dormant because of financial problems. As a result, the PTCCS do not have access to union services and may lose the capital invested in the unions. Some of the active

unions also have a problem with overdues on loans they have made to the PTCCS. If the loans are not repaid, the union—and its cooperative members—will lose both principal and interest.

At the apex level, the Sanasa Federation, relying on membership fees and charges for its services, has been running at a small loss during each the past five years—LKR163,000 in 2005 (US\$1,680).

By contrast the Sanasa Development Bank Ltd. (SDBL) has been regularly profitable. The bank, owned by over 3700 Sanasa cooperatives, 25 district unions, and the federation, recorded its highest-ever pretax profit in 2005—LKR58.6 million (US\$600,000). The bank declared a 12 percent dividend for the year. SDBL is operated as a commercial bank and does not use its funds to increase the outreach of the Sanasa network or recapitalize potentially failing PTCCS.

Regulation and supervision are weak and constrain the network's development. Under Sri Lankan cooperative law, government, through its departments of cooperation, plays a predominant role in supervising and "assisting" the primary financial cooperatives. However, the cooperative department staff do not have the financial regulation skills needed.

In addition, government regulation does not permit financial cooperatives to develop in line with demand by expanding membership, merging, or broadening their product range. As a result, the financial cooperatives cannot grow and this is a key reason that most primary financial cooperatives have remained very small and offer few services.

Summary. The Sanasa network has achieved very high rural outreach, serving over 20 percent of the population, almost two-thirds of them women. However, with one-quarter of loans overdue, some unions failing, and with some financial cooperatives unable to repay loans they have received from their union, there are problems of profitability and viability that threaten outreach and sustainability. The principal factors behind this vulnerability appear to be the regulations which constrain normal growth of the financial cooperative sector, excessive government control in supervising the primary financial cooperatives, and weak integration of the system. The cooperative bank has proved able to maintain its independence and profitability despite the financial troubles of its owners.

Box 7: Savings and Credit Cooperatives in Kenya

- Kenyan Savings and Credit Cooperative Societies (SACCOs) comprise Raiffeisen-type rural SACCOs and credit union-type urban SACCOs.
- Both types of SACCOs are affiliated to the Kenya Union of Savings and Credit Cooperatives (KUSCCO), which has 1,766 member cooperatives.
- 45 rural SACCOs are members of Kenya Rural Savings and Credit Cooperative Societies Union (KERUSSU).
- Nearly 1,000 SACCOs are not affiliated to any national union, but some of them may be customers of the Cooperative Bank of Kenya Ltd., which is the fourth largest bank in Kenya.
- The total individual membership of SACCOs is about 2.5 million.
- Financial cooperatives are regulated and supervised by the MoCDM. The unions have no delegated or auxiliary supervision role but see themselves as service agencies for their SACCO members.

Source: Owen 2007a.

KENYA

Kenya's population is predominantly (80 percent) rural, and three-quarters of the country's poor live in rural areas. The country has a long history of cooperative development, and in 2003 recreated its Ministry of Cooperative Development and Marketing (MoCDM), a sign of commitment to cooperative development as a key mechanism in wealth and employment creation. MFIs are also growing fast, and now have 2 million savers, largely in urban areas.

Kenya's financial cooperatives have a very broad rural outreach. The financial cooperatives (SACCOs and the Cooperative Bank of Kenya) reach 2.3 million clients and are important in both rural and urban areas (Box 7). With membership of rural SACCOs growing from 500,000 in 1975 to 1.2 million in 2005, SACCOs have been an important factor in Kenya's rural development, serving some 30 percent of the 4 million rural families.

Recent regulatory changes have allowed them to open to a wider clientele. For about three decades, the SACCOs were "closed" cooperatives, dealing only with their members, who also had to be active members of a marketing cooperative for a specific crop or product. Many SACCOs still offer a limited product range to members only, but larger SACCOs have now opened their doors to non-member clients and to families engaged in occupations other than farming.

SACCOs broaden the range of products offered. These larger SACCOs have further increased outreach by establishing 45 Front Office Service Activities (FOSAs), which are licensed to provide a broad range of financial services to members and non-members alike. Larger SACCOs started to establish FOSAs during the economic liberalization period in the 1990s at a time when formal banks were withdrawing from less profitable towns and villages. The FOSAs were able to attract local bank customers left without financial services.

The smaller SACCOs do not have these FOSAs with their broader services. They still deal essentially with their traditional membership, calling their offices BOSAs for Back-Office Service Activities. The larger SACCOs maintains both BOSAs, offering limited savings and loan services to members only, and a FOSA offering a wider product range to members and non-members.

Outreach has been further increased by links to informal savings groups. A further innovation to increase outreach has been that some SACCOs also act as savings and loan centers for informal village groups, thus reaching deeper into rural areas without the high overhead costs of establishing full branch offices. Thus, the SACCOs keep deposits safe for various self-help groups (for example, harambee groups) and community-based organizations, such as rotating savings and credit associations (ROSCAs) and accumulating savings and credit associations (ASCAs). As confidence grows,

loans are provided to groups for onlending to their members and may also be granted to individual group members.

The financial cooperatives offer a very wide range of attractive products. Rural SACCOs that have FOSAs provide most of the same products that banks do (or more), often in collaboration with the Cooperative Bank of Kenya, including a wide variety of savings products and consumer loans, working capital credit, salary and crop advances, development loans (for business or farming activities, solar panels, water tanks and biogas), investment loans, emergency/express loans (for instance, for families with HIV/AIDS patients), loans for school fees and several other purposes. Some SACCOs also provide housing loans to members through the KUSCCO Housing Fund. Members can also apply through their SACCO for project financing from the Cooperative Bank.

Other special services provided include check cashing and purchase of banker's checks, money transfer, and access to ATMs. Outreach is further extended by bringing services closer to members, both by mobile banking services in areas not covered by branches, and by setting up "payment points", usually at marketing cooperatives, where members can receive their salaries and pensions and farmers can receive their crop payments.

SACCOs have grown steadily and with good overall financial performance. The growth of the SACCOs has been impressive: during the period 2000–2004 the share capital and savings increased from the equivalent of US\$532 million to US\$1.2 billion, and outstanding loans from US\$498 million to US\$1.0 billion. In 2005, reserves totaled US\$60.1 million, equivalent to a 6 percent solvency ratio, suggesting an overall satisfactory financial position.

The regulatory framework may not ensure prudent financial management. The lack of a regulatory and supervisory framework that is appropriate for financial cooperatives is a concern, and makes difficult the accurate estimation of the financial health of the sector. Provisions for non-performing loans may be inadequate and the regulatory framework has failed to prevent some large SACCOs from over-investing in non-liquid commercial property assets.

The Cooperative Bank of Kenya—which is majority-owned by the financial cooperatives and their unions, and regulated and supervised by the Central Bank—is profitable and has been able to expand its network prudently during the past years. It is now successfully expanding its services beyond the SACCOs.

Many SACCOs can continue expansion, but some are nearing the saturation point. The generally sound finances and the growing range of products provide a sound base for further outreach. However, some SACCOs may be constrained by a shaky balance sheet. Others may be near to the saturation point in their areas.

Summary. Financial cooperatives, backed by the cooperative bank, reach 40 percent of the rural population with a broad range of products. Financial cooperatives have increased outreach by opening up services to non-members, by linking to informal savings groups, and by running mobile banking services and "payment points". Nevertheless, the regulatory framework—which is sanctioned and supervised by government—may be inadequate to ensure sound balance sheets. Prospects for increasing outreach are generally good, but some financial cooperatives may be constrained by a weak financial situation, and some may find their market is saturated.

Legal, Regulatory and Supervision Framework

There is nothing that is 'rural' about the legal framework of financial cooperatives, and their regulations, and supervision.

Both urban and rural financial cooperatives need a clear legal basis, appropriate regulations, and effective supervision to function and grow sustainably. Appropriateness of regulations and supervisory arrangements vary with size and volume of operations of financial cooperatives rather than with their geographic location. For example, many rural financial cooperatives in Kenya are large organizations with several thousand members, providing services to non-members, and transacting large volumes of funds. In contrast, some have less than one hundred members and provide solely savings and credit services to members. The former, larger cooperatives need to adhere to more rigorous regulatory requirements than the latter, smaller units even though both are rural. Regulatory requirements and quality of supervision for urban and rural cooperatives of similar size have to be same.

LAWS GOVERNING FINANCIAL COOPERATIVES: SEVERAL MODELS

The legal framework for financial cooperatives plays a double role. The legal framework governing financial cooperatives should empower them, enabling their development and encouraging outreach towards their target population as cooperative development institutions. At the same time, the law has to ensure that financial sector rules are appropriately applied, particularly to protect owners and depositors against poor financial management.

In many countries, this double role is recognized by bringing financial cooperatives under more than one law. In Latin America, for example, financial cooperatives often fall under both a cooperative societies law and under banking law (for instance in Bolivia, Brazil, Uruguay, and Argentina). In other countries of the region, governments have passed special laws for financial cooperatives, and financial cooperatives come under both those statutes and the general cooperatives law (for instance, in Mexico, Guatemala, Honduras, and Nicaragua). Other countries have enacted just a single law for financial cooperatives (e.g., Chile, Colombia, Costa Rica, El Salvador, and Peru).

In the highly developed financial cooperative systems of developed countries, all three types of law may apply. In Finland, for example, where all financial cooperatives are now banking institutions:

the banking law regulates the cooperative banks' liquidity, solvency, and risk management; the general cooperative law regulates the use of surpluses and the constitution of reserves; and the financial cooperative law regulates everything else, including the governance and role of the apex organizations of the financial cooperatives.¹³

The legal framework may evolve over time and it has an important role in promoting the growth of a cooperative financial system. As the financial cooperative sector has developed in Brazil in recent years, the law has been progressively adjusted to allow further growth and to amend the regulatory and supervisory framework to reflect changing risk. The adjustments have encouraged the development of high standards of management and progressive growth in the range and volume of services provided and in the number of customers served, while promoting the security, professionalism, and transparency required in a deposit-taking institution. Although modifying laws and regulations can be cumbersome, the Brazilian approach offers an example of step-by-step development that could be followed also in other countries. At some stages of the development of a financial cooperative sector, lifting restrictive legislation appropriate for early stages of development, but not for a full-fledged sector, may be the most important step in promoting growth.

Box 8 gives further examples from Mexico and Colombia of how legal frameworks can be updated to support rapid expansion of financial cooperatives while protecting depositors and the public interest.

The legal framework may provide for a tiered set of powers and duties. In Peru, Bolivia, and Ecuador, for example, small credit unions with assets below a ceiling are not supervised by the banking regulator but they are restricted to lending and borrowing among members. Only when they have achieved a certain minimum level of assets are they authorized to offer deposit services to the public, at which time they come under the supervision of the regulator.

Also important is the legal framework for the financial sector as a whole, for example, the legal framework on collateral, the judicial process, and enforcement mechanisms. An efficient financial sector, of which financial cooperatives are a part, will require: laws on property, especially regarding land, but also regarding other kinds of physical property, and their use as collateral; and efficient bankruptcy laws.

Effective, accessible, and accountable institutions and procedures to administer and enforce these laws are also required, with both legal backing and social legitimacy.

NEED FOR REGULATION AND REGULATORY STANDARDS

Regulation and supervision are critical to the sustainability and growth of financial cooperatives. In the case of financial cooperatives, as for any other financial institution, there is a public interest function to ensure solvency, to protect depositors' funds, and to ensure the stability of the financial system. In order to ensure that the public interest is protected, and that financial cooperatives carry out their fiduciary responsibilities, regulation and supervision are needed.

Regulation addresses the main risks. Regulation addresses financial risks by requiring maintenance of prudential norms: at a minimum, ratios for liquidity and equity to liabilities, and provisioning of non-performing assets. Regulation will also cover whether deposits may be accepted from the public and the range of authorized products, and will set up rules to prevent concentration of credit risks in one sector, or concentration of shares, deposits, or loans in the hands of a few members. Regulation may also require deposit insurance. This is the case, for example, for the larger financial cooperatives in most Latin American countries, as these are effectively providing banking services.

Regulation also typically addresses governance risks by setting out the minimum qualifications for board members, the fiduciary responsibilities of the boards, and audit requirements.

In general, regulation should remain simple (at least initially) and not so detailed as to prevent the development and growth of cooperatives. Regulatory requirements and supervision arrangements may be very simple for small cooperatives, especially when these deal only with members' funds. For example, most countries in Latin America have very low or no capital requirements for licensing simple "closed" financial cooperatives that only lend members' savings. These simple regulations need to be accessible to all and understood by all. In Tanzania, for example, regulations have been simplified and

¹³ Government of Finland 2001.

Box 8: Modernizing Laws Promote Growth of Financial Cooperatives

Several Latin American countries are supporting the growth of the financial cooperative sector by introducing new laws.

In 2001, two laws were introduced in Mexico to strengthen the legal foundations of the financial cooperative sector: (a) the Savings and *Credit Law* designates the National Banking and Securities Commission as the financial authority responsible for authorizing formation of new savings and credit institutions and regulating the savings and credit sector; and (b) the *National Savings and Financial Services Bank Organic Law* sets up the National Savings and Financial Services Bank (BANSEFI) to promote a savings culture, operate as the central bank of the savings and credit sector, and to coordinate aid for develop-

ment of the financial cooperative sector. Together these laws provide the foundation for a financially and institutionally sound financial cooperative sector that is integrated into the formal financial sector and regulated by the Central Bank (CNBV).

A new law in Columbia establishes the legal framework for financial cooperative activities by authorizing three categories of institutions: (a) financial cooperatives, which are “open” to providing services to the general public; (b) savings and credit cooperatives, which are “closed” – i.e. deal with members only; and (c) multipurpose cooperatives with a savings and cooperative section (also “closed”). Financial cooperatives, as “open” organizations, are subject to a higher level of regulation than the “closed” cooperatives.

Source: Unpublished proceedings of Regional Conference on Strengthening Financial Cooperatives in Latin America, held in Recife, Brazil June 2004.

translated into local languages to ensure that all members and managers of financial cooperatives understand them.

As financial cooperatives grow, regulatory requirements typically become more complex. In particular, capital requirements and prudential norms are higher when a financial cooperative is “open” and is allowed to deal with non-members and to collect savings from them. For example, in Argentina, Bolivia, and Mexico financial cooperatives authorized to receive deposits from non-members must have capital above US\$1 million before they can be licensed. Most countries in Latin America require financial cooperatives accepting third party deposits to maintain solvency ratios equal to or above 8 percent, the international standard for banks.¹⁴

There is still a large and risky gap in regulatory standards in many countries. If regulatory standards are inadequate, financial cooperatives may fail unless corrective action is taken (Box 9). For example, regulation and supervision of financial cooperatives in Eastern Europe and Central Asia are still in an embryonic stage, and no standardized approaches have yet been developed. The risks are considerable. In some cases, federated networks may step in and set their own prudential norms and regula-

tions instead of, or in addition to, those set by law. In Ghana, for example, the Credit Union Association of Ghana took the initiative to institute prudential norms based on international standards for financial cooperatives.¹⁵

SUPERVISION

In order to ensure that financial cooperatives are adhering to the regulatory standards, virtually every country provides for external supervision. There are four types of supervision: direct, auxiliary, delegated, and self-regulation (Box 10). Direct supervision is carried out by a public regulatory authority, typically a central bank or a ministry of cooperatives.

¹⁴ For example, in the 1988 Basel Accord on credit risk, under which the assets of banks are classified in five categories according to the degree of credit risk, carrying risk weights from zero (e.g., home country sovereign debt) to 100 percent (e.g. most corporate debt). Banks with an international presence are required to hold capital equal to 8 percent of their risk-weighted assets.

¹⁵ The Credit Union Association of Ghana adopted a set of standards and indicators developed by WOCCU, the international credit union organization. For details see www.woccu.org/pearls/pearls_tech.php.

Box 9: Kenya—The Risks of an Inadequate Regulatory and Supervisory Framework

In Kenya, many of the larger financial cooperatives offer a range of products and services little different from those of banks but they are regulated under the Cooperative Societies Act, which does not address the specific regulatory needs of financial cooperatives.

As a result, financial cooperatives in Kenya have been permitted to tie up large parts of their portfolios in commercial real estate and other assets that are low yielding and illiquid.

The Kenyan parliament is now considering a *Savings and Credit Societies Regulatory Act* that will establish new regulatory standards for financial cooperatives, including: requiring higher liquidity ratios; limiting the concentration of investments; defining new prudential norms and the means for their enforcement; strengthening audit requirements; and setting up a new, independent regulatory body for the larger financial cooperatives.

Source: Owen 2007a.

Box 10: The Multiple Forms of Supervision: Latin America, Eastern Europe, and Central Asia Experience

Latin America

All four forms of supervision are used in Latin America and, at least in principle, they all examine issues such as auditing, good governance, accounting, payment systems, deposit protection, and regulations on mergers and acquisitions. Direct supervision is used in Argentina, Bolivia, and Uruguay, where supervision of financial cooperatives is carried out by the central bank or by a designated public regulator. Auxiliary supervision is practiced in Chile, Ecuador, El Salvador, and Mexico. Delegated supervision is used in Peru, where the federation of financial cooperatives (FE-NACREP) is the delegated supervisory agent. Other countries (El Salvador, Guatemala, Honduras, Dominican Republic, and Colombia) use self-regulation. In three countries (Venezuela, Nicaragua, and

Panama) there are no formal supervision arrangements for financial cooperatives at all.

Eastern Europe and Central Asia

Each of the transitional economies in Eastern Europe and Central Asia theoretically uses one of four types of supervision systems. Direct supervision is by law performed by the central banks in Albania, Azerbaijan, Lithuania, and Uzbekistan; and by the ministry of finance or a special supervisory body in Moldova. Auxiliary or delegated supervision is carried out by the national or regional federation in Romania. In Russia, the self-regulatory approach is used. In practice, however, most financial cooperatives in East European and Central Asian countries are *not yet subject to effective supervision*.

Source: Unpublished proceedings of regional conference in Latin America in June 2004, and Eastern Europe and Central Asia, November 2004.

Auxiliary supervision leaves supervisory responsibility with the mandated government agency, but allows a cooperative apex federation or an auditing firm to carry out the supervision. In delegated supervision, the central bank or a mandated agency fully delegates supervision to a private agent, such as the cooperative federation. Under self-regulation, a federation of cooperatives performs certain control functions based on a regulatory framework

and monitoring process voluntarily accepted by the cooperatives.

Yet, in many cases, financial cooperatives go essentially unregulated. In Latin America, the majority of financial cooperatives are not supervised at all (about 4,500 out of the total 7,500). So is the case in Eastern Europe and Central Asia.

Although direct supervision is ideal, it is high cost and often ineffective. Direct supervision of all finan-

cial cooperatives has proved difficult in most countries, both when supervision is the responsibility of the central bank or ministry of finance or when it is the responsibility of the ministry of cooperatives. Both often lack the skills needed to supervise financial cooperatives—the former have skills primarily in supervising banks and other commercial financial institutions, while the latter lack skills in financial regulation. Less than 40 percent of financial cooperatives in Latin America are supervised by the central bank or by government supervisory bodies. Unable to cope, many governments have agreed on delegated or auxiliary supervision arrangements, or on self-regulation by the sector (Box 10).

Where financial cooperatives are essentially banking institutions, they are usually supervised by the central bank. The main problems affecting supervision of financial cooperatives by government agencies are high cost and shortage of skilled personnel. In some countries, there is a “graduation” process, by which “closed” financial cooperatives will come under central bank supervision once they “open” and accept third-party business.

Cooperative banks are also usually supervised by the central bank. If the cooperative financial institution is a bank (such as the Cooperative Bank of Kenya), then the supervising body is usually the central bank, or both the ministry in charge of cooperatives and the central bank. For example, in Sri Lanka, the Sanasa Development Bank Ltd. is licensed and supervised by the central bank.

Supervision may also be carried out in “cascade.” For example, in Brazil, the central bank directly supervises the regional unions of the SICREDI network, which must also undergo an annual audit by external auditors. The central bank then relies on the regional unions for “auxiliary supervision” of the primary financial cooperatives. Supervision quality by the different unions is said to vary with their maturity and with the competency of the individual professionals.

Where financial cooperatives are supervised by the government’s cooperative department, this may well go beyond ensuring compliance with the regulatory framework. In most English-speaking countries, financial cooperatives are supervised by a ministry in charge of cooperatives. For example, in Sri Lanka, financial cooperatives at all levels from primary cooperative to federation are regulated and supervised by the Ministry of Cooperatives

under the Cooperative Law. In these cases, supervision typically covers not only aspects of the regulatory framework but aspects of governance and business as well. In the Sri Lankan case, the ministry not only carries out yearly audits but also has extensive powers to intervene in management. It can, for instance, decide on any requests for geographical expansion or for merger, replace the boards of troubled financial cooperatives with an interim board, or even put the financial cooperative into compulsory liquidation.

Cooperative departments may not apply best practice audit standards to financial cooperatives. Cooperative departments often lack financial expertise needed to supervise financial sector regulations. In Sri Lanka, for example, ministry auditors frequently object to a financial cooperative writing off bad loans, even where prudent banking practice would require it. Similarly in Kenya, audit reports often certify accounts of financial cooperatives that make no provision against non-performing loans.

Self-regulation also presents several problems. When financial cooperative federations or other sector institutions take on this role simply by default, as in Burkina Faso (Box 11), they are unlikely to be adequately staffed and equipped. If cooperative federations or unions are to be effective in supervision, they need to be empowered—i.e. they need a legal mandate, and they may need capacity building. In Kenya, for example, supervision was delegated abruptly to the cooperative sector, and subsequently taken back again into government hands when the sector proved unready for the challenge (Box 12). There is also a risk of conflict of interest, especially when the supervising federation is formally owned by the cooperatives that it supervises.¹⁶

In some cases, there may be too much supervision. Having multiple regulating authorities (e.g. both the central bank and a line ministry, and possibly a cooperative network as well) can cause confusion, lead to multiple reporting requirements, and dilute the impact of the supervision effort (Box 13).

Summary. Indirect supervision (auxiliary or delegated) works best for smaller “closed” financial cooperatives, while large and “open” financial

¹⁶ One possible solution is an approach practiced in Germany, under which supervision is delegated to specialized regional supervision federations that do nothing but auditing and supervision.

Box 11: The Gap Between Law and Practice In Burkina Faso - And the Shortcomings of Self-Regulation

In Burkina Faso, the law requires direct supervision of financial cooperatives by the Regional Central Bank and by the Burkinabé Ministry of Finance. However, neither of these agencies has resources to carry out the task. None of the financial cooperatives visited during preparation of the Burkina Faso case study had ever been inspected by the formal supervisory agencies. As a result of these shortcomings, the financial coopera-

tive federation RCPB has instituted extensive internal supervision.

However, the quality of this supervision is inadequate. The federation's *Direction de l'Inspection Générale* (DIG) has good work plans but too few competent inspectors to carry out professional inspections and audits. The inspectors have too little time to evaluate the different types of risk faced by the financial cooperatives, especially credit risk.

Source: Aeschliman 2007.

Box 12: Back and Forth on Cooperative Supervision in Kenya

Under the Cooperative Societies Act, the Ministry of Cooperatives was until 1997 responsible for supervision of financial cooperatives. Following adoption of economic liberalization policies in the late 1990s, the Ministry of Cooperatives was closed and the cooperative sector was essentially left to regulate itself. The Kenyan apex organizations, KUSCCO and KERUSSU, saw themselves only as service agencies and had little capacity or inclination to supervise the financial cooperatives, so each cooperative had, in effect, to regulate itself.

It quickly emerged that the financial cooperatives were ill-prepared for self-regulation. Many cases of mismanagement and misuse of funds were reported, endangering the reputation and solvency of the financial cooperatives. Partly in response, and partly because the government developed a more proactive vision of the role of cooperatives in national growth, the Ministry of Cooperative Development was reestablished in 2003, and is once again responsible for regulating financial cooperatives and providing audit services, including approval of annual audits and provision of audit certificates.

Source: Owen 2007a.

Box 13: Over-regulation in Ghana

In Ghana, credit unions are registered with the Department of Cooperatives, which supervises them. However, the Bank of Ghana also has regulatory and supervisory functions under the law on non-bank financial institutions. In addition, the Credit Union

Association (CUA), a self-regulating apex body, also registers and supervises the member institutions. A new law is to streamline the situation, bringing the CUA squarely under the supervision of the Bank of Ghana.

Source: Authors.

cooperatives are best placed under banking authority supervision.¹⁷ Indirect supervision also creates a bridge for the subsequent progressive integration of financial cooperatives into a supervision environment that uses general financial sector standards.

LESSONS

Clarity on the powers and duties of financial cooperatives, and on regulatory and supervisory responsibilities is important—whether one law or several applies is immaterial. Legal frameworks should evolve with the growth of the financial cooperative sector.

Regulatory requirements should reflect both the degree of complexity and degree of risk, and should be accompanied by a supervisory arrangement that works and is cost effective. A specialized regulatory framework with a tiered supervisory regime appears to be a good practice.

A good legal, regulatory, and supervisory framework is a prerequisite for sustainable growth and development of financial cooperatives, and hence for sustainable rural outreach.

¹⁷ This assessment draws heavily on Cuevas and Fischer (2006).

Internal Governance and Management

Again, there is nothing inherently 'rural' about good internal governance and management.

While it is true that in practice, rural financial cooperatives often have weaker governance and managements than the urban ones, this is often the function of how these cooperatives emerged. When rural financial cooperatives emerge organically, based on felt need and voluntary leadership, and function in a regulatory and supervisory environment that is conducive to the development of good governance, appropriate modes of governance and management emerge. However, when cooperatives are created with external impetus, either from governments or donors, and function in environments where regulation and supervision is weak and governments exert excessive control, they often have weak governance and managements. Brazil is a good example for the former and Kenya and Sri Lanka of the latter situations.

STRENGTHS AND WEAKNESSES OF TYPICAL GOVERNANCE STRUCTURES

Perhaps the most important factor that determines the success of financial cooperatives is the quality of internal governance. The governance structures of financial cooperatives typically have three tiers: the General Assembly of all members; a board of directors elected by the General Assembly; and management, appointed by the board. The *General Assembly* is the supreme authority consisting of all member owners of the cooperative, and it elects the board of directors. The *board's* role is to establish strategic direction, make policies, and hire, supervise and fire managers. *Management* takes care of the day-to-day operations of the cooperative within the powers delegated to it by the board.

This structure is characteristic of cooperation and provides—together with the one-member, one-vote cooperative principle—the base for member control and accountability in cooperatives all over the world. Control and accountability depend in turn on the awareness and skills of members and directors. Thus education and training are essential, and as boards rotate frequently, the education and training effort has to be continuous.

Among the case studies, Brazil's SICREDI presents the case of internal governance arrangements that clearly allocate responsibilities

and aligns incentives to responsibilities. Presidents and vice presidents of cooperatives direct the board of administration. To be elected, they are required to have a clean credit record and no political affiliations, and their remuneration is tied to performance of the cooperative.

Internal controls and checks also have to be properly in place. Good accounting and high standards of financial management are essential features of good governance. When part of an integrated network, these are considerably aided by the standard accounting packages, and by the training and supervision generally provided by the network. There needs also to be provision for internal audits. Only large financial cooperatives can afford a salaried internal auditor. In smaller financial cooperatives, there is usually an audit committee appointed by the board, or the board itself may carry out internal audits. This is common in the smallest cooperatives in Sri Lanka, for example. This approach requires training, which is often inadequate, and frequent rotation of board members compounds the difficulty.

External support to governance and capacity building are also essential. External support is usually obtainable from a network. In line with the principle of “cooperation amongst cooperatives” (section 2.1), financial cooperatives typically have access to—and are often promoted by—a network of financial cooperatives. A good example is that of Burkina Faso, where financial cooperatives grew up with relatively little government support, but are aided by strong regional unions and a national federation.¹⁸

A network structure improves governance in two ways. First, the network can provide templates and training, for example, to establish good governance practices and capacity within the cooperative. Second, if the financial cooperative formally joins the network, this creates contractual obligations to participate in the norms, standards, and operational procedures of the network. Mali and Senegal are good examples of how the networks have promoted good governance in member cooperatives through intensive support to the primary financial cooperatives.

In contrast, external support by government that goes beyond supervision of regulatory aspects can be problematic. For example, the powers of the government to intervene in governance of financial cooperatives, which claims to be intended for assisting the cooperatives, is at best ineffective, and

at worse prevents a more effective role that can be played by the network organizations.

KEY ROLE OF LEADERSHIP AND HUMAN RESOURCE ISSUES

Leadership is a key factor in development of financial cooperatives. The financial cooperative networks in Sri Lanka and Brazil grew as a result of visionary leaders, and many other cooperative networks celebrate similar “cooperative parents”. Without the confidence in the cooperative approach of visionaries in Germany, Finland, and India,¹⁹ for example, the cooperative networks there would be much less important, or perhaps nonexistent.

Visionaries are, however, not essential. Competent leaders can do the job, and examples of excellent leadership were found among the high-level staff in all four countries that were the subject of the case studies. Leaders are people who can clearly articulate a long-term vision, motivate members at all levels to share this vision, and engage the whole organization in long-term planning. Financial cooperatives look for board members and managers with leadership skills and provide opportunities for them to advance.

Attracting, developing, and retaining capable staff is essential to efficient management—but remains a major challenge. Financial cooperatives that begin as small community-based “closed” groups usually depend on volunteers for most management and administration tasks. This keeps costs low. As they expand, financial cooperatives inevitably require more and more highly skilled staff. They need to have a human resources management system that is capable of attracting good staff with appropriate incentive packages, setting staff objectives, organizing performance reviews, and managing career development plans. However, many primary cooperatives have low profitability and operate in areas where the pool of educated workers is small. Staffing is thus often a problem and may be a constraint to outreach. Solutions may have to be sought in the power of the network to deliver staffing and career development solutions that are beyond the scope of the individual cooperatives.

¹⁸ The advantages and challenges of network support are discussed in full in Chapter 7 below.

¹⁹ Such as Raiffeisen and Schultze-Delitzsch in Germany, Hannes Gebhard in Finland, and Verghese Kurien in India.

Training is a massive and constant requirement. The need for training of members, directors, and staff is a key need. The financial cooperatives in the case study countries invested a lot in training their staff, their committee members, and their ordinary members. This will be particularly true for financial cooperatives functioning in environments where literacy is poor. But training is expensive, and this represents an area where public or external support is often forthcoming and justified. In addition to the case studies, a good example of significant investment on training is the World Bank project that is supporting the rural banks in Ghana that are modeled after the Rabobank Netherlands.

At the national or network level, cooperative colleges and standardized training materials are effective. In many countries, cooperative training institutions are effective ways to improve human resource ca-

pabilities. At the national or network level, courses, manuals, and training materials have been developed directed to the specific skills needed by financial cooperatives: for example, risk assessment and financial management skills.

LESSONS

The basic governance and management structures of financial cooperatives are workable, both in rural and urban financial cooperatives.

Access to external support from a network can strengthen governance and management and is better than having such support provided by government departments in charge of supervision.

Ongoing training of human resources is a massive challenge and is an area where public or external support can certainly make a contribution.

Financial Cooperatives as Businesses

There is nothing 'rural' about the fundamental principles of good businesses, but products and practices often can and should vary.

If financial cooperatives that provide financial services in rural areas or rural financial cooperatives have something unique, it is in the products and practices. Products demanded by members or customers in rural areas reflect the nature of rural economies, characterized by predominance of agriculture. This in turn, means seasonality of cash-flows, covariant risks, and low availability of assets that can be used as collateral. Hence, savings and loan products that match agricultural cash flows will have to be provided. Provision of financial and non-financial products on an agency basis also becomes more relevant in rural areas than in urban areas.

THE BUSINESS MODEL

Financial cooperatives have four characteristics which distinguish their business model from that of other financial institutions.

First, their clients are largely outside the ambit of most formal banking services. Financial cooperatives effectively address a gap in the market, reaching a clientele too high cost or high risk to interest the formal banking system but who are nonetheless bankable—or can be made bankable.

Second, financial cooperatives are member-owned service organizations, based on the cooperative principles of mutual self-help, self-governance, proximity, and local knowledge.

Third, the financial cooperative business model is driven by demand. Financial cooperatives are set up because their members need financial services. The product range develops in response to demand, and becomes broader and richer as economic development leads to demand for more sophisticated products and as the institution and its members gain management experience and financial strength.

The fourth distinguishing characteristic of financial cooperatives is their financial self-reliance, characterized by a “savings first” approach and by a reluctance to draw on financing from outside.

THE PRODUCT RANGE

The progressive development of what ultimately can be a very broad range of products is one of the hallmarks of the financial cooperative sector, and a key to its success.

A wide array of products and services facilitates financial stability and efficiency. Networking and standardization of products and systems produce economies of scale, which have enabled cooperatives to compete with larger and better capitalized commercial banks. However, this degree of development comes only slowly through the step-by-step growth of financial cooperative institutions and their integration into broader networks. Caution and risk sharing typical of cooperative institutions characterize the process.

Typically, financial cooperatives provide only a limited product range in their early years. In the early years of a financial cooperative, resources are generally limited to members' savings and the product range is limited. For example, most of the small primary financial cooperatives found in Anglophone Africa provide a very limited range of products: one or two types of credit (for farm inputs and for emergencies), and one savings product.

Development of the product range may come slowly. Development of products comes progressively, as demand and the economy grow, and as financial cooperatives gather institutional and financial strength. In developing countries, there is often little competition to provide financial services to the economically weaker sections of the population and there is little incentive to develop an extensive range of products and services. In addition, financial resources and institutional capacity of the financial cooperatives increase only gradually. Thus, developing a broader array of products and services is operationally difficult and a cautious approach is usually followed.

This is particularly the case as long as financial cooperatives remain small, "closed" organizations self-financed through members' savings and are not vertically integrated within a federation. They will be financially constrained and will not have access to networks that can help develop the product range. These "first stage" financial cooperatives are also understandably risk averse, especially as they usually do not have the support of regulation and supervision.

Financial cooperatives may gradually come to offer a wider range of products and services, usually when they link in to a successful network of financial cooperatives and cooperative banks.

In most countries, linking to federations and cooperative banks allows the offer of a wider range of products. The costs of developing and promoting new products are spread across the whole network; standardization of procedures and forms and access to training further reduces costs and risks; and links to a union or cooperative bank may make pooled resources available to finance products.

In this way, for example, the larger financial cooperatives in Kenya, through their links to the Cooperative Bank of Kenya and KUSCCO have been able to greatly expand their range of services. Other good examples of this kind of expansion in developing countries can be found in the Philippines and South Korea. Ultimately, financial cooperatives may come to offer a range of products equivalent to that available from the banking sector (Box 14).

When financial cooperatives reach a high degree of maturity, they may begin to offer life insurance and other non-financial products, typically on an agency basis.

Individual life, health, and asset insurance policies are often in high demand among cooperative members. They may also be required by the financial cooperative to protect against default. These and other specialized financial products—like equipment leasing or mortgage loans—are typically handled by the financial cooperative on an agency basis, on behalf of a firm within the cooperative network or outside. For example, in Kenya, the financial cooperatives sell insurance on behalf of the Cooperative Insurance Company of Kenya, or housing loans for the KUSCCO Housing Fund.

Financial cooperatives have to assess the business implications of each new product. Financial cooperatives need to make a profit on all their products and services, and they need also to manage risk. Feasibility studies are needed to review the costs and risks of each new service and to price the product accordingly.

The necessary risk aversion of financial cooperatives in their early stages of development is replaced by prudent financial management made possible within a network structure, where product devel-

Box 14: As the Economy Grows and Financial Cooperatives Gather Strength, Demand for a Broader Range of Products can be Met Step-by-Step

The case studies demonstrate the range of products that financial cooperatives have progressively developed. These can be classified as:

- A broad range of sight and term deposit accounts, special savings accounts (for funerals, retirement etc.), and offset savings accounts (against loans).
- A large variety of loan accounts, including consumer loans, furniture and equipment loans, seasonal and term agricultural loans, and loans for commercial projects.
- Commercial facilities, for working capital, warehousing and equipment.
- Other financial services like ATM banking, check cashing, salary transfers, and foreign exchange services.
- Leasing services.
- Non-financial services, such as life assurance, motor, property and household insurance, and agricultural insurance.

Source: Case Studies.

opment and testing are conducted by a federation or by a cooperative bank on behalf of members.

The products that financial cooperatives can offer may be restricted by law. Often regulatory authorities, or even the law, may seek to protect members' interest by restricting the range of products that can be offered. For example, in Eastern Europe, laws restrict the range of products that may be offered. As a result, the financial cooperatives offer a very limited range of services. In seven Eastern European countries, financial cooperatives offer only two to four types of loans.

This protection may be appropriate in the early stage of development of financial cooperatives, but it may later restrict growth and artificially segment financial markets.

A flexible and iterative interaction between the developing financial cooperative sector and regulatory authority can ensure the easing of restrictions as they become constraining or redundant. This is the path being followed with success in Brazil, for example.

THE QUESTION OF COLLATERAL

The mutualist business model of financial cooperatives reduces—but does not eliminate—the problems of lack of collateral.

A principal reason why commercial banks shy away from rural lending is the problem of collateral. Typically, rural customers have little collateral other than some form of land title, and even land titles are viewed by banks with reservation. The calling in of freehold land collateral is notoriously difficult in law and often “socially” impossible, and leaseholds and usufruct titles usually have little value for third parties.

Financial cooperatives typically overcome this problem by relying on their mutualist structure, proximity to clients, and cautious lending policy to make what are essentially unsecured loans. Personal guarantees and rules about domiciliation of salaries, crop sale proceeds, for example, help reduce risk. Local knowledge allows the financial cooperative to reduce risk by aligning repayment schedules with clients' expected cash flow, for example, in the months after harvest.

As the product range and client base expand, risks increase and financial cooperatives seek more innovative forms of collateral. In Kenya, warehouse receipts for coffee deliveries are accepted and often the proceeds of crop sales through an agricultural cooperative (coffee, tea, pyrethrum etc.) can be automatically transferred to the financial cooperative for loan repayment.

Leasing offers a promising form of automatic collateral for equipment financing because the leased asset serves as collateral. Leasing has been introduced for small enterprises and farmers in Uganda and Madagascar.

THE SAVINGS FIRST APPROACH

The savings and loan model is well adapted to a relatively poor rural clientele.

Many financial cooperatives start with a small and relatively poor client base, essentially composed of people of no interest to the banking system. The savings and loan model is an ideal one for serving this poor clientele. It is based on the fact that economically active poorer people may have a high demand for credit, but they also have a high propensity to save—i.e., for consumption smoothing, risk management, and preparation for investment. There is extensive evidence that poor people can and do save, and these savings increase their economic security by enabling them to accumulate funds slowly over time.²⁰ This fact has allowed start-up financial cooperatives to build a credit operation based entirely on members' savings deposits. In fact, many financial cooperatives do not progress beyond this stage. See for example the case of Sri Lanka (section 3.3), where two-thirds of financial cooperatives remain "closed", basing their lending entirely on the savings of their own members.

Basing lending on members' own savings creates an extraordinary financial discipline at the level of the financial cooperative.

An operation based on lending members' savings to other members creates a strong sense of ownership and responsibility. This reliance on savings is usually translated into a "savings first" approach at the level of individual members. Would-be borrowers are expected to save first, to show their income generation capacity, and their ability to manage money. Often savings must be

left as "collateral" in a blocked account when a loan is given. All this strengthens financial discipline. Even lending also aims at creating savings capacity by providing small loans first.

Once financial cooperatives have established operations based on sound management of members' resources, they usually move only cautiously to drawing on outside funds.

After years of cautious management of members' savings, financial cooperatives may begin to access funds from their apex organizations or a cooperative bank if they run into liquidity problems. They may also draw on pooled funds to finance particular lending products. The keynote is prudence. The networks may also draw on funds from outside the network, for example, from the banking system or from government programs. In practice, however, most financial cooperative federations retain their reflex of caution and financial self-reliance. None of the networks reviewed in the four case studies, for example, had drawn on funds from outside the network.

EXPANDING THE CUSTOMER BASE

The saving and loans approach is a proven one, but risks leaving financial cooperatives in a low equilibrium state.

Financial cooperatives, after an initial success, may find themselves unable to expand because of limited financial resources, and unable to attract new customers because of lack of interesting products. There is a financial risk, too, in this low equilibrium. For example, where all members are poor farmers, they are all subject to the same risks of climate and crop failure. Dealing only with poorer people has higher transaction costs too, as small savings balances and small loan accounts involve higher costs in relation to revenues. There is a strong business case for expanding the customer base.

²⁰ The pioneer in showing that small farmers and poor people can save was J. D. Von Pischke in his 1974 paper *A Penny Saved: Kenya's Cooperative Savings Scheme*, published in J. D. Von Pischke, Dale Adams, Gordon Donalds: "Rural Finance Markets in Developing Countries." Johns Hopkins University Press, 1983. The issues of savings by poor people have been even more broadly dealt with in Madeleine Hirschland (ed.): "Savings Services for the Poor: An Operational Guide." Aumarian Press 2005.

Membership can grow progressively, but risks change. In many countries, membership expands within the area as the economy grows and the financial cooperative develops and is able to offer a broader range of products. Options for expanding the customer base require evaluation of costs, benefits, and risks, but it is likely that after the initial stage of development, financial cooperatives will try to attract a broader range of members. Diversification of clientele, blending service to the poor with services to a broader spectrum of the local population, should improve financial viability and sustainability. Where the financial cooperative attracts some better off members, governance procedures have to be adequate to prevent capture and control of the cooperative by these “stronger” members for their own ends.

Financial cooperatives may also decide to open services to non-members. A critical moment for any financial cooperative is the decision on whether to remain “closed”, serving only members, or to “open” to provide services to non-members. This is a major step as it has legal and regulatory repercussions (Chapter 4). An “open” cooperative accepting deposits from the general public has higher public fiduciary obligations than a “closed” financial cooperative handling only members’ funds. Risk is increased too, and a financial cooperative’s reliance on a mutualist relationship is replaced by a need for skills in commercial risk appraisal.

Financial cooperatives may be able to play it both ways, serving non-members on different terms and with different risk management criteria, as in the set-up in Kenya with its distinction between FOSAs and BOSAs (section 3.4). Ultimately, financial cooperatives may also decide to open up their services to businesses and corporate clients, by which stage their services and skills will differ little from those of commercial banks.

FINANCIAL MANAGEMENT

Prudent financial management is critical and needs good information and monitoring.

As financial institutions, financial cooperatives have to observe prudential norms that will protect depositors and ensure the continuation of the business on a sustainable and profitable basis (Chapter

4). Thus, they need the skills and tools to ensure objective and monitorable measures of depositor protection, financial structure, asset quality, profitability, and liquidity. For this, a sophisticated management information system (MIS) is required, often not feasible to be managed at the primary financial cooperative level. For example, in Kenya, several financial cooperatives have attempted to develop such systems without adequate success. In contrast, well integrated networks, such as SICREDI in Brazil, have good MIS, which are managed centrally. The absence of such a system in Kenya, Burkina Faso, and Sri Lanka is one of the major weaknesses identified in these cases. However, infrastructural constraints, such as lack of regular availability of power and absence of access to communication infrastructure, makes the development of such systems difficult in countries such as Burkina Faso.

Interest rate policy is a critical parameter—but there may be significant differences from the banking sector. Financial cooperatives have to charge interest on their loans and fees for other services and products that are adequate to cover all costs and risks, to thereby ensure their profitability. However, the factors determining interest rate policy differ from those of banks. Cost of funds may be different, as deposit rates are typically lower than that in banks. Administration costs are different, as financial cooperatives deal with numerous very small deposits, but administrative services are typically very low cost—or even provided on an unpaid, voluntary basis. Risk is different, as financial cooperatives operate much more on local knowledge and trust. Finally, profit margins will be different, as financial cooperatives are not profit maximizing, but mutualist service organizations.

One key issue in many financial cooperatives is that the low lending rates may be coming at the expense of low deposit interest rates, that sometimes are not adequate to offset the level of inflation. This can occur because of the domination in governance of members who are net-borrowers and hence benefit from low lending rates. It can also occur because of inadequate understanding of financial management. Either way, this risks the sustainability of financial cooperatives. The case of RCPB in Burkina Faso is a good example of this situation (section 3.1).

As financial cooperatives become larger and more mature, many of these factors will change and interest rate policy will come much more closely into line with the for-profit sector. The mutualist advantages will diminish and commercial factors will play a growing role. Spreads may shrink as higher volume reduces costs, and as diversification of products and clients reduces risks.

LESSONS

The business basis for financial cooperatives in rural areas or providing services in rural areas is the ability to provide an unserved but bankable clientele, products and

services they demand, at costs that are typically less than that for banks and other commercial financial institutions.

The business basis is built on their proximity to clients, knowledge of local circumstances, high loan-recovery rates, prudent financial management, and ability to adapt their products and services to their customers' needs.

Successful financial cooperatives have followed a cautious, step-by-step approach to expanding the product range and the client base.

Financial self-reliance and savings first approach underwrites a strong financial discipline and does not limit growth.

Higher-level structures are more valuable to rural financial cooperatives than to the urban cooperatives. On the other hand, rural financial cooperatives are more susceptible to factors related to political economy.

Access to higher-level structures, such as federations and cooperative banks, generally improves the performance of financial cooperatives and makes it feasible for financial cooperatives to offer products that they otherwise cannot offer. Since there is less presence of banks and other commercial financial institutions in rural areas than in urban areas, access to higher-level structures is more valuable to rural financial cooperatives than to the urban ones.

Rural financial cooperatives are often more susceptible to interference from governments and politics because of the large role government plays in rural development in many countries. Locally, rural financial cooperatives are more susceptible to capture because they are often the only significant rural economic organizations. Hence, their control is seen as prestigious, powerful, and a potential source of corruption.

THE ADVANTAGES OF NETWORKS

When there are a sufficient number of financial cooperatives in a country, they often form a network. In this network, the primary cooperatives provide financial services to individual members but are linked to higher-level structures of which they are members in order to benefit from common services and economies of scale.

In larger countries, unions for the primary cooperatives may be formed at the regional level, and federations or confederations at the national level. The primary cooperatives will typically be the owner shareholders of the unions, and the unions will be the owner shareholders of the federation. The ownership structure will determine voting power. In smaller countries, primary cooperatives may directly join a national-level union or federation.

There are different levels of integration for financial cooperative networks. The first level consists of a loose network, also sometimes called an atomistic network. In this stage, each cooperative remains in principle a fully autonomous, stand-alone unit, but adheres to a network simply in order to access some common services such as advocacy, lobbying, and representation, as well as perhaps capacity building services, such as training.

At a more integrated stage, primary financial cooperatives will agree to pool some of their resources and to underwrite some pooled liabilities. In this stage, the primary financial cooperative members would pool some funds at the level of a union or federation, and perhaps access resources and accept some degree of risk sharing. Depending on the level of resource and risk pooling, two levels of integration are usually identified—consensual, when this is relatively low, and strategic, when it is relatively high.²¹ This resource sharing brings considerable benefits: it makes for more efficient use of funds; increases the resource availability to financial cooperatives; and obliges members to accept common prudential standards, monitoring, and supervision. Usually it will lead to the standardization of operating systems, including management information systems. Finally, it will allow economies of scale, for example, in product development, or maintenance of uniform technological systems. It will, of course, also increase the risk for primary societies, which are at risk of financial loss from decisions taken beyond the level of their own boards. Box 15 illustrates some advantages of federation in Brazil and Mexico.

The setting up of a cooperative bank can occur with different levels of integration. For example, cooperative banks have been set up both in Brazil, where the level of integration is high, and in Kenya and Sri Lanka, where the level of integration is low. Typically, a cooperative bank is collectively owned by the member cooperatives, and acts as a central bank to the sector, managing liquidity, recycling deposits, accessing financial markets, and sometimes also providing retail financial services. There may also be other network institutions for deposit insurance, life assurance, and so forth. Network institutions may also help financial cooperative networks develop alliances and strategic partnerships with a wide range of organizations, which can further improve their ability to provide services and increase outreach.²²

Federations and apex institutions can also be set up to instigate development of a financial cooperative sector. Federations or a cooperative bank can even be established before there are any primary financial cooperatives, to facilitate the promotion of primary cooperatives. The cooperative financial network was built in this way in Finland 100 years ago and in Kenya from the late 1960s.

UNIONS AND FEDERATIONS

There are many benefits to be derived from unions and federations. The advantages for a financial cooperative of joining a union and federation structure are essentially threefold:

- Improvements to governance through harmonized internal procedures, standardized operations, operational systems, policies, norms, and products, and professional supervision of the primary cooperatives, including audits.
- Improved financial capacity and reduced risk through pooled resources, a wide array of products and services, and mutual solidarity (underwriting of each others' liabilities, pooled insurance schemes etc.).
- Economies of scale at every level from shared image and political representation, market information systems, and an integrated development plan down to institutional templates and off-the-peg accounting systems.
- Improvement in transparency through regular reporting of the performance data.

In growing systems, network services may be set up step-by-step as demand arises. In Eastern Europe and Central Asia, for example, demand is driving a move from basic network services towards a more integrated structure (Box 16).

Vertically integrated networks—in which the federations have supervisory roles, with the requisite legal backing and the requisite capacity—seem to be an effective model. However, to be effective there needs to be checks to prevent conflict of interest and primacy of democratic control of federations by member cooperatives.

COOPERATIVE BANKS AND OTHER APEX INSTITUTIONS

The role of a cooperative bank is different from that of cooperative unions or federations. The bank's role is typically to link the financial cooperative sector to the financial system of the country, and thereby help the financial cooperatives and their members obtain services they cannot otherwise obtain. Therefore,

²¹ Cuevas and Fisher 2006.

²² Gallardo, Goldberg, and Randhawa 2006.

Box 15: The Advantages of Federations in Brazil and Mexico

About 80 percent of financial cooperatives in Brazil are members of federations. There are 36 central, regional, or state-level unions, and four confederations. The central and national unions advise interested parties on how to establish cooperatives, and provide training to staff and members of new cooperatives. As a result, new cooperatives almost automatically join the network, although it is not obligatory.

In Mexico, the financial cooperatives are integrated into state-level federations that handle representa-

tional responsibilities, provide technical assistance, training, and auxiliary supervision services. The supervision system helps detect problems that may affect the viability of each financial cooperative and which may turn into a systemic risk for the federation. The supervisors can require corrective programs to be implemented. At the national level, the federations are grouped into confederations which, by law, also carry out representational responsibilities and manage savings protection funds for the sector.

Source: Brusky 2007; Kloeppinger-Todd and Esangga 2006.

the creation of these banks has to be done within the banking laws of the country.

A cooperative bank (typically owned by unions and the federation) will act as a central bank for cooperatives: holding excess and liquidity funds, and also providing supplemental funds for cooperatives. It provides wholesale banking services to individual financial cooperatives, which then provide individual retail banking services to their members and customers. If there are no regional unions, the central cooperative bank may establish regional branch offices to expand its reach toward financial and other cooperatives. In addition to wholesale banking services to financial coopera-

tives, cooperative banks also provide retail banking services to financial cooperative members and to the general public.

In the more advanced financial cooperative systems, a cooperative bank may provide other services, including deposit and loan insurance, credit and debit cards, and centralized processing of domestic and foreign transactions. This is particularly useful as incomes of financial cooperative members/clients increase and they demand more sophisticated financial products. In addition, in some countries, supervision of the primary financial cooperatives is delegated to the cooperative bank.

Box 16: In Eastern Europe and Central Asia, Demand is Driving the Move to More Integrated Network Services

As development of financial cooperatives in Eastern Europe and Central Asia accelerates, the need is growing for federations to provide centralized services for financial cooperatives. Among the countries participating in the Baku conference, all except Uzbekistan have a national lobbying body, federation, or association.

Several of the financial cooperative networks also have common facilities or services. For example,

Albania, Lithuania, Moldova, Russia, and Ukraine have training centers for financial cooperatives. Albania and Moldova have a central finance facility or liquidity pool, and Lithuania and Ukraine have a clearing center for their financial cooperatives. Lithuania even has a deposit insurance fund to help secure the members' savings, and Ukraine has linkages with an insurance company for life assurance and asset insurance services.

Source: Authors.

Specific legislation may be needed to accommodate the double nature of these institutions, at once commercial bank and cooperative. In Brazil, for example, the government issued a resolution in 1995 that enabled cooperative banks to be established and to gain direct access to the financial market, to clearing and settlement services, and to Central Bank reserve accounts. Two cooperative banks have now been set up, BANCOOP and BANCREDI, owned respectively by the financial cooperative sector. They act as regular commercial banks, but specialize in products for the cooperative sector. For example, they will offer their primary credit cooperative members foreign exchange services, leasing, or housing finance.

In addition to a cooperative bank, other central cooperative service organizations may be established. In addition to a cooperative bank, many financial cooperative sectors have set up central deposit guarantee schemes. Some have established a cooperative insurance company, housing mortgage finance companies, and leasing companies.

THE ROLE OF GOVERNMENTS

Governments have an essential role in setting up the enabling environment for financial cooperatives, but they often go well beyond that. As with any analysis of the role of government, there has to be a distinction between government's essential roles and the elective roles that governments may choose to fulfill in order to guide and accelerate development, and maintain control over institutions.

For financial cooperatives, government's essential roles, in addition to ensuring the general factors required for the functioning of an efficient financial sector, includes setting the legal frame-

work, and mandating the regulatory and supervisory system. But many governments have gone well beyond this: getting into operation of the regulatory and supervisory system through ministries, and taking a proactive role in encouraging the creation of financial cooperatives and facilitating and controlling their development (see sections 4.3 and 5.1).

The history of government involvement in the development of financial cooperatives is mixed. There are examples where a proactive government has helped development: an example cited is that of Kenya where the sector grew strongly over 30 years with supervision and guidance from the government. In other cases, government intervention has undermined cooperatives' ability to develop normally. India and Sri Lanka are good examples. Government's role in development of financial cooperatives has gone through helpful and harmful phases in Brazil.

On balance, financial cooperatives do better with less government intervention rather than more. There are many examples, particularly from Latin America, where financial cooperatives thrive and there is no ministry involvement at all. The private nature of the financial cooperatives suggest that governments should allow the financial cooperatives to grow and gather strength with little intervention beyond the public interest of the legal, regulatory, and supervisory framework. Where governments remain more proactive, there is clearly a case for financial cooperative sector institutions, such as federations, retaining the leadership and control.

A good example of both the challenge and the options for rebalancing between government and the financial cooperative sector is provided by the Sri Lanka case study (Box 17).

Box 17: In Sri Lanka, Growth of Financial Cooperatives Requires a Substantive Dialogue with Government

In Sri Lanka, most of the primary cooperatives are too small and they have financial problems. The legal, regulatory, and supervisory framework makes it hard for them to consolidate and expand their membership and product range. Many district unions are dormant.

Government involvement keeps the unions and federation weak and inhibits the natural process of vertical integration. Government needs to reduce its interventions and to allow the financial cooperative sector to grow in strength.

POLITICAL SUPPORT AND OPPOSITION

Political involvement in financial cooperatives has had generally negative impacts. In developing countries where institutions are frail, financial cooperatives are exceptionally liable to political interference, which may be well meaning (governments may wish to use financial cooperatives as instruments of development policy) or perverse (governments may use financial cooperatives as instruments of political and economic control) or corrupt (governments or corrupt politicians may siphon off money of financial cooperatives, or take loans with no intention of repaying).

Political support has also helped the development of financial cooperatives in several countries. Clearly, political interest in cooperatives is a two-edged sword. In many countries, interest and confidence that some politicians have shown in financial cooperatives has greatly helped the cooperatives to flourish. Financial cooperatives in Brazil have particularly benefited from political support. The negative aspects of this political involvement seem to have been avoided in Brazil, where financial cooperatives benefit from strong and widely accepted

safeguards against political interference—the most important being the requirement that staff and management at all levels of the financial cooperatives and the network institutions do not have any political affiliation. In Kenya and Sri Lanka, politicians have also provided highly visible support, but there have also been attempts in those countries to use cooperatives to achieve political objectives.

SUMMARY

Integration allows financial cooperatives to provide an increasing array of services and products over time, and thus to compete with other types of financial institutions.

Integration also helps improve governance, improve financial capacity, and reduce risk.

Cooperative banks help link financial cooperatives to the wider financial market, thereby helping to spread risk and allow more efficient use of liquidity.

On balance, financial cooperatives grow faster and more sustainably by handling their own development and by keeping government intervention to the minimum.

Safeguards have to be written into financial cooperative governance against inappropriate or corrupt political interference.

Expanding Rural Outreach: Performance and Potential

THE SUCCESS OF FINANCIAL COOPERATIVES IN EXPANDING RURAL OUTREACH

Outreach is the penetration of a market in terms of customers, products, and financial volume of business.

For financial cooperatives there are three basic indicators of outreach. The first indicator is the number of clients. The number of accounts also indicates how the diversification of products is improving outreach. The turnover and financial performance of financial cooperatives are also important indicators because they show the rate of growth in business and the sustainability of current outreach as well as the potential for additional outreach.

By these measures, many financial cooperatives are very successful in their rural outreach. The case studies show that financial cooperatives can be a major provider of rural financial services. In all but one case they are the largest rural financial institutions in their respective countries. On the other hand, all these countries also have significant urban outreach. The overall outreach in all of the case study countries is significant (Table 3). In fact, the four organizations studied reach between 11 percent and 33 percent of the households in their areas of operation. Financial cooperatives in Brazil serve almost a quarter of the population in the areas where they operate (22 percent), and in Kenya, fully one-half of households across the nation have an account with a financial cooperative.

Other examples from around the world show that financial cooperatives can grow fast. Between 1999 and 2003, Mali's financial cooperatives gained 56,000 new members, while Senegal gained 98,000. Similarly fast growth has taken place in Ecuador, where between 1996 and 2001, membership in the 23 credit unions increased by almost 350,000. Similar growth can be found in many other developing countries.

TRIGGERS FOR EXPANDING OUTREACH

The pace of growth of financial cooperative sectors varies considerably. The oldest organizations reviewed in the case studies (Sanasa in Sri Lanka and SICREDI in Brazil) go back more than 100 years. In both cases, development was slow or very uneven for decades, and then a rapid expansion took place. The financial cooperative networks in Burkina

Table 3: Outreach of Financial Cooperation in the Four Case Study Countries

Country	Financial cooperatives	Number of primary financial cooperatives	Number of individual members/clients	Outreach	
				% of households in area covered	Area covered
Burkina Faso	RCPB	124	430,000	20%	32 of 45 provinces
Brazil	SICREDI	130	1,000,000	11%	Nationwide
	All financial cooperatives	n.a.	2,400,000	22%	Nationwide
Sri Lanka	Sanasa financial cooperatives	8,440	855,000	20%	Nationwide
Kenya	Rural SACCOs	115	1,200,000	33%*	All rural areas
	All SACCOs	2,700	2,500,000	50%	Nationwide

* 33 percent of rural households.

Source: Case Studies.

Faso and Kenya are substantially younger. The Burkina network grew rather slowly until 2000, but since then membership has nearly doubled. The Kenya network grew rapidly in its early days in the 1970s, and then paused until a second wave of growth in the 1990s. This section highlights events or decisions which triggered significant growth in outreach.

In the case of Sri Lanka, it was a combination of institutional change (from savings clubs to financial cooperatives) and the growth of demand which triggered a rapid expansion.

The real growth of the Sanasa network started only in 1978 when, under the impulse of new leadership, societies were transformed from being effectively small savings clubs into financial cooperatives. The new financial cooperatives accepted a wider membership, started to offer more savings and loan products and became involved in community projects and social services. Since 1978, the number of Sanasa societies and members has increased more than eightfold.

In the case of Brazil, a change in the law triggered a rapid expansion. For SICREDI cooperatives, government restrictions curbed growth until 1988, after which gradual changes in financial laws and government regulations allowed the cooperatives to enter new areas and to reach new customer groups. The result was very fast growth.

In Kenya, it was the link to the successful produce processing and marketing cooperatives that triggered early growth. A second wave was triggered when the law changed to allow broader membership.

In Kenya, the financial cooperatives had their origin as the Union Banking Sections of regional crop-specific unions of processing and marketing cooperatives. Farmers' crop sales proceeds were passed through their accounts in the banking sections. In this way, they expanded very rapidly early on, reaching half a million members by the mid-1970s. Once the Union Banking Sections were transformed into financial cooperatives, they had a ready membership. A further wave of growth was triggered in the early 1990s, when the rules were changed to allow the financial cooperatives to take in as members people other than agricultural producers, thus allowing the membership and client basis to continue to grow.

SPOTTING POTENTIAL FOR INCREASED RURAL OUTREACH

There are three factors that suggest that in many countries there is good market potential for financial cooperatives.

The first indicator is the presence of a large population of poor rural people unserved by other financial institutions. In many countries, much of the rural population is not served by any formal financial institution. In some countries like Kenya, this population has actually increased in recent years as governments have liberalized the banking sector and commercial and parastatal banks have withdrawn from less profitable rural business. This unserved population is the natural market for further outreach by financial cooperatives.

A second indicator is a lack of fast growing alternatives. Other rural finance providers that might provide a service equivalent to that of financial cooperatives were discussed in section 1.4. In a few countries, these alternative providers supply financial services to a significant portion of rural people. Examples include the Khan Bank in Mongolia, BRI in Indonesia, and Grameen Bank in Bangladesh. But in a large number of countries, there is considerable potential demand that is unlikely to be met by alternative providers.

A third indicator is rural economic growth. Where there is a dynamic rural economy, there will be a demand for not only basic services but also for a broader range of products. This demand can drive the rapid growth of financial cooperatives.

COUNTRIES AND REGIONS WITH PARTICULAR POTENTIAL FOR INCREASED RURAL OUTREACH

Some parts of the world probably have little potential for increasing the number of clients although there may be scope for providing a wider range of services, particularly in areas where the rural economy is growing fast. Most parts of the world have high potential for increasing rural outreach. The following paragraphs discuss three regions of particular potential: Sub-Saharan Africa, Eastern Europe and Central Asia, and Latin America.

In Sub-Saharan Africa, the potential is high, because of the high percentage of populations in rural areas and the lack of alternative providers.

Financial cooperatives have proved quite successful in achieving rural outreach in several Sub-

Saharan Africa countries but their long-term sustainability is not yet assured (Box 18). There are a number of countries where financial cooperatives could make an equivalent contribution, but where the financial cooperative sector has not really taken off or is in its infancy. In other countries, there are institutional constraints to development and their removal could trigger rapid expansion of outreach. Sub-Saharan Africa is one key region where some external support could help trigger rapid growth.

In Eastern Europe and Central Asia, there has been limited growth of financial cooperatives to date, but there is considerable potential, including in rural areas.

In Eastern Europe and Central Asia, financial cooperatives have great potential for expansion. Existing financial cooperatives generally have limited outreach. In the nine countries represented at the Baku Conference, financial cooperatives serve a very small percentage of the population: the maximum coverage is 6.5 percent in Romania. Apart from Moldova, where coverage is 2.1 percent, financial cooperatives reach less than 1 percent of the population in the remaining seven countries.

The potential for further outreach is very great. Financial cooperatives are often the only financial institutions in rural areas and there is considerable unmet demand for a range of products, including safe savings, credit to form and expand enterprises, working capital, and housing loans.

In Latin America, financial cooperatives reach a significant number of households, but there is enormous scope for expanding rural membership and deepening financial outreach—and the networks have the needed financial capacity.

Outreach in Latin America is clearly considerable. In Ecuador, financial cooperatives have 1.7

Box 18: Outreach in Sub-Saharan Africa

- The 2,700 financial cooperatives in Kenya have more than 2.5 million members, including 1.2 million who are members of rural financial cooperatives.
- In **Burkina Faso** there are 276 financial cooperatives and three networks. The largest network reaches one-fifth of the nation's households.
- **Uganda** has 1,232 financial cooperatives.
- The Bauchi State Federation in **Nigeria**, which has the most successful financial cooperatives network in that country, has 300 registered cooperatives as its members.
- **Ghana** has 261 credit unions, as well as an extensive network of rural and community banks.

Source: Case Studies.

million members out of the population of 13.3 million. Thus, up to half of households nationwide may have an account in a financial cooperative. In Brazil, financial cooperatives provide services to 2.4 million members, reaching about 10 percent of households in the nation. Yet the scope for expanding membership and deepening financial outreach is considerable. Only one-third of the Brazilian population has a bank account, and certainly a smaller proportion in the rural areas. There is thus ample scope for increasing rural outreach. In addition, as the economy expands there is growing demand for a broader range of products.

ASSESSING IF FINANCIAL COOPERATIVES ARE READY TO EXPAND THEIR OUTREACH

Financial cooperatives typically do appear to seek to expand their outreach. Expanding outreach requires not only market potential and the correct governance and business conditions. It also requires that a financial cooperative or a financial cooperative sector be ready and willing to expand. Indicators that show that the financial cooperative sector is in an expansionary mode are: new financial cooperatives are being founded, membership is rising, new accounts are being set up, and turnover and financial performance are increasing.

The assumption is that they can and should do so. The simplest behavioral model suggests that financial cooperatives will seek to expand their membership base and their financial activities, as that is what they are set up to do. In addition, outside agencies will encourage an expansionary spirit as financial cooperatives offer governments and donor agencies the prospect of getting rural people involved in their own development through building up their own institutions.

However, financial cooperatives are not necessarily risk-taking maximizers. Financial cooperatives may not necessarily wish to grow too much. They may prefer to remain local and community-based, and to work with known activities rather than risk innovative ones. They may prefer to remain closed rather than open to new clients. One strength of financial cooperatives in their early stages is the common bond for their members, who may be unwilling to see this local base diluted and the common bonds loosened. There are cases where cooperatives have refused expansion. For example,

in the 1980s and 1990s, many American and Canadian production and marketing cooperatives decided not to expand. They refused to take new members or established very high entry requirements for new members.

Expanding outreach may indeed be risky and expensive. Most financial cooperatives in developing countries are relatively weak financially. They have been established for the economic advancement of their members, not for reaching out to a more risky or more expensive clientele. Current members may well not find it to be in their interest to use their limited resources to serve such groups.

Pushing for outreach may also create tensions within the financial cooperatives between managers and members. Managers may favor expanding their financial cooperatives as fast as possible, for prestige and better benefits, or for the financial benefit of the cooperative. But the board and ordinary members may see it differently—in terms of increased risk. They may ask the manager: *Who will pay for the expansion of outreach? Are you using the capital we have accumulated to gain new and perhaps unprofitable clients?*

SUMMARY

Based on market potential, there is considerable potential in many countries for expanding rural outreach.

However, the decision to expand and the adoption of a growth strategy has to be made by financial cooperative sector institutions.

THE CHARACTERISTICS OF “GOOD” EXTERNAL INTERVENTION

Long-term partnership approaches bring sustainable institutional growth. Evidence from many countries suggests that technical assistance can bring sustainable institutional growth, and that long-term partnerships are the effective approach. See Box 19 for some cases. In Kenya, for example, the Nordic countries teamed up to provide sustained technical assistance to build up the rural financial cooperative sector over a period of almost 20 years. The result was a financial cooperative sector with a sound institutional structure, financial autonomy, and very broad outreach.

Network-to-network partnerships have been particularly successful. The rapid expansion of the Burkina financial cooperative sector (see section 3.1) was considerably assisted by a 30-year partnership with the Canadian financial cooperative network. Brazil’s SICREDI (section 3.2) has benefited from a decade-long partnership with the German financial cooperative network.

External partners have helped to initiate a sustainable financial cooperative sector in several countries by supporting new central organizations and financial cooperative networks.

With the help of cooperative organizations from the developed world, external partners have helped build up entirely new networks of financial cooperatives in developing countries where they did not exist. For example, German technical and financial aid were key to setting up of financial cooperatives in the Volgograd region of Russia and in Kyrgyzstan. World Bank support was instrumental in supporting the creation of financial cooperatives in Moldova, Albania, and Madagascar. The U.S. Agency for International Development (USAID) has helped strengthen budding credit union structures in East European and Central Asian countries. The *Savings and Credit Sector Strengthening Project* in Mexico, supported by the World Bank and the Inter-American Development Bank, is helping to develop a central organization, BANSEFI, to promote a savings culture and to operate as a bank for the savings and credit sector. In this case, the project is intended as a one-time investment, to avoid creating dependence on external aid.

Box 19: Long-term Technical Assistance Partnerships Bring Sustainable Institutional Growth

The Nordic countries assisted Kenya from the late 1960s to the mid 1980s to build up rural financial cooperatives (as Union Banking Sections) and to develop the Cooperative Bank of Kenya. Kenya also received financial assistance for developing a training department for financial cooperatives within the Cooperative College and for constructing a very impressive building for the Cooperative Bank.

In Ecuador, WOCCU's support resulted in the development of effective regulations and supervision, the training of personnel, and the drafting of a new regulatory framework.

The Sri Lankan Sanasa network has benefited from long-term technical and financial assistance from the Canadian Cooperative Association (CCA), Développement International Desjardins (DID), Rabobank, and WOCCU.

Burkina Faso's RCPB has received technical assistance from DID for more than three decades.

The Brazilian SICREDI network of financial cooperatives has received technical assistance since 1996 from the German Confederations of Credit Cooperatives.

Source: Authors.

Projects can help create the legal, regulatory, and supervisory framework conditions for a sustainable financial cooperative sector and can help to scale up some of the institutions.

Most of the East European and Central Asian countries have received project technical assistance to develop legislation and the regulatory and supervisory frameworks to promote development of their financial cooperative sectors.

Successful donor interventions have focused on developing sector institutions to the point where the financial cooperatives are sustainable.

Numerous success stories point to the need for external assistance to focus on institutional development (rather than on capital investment or financial resource transfer). The support provided by the Canadian financial cooperative network Desjardins in Mali and Senegal, for example, was successful in improving outreach and sustainability because it targeted strengthened governance, good management, and standardization of prudential norms and operating rules. Similarly, WOCCU assistance to the Ecuadorian sector was successful in promoting growth because it focused on the enabling environment of regulation and supervision, and on human resource development (Box 20).

Donors have also helped develop new products for financial cooperatives and financed the creation of a technology platform.

Outside support can also be catalytic in promoting innovation. For example, the World Bank's Commodity Risk Management Group (CRMG) has worked in Tanzania to demonstrate how the use of risk management instruments can mitigate the price risk for both farmers and their cooperatives. The CRMG then helped develop market-based products for these risks, which a local bank now offers for sale to its clients.

A World Bank project is supporting the creation of a networked technology platform for financial cooperatives in Mexico that is expected to allow the development of an online MIS. This will allow financial cooperatives to significantly improve their financial management.

THE RISKS OF EXTERNAL INVOLVEMENT

External involvement may undermine the savings-based business model and the savings-first credit discipline model by over-doing credit supply or by under-pricing resources.

The development of rural finance has been plagued by the perception that the problem is lack of liquidity. Lines of credit at reduced interest rates, sometimes on a "no responsibility" agency basis have been mobilized. Usually these have

Box 20: How Sustained Technical Assistance Targeted at Sustainable Institutional Development Helped Sustainability and Growth in Four Countries

The Canadian cooperative development agency DID, owned by Desjardins, has for years provided technical support to federated networks of financial cooperatives in **Mali** and **Senegal** that has improved their outreach and financial sustainability. A strong emphasis on good governance, internal discipline and control, and harmonization of operational rules across the networks contributed to these achievements. As a result, between 1999 and 2003, the cooperative customer base in Mali grew by 56,000 and in Senegal by 98,000 new members. During the same period, the financial self-sufficiency of cooperatives in Mali rose from 75 percent to 111 percent and in Senegal from 80 percent to 140 percent.

In **Ecuador**, WOCCU has provided technical assistance for the development of effective regulatory and supervision systems for financial cooperatives, trained personnel, and drafted a new regulatory framework.

Between 1996 and 2001, outreach in terms of membership has grown by almost 350,000 new members in 23 credit unions. In the same period, the assets of these credit unions increased from US\$114 million to US\$293 million equivalent, and the rate of overdue loans was reduced from 17.5 percent to 5.8 percent.

After **Russia** experienced a banking crisis in the 1990s, DGRV of Germany supported the rural savings and credit cooperatives in the Volgograd region. The objective was to develop a decentralized system, with regional and national federations offering network services. By 2003, the program had grown to 44 rural savings and credit cooperatives with 23,400 members and loans of approximately 415 million rubles, compared with the approximately 30 million rubles provided to rural borrowers in the region by commercial banks. From 2000 to 2003, the cooperative savings increased from 20 million rubles to 204 million rubles.

Source: Case Studies at the Washington Conference

missed the key problems—of absence of viable institutions and of financial markets—and have undermined what frail institutions may have existed. For example, a USAID-financed government program in Sri Lanka used the Sanasa organization as a channel for “delivering credit” to farmers and financed expansion into new activities that proved unsustainable once the external financial assistance ended. This weakened the fragile savings-based discipline of the financial cooperatives and reduced rather than increased the prospects for sustainable growth and increased outreach.

Donors do not always know best. In the 1970s and 1980s, the Cooperative Bank of Kenya and the Ministry of Cooperative Development had to turn down several proposals from donors to use financial cooperatives as means to implement their projects, because the Kenyan sector saw, almost certainly correctly, that the proffered aid could overtax the system, promoting “over-reach” rather

than increasing outreach. Similarly, Brazil’s SI-CREDI has correctly grasped Gresham’s Law—that bad money drives out good—and has refused foreign resource transfers.

SUMMARY

Successful development assistance has focused on longer-term partnerships.

The best mechanism of support appears to be network-to-network, twinning networks in countries with weak financial cooperatives sectors with networks from countries with advanced financial cooperative networks.

The focus of support in successful external assistance has been on institutional development—both that of the enabling environment and that of sector institutions.

Rural finance donors have made the mistake of providing assistance that undermined the financial profitability and savings-based business model of financial cooperatives by providing cheap credit.

Based on the discussion in the previous chapter, the following general principles of external intervention emerge: long-term partnerships, preferably sector-to-sector; focus on institutional development; support for innovation; and avoidance of dependence on subsidies and lines of credit. But what can donors and other external agencies actually do to promote the sustainable growth and rural outreach of financial cooperatives?

Essentially, external interventions may be helpful at three levels: (i) in support of the enabling environment; (ii) in assisting higher-level federated structures, networks, and apex institutions to develop; and (iii) in support of the grass roots financial cooperatives to increase their outreach sustainably. This chapter explores ways in which areas of support might be selected and how support can best be articulated.

SUPPORTING THE ENABLING ENVIRONMENT

Support to the enabling environment can be highly effective. The most highly geared support that will have long-term beneficial results in terms of outreach and sustainability of financial cooperatives will not necessarily be addressed directly to the financial cooperatives themselves but to the development of an enabling environment that will facilitate their growth, performance, and integrity. Apart from the creation of core physical infrastructure—such as energy, transport, and communications—these include creation of a macroeconomic, legal, and regulatory environment that encourages financial sector development.

Policy dialogue is an important component of this support, and here external organizations should have a comparative advantage.

This comparative advantage stems from global experience, long and broad in-country knowledge, and the “convening power” that knowledge and financial resources bestow. External agencies can encourage governments to maintain a sound macroeconomic policy and to pursue policies that favor the development of a sound financial sector, including a legal system that protects property and land-use rights and the autonomy of financial institutions and regulatory authorities. The dialogue can support national cooperative sectors in encouraging governments to make sure the overall policy framework is conducive to the development of financial cooperatives.

External agencies can support the development of an appropriate legal framework. External agencies may bring cross-country experience to help governments and cooperative sectors to develop a straightforward legal framework empowering the financial cooperative sector for growing outreach, and providing for a supportive regulatory and supervisory system with clear lines of responsibility. Box 21 lists some of the legal changes that can benefit financial cooperatives in Eastern Europe and Central Asia.

External agencies can also support the development of regulation and supervision capacity, and the development of prudential norms and standards.

The weakness of many regulation and supervision systems undermines the healthy growth of financial cooperatives in many countries (Chapter 5). External agencies, with their global experience, can help build up the regulatory and supervisory structures to carry out their functions effectively. Support to regulatory systems could help develop the prudential norms and standards to be applied by the supervisory authority. Time-bound technical and material support to supervisory units could help build permanent in-country capacity.²³ Box 22 identifies some regulatory requirements that can help ease financial cooperative start ups.

External partners can also support development of new products, particularly those of practical value to financial cooperatives.

With their cross-country experience and broad perspective on the financial sector, external agencies can help with the development of new products for

financial cooperatives and other financial institutions. This type of support can be particularly valuable in countries where the financial sector is little developed—for example in the transition economies of Eastern Europe and Central Asia. In addition to the examples given in previous chapters—for instance, risk management instruments (see section 9.1)—examples of innovative products that could be developed with external support include: creating a warranty system for crops in warehouses to be used as collateral for loans; supporting the establishment of credit bureaus for risk evaluation and mitigation; and using hypothecation registers to facilitate the use of collateral.

NETWORK LEVEL INTERVENTIONS

External intervention is also highly geared at the network level. It is most effective to build financial cooperatives and extend their outreach through national organizations, if they exist. If not, external support could be a catalyst to setting up these higher-level organizations and to the vertical integration of the local financial cooperatives. There are several successful examples of external support aiding this process (see section 9.1).

Activities are best planned and implemented through a long-term, technical assistance relationship, notably network-to-network twinning.

²³ World Bank 2003.

Box 21: Legal Changes that Could Help Financial Cooperatives in Eastern Europe and Central Asia to Expand Outreach

Legal systems in Eastern European and Central Asian countries show many similarities, including the need for a set of common legal amendments that could help sectors to grow fast.

- Amending laws to allow financial cooperatives to integrate vertically within federations, diversify their product range, and evolve into general banking organizations.
- Developing a legal framework for insurance to guarantee the safety of deposits.
- Modifying the legislation to allow both individuals and legal entities to become members of financial cooperatives.
- Enabling laws that permit correspondent banking and ease use of ICT for client transactions.
- Improving the legislation on collateral, including movable property.
- Developing mortgage and leasing legislation.
- Preparing a comprehensive legal framework that covers all forms of microfinance agencies.

Box 22: Easing Financial Cooperative Start Ups

Entry requirements should be kept simple.

Some countries, such as Bolivia, now require feasibility studies on sustainability before permitting new financial cooperatives to be incorporated. This can be helpful, but should not raise the bar too high. A few countries have established high capital requirements; these constitute an entry barrier and will reduce the scope for improving outreach.

The particular character of financial cooperatives should be taken into account.

Start up regulations for financial cooperatives should emphasize the particular risks and fiduciary responsibilities of a deposit-taking institution, and ensure that internal governance and checks are established from the very start.

Source: Authors.

The most successful technical assistance partnerships have been long term (see Chapter 10). One approach that has been notably successful is “twinning,” where a financial cooperative sector in a developed country provides structured technical assistance to a network in a developing country over an extended period.

External support to networks needs to be driven by demand from the national financial cooperative networks.

The range of possible external support is limitless, and any support program has to be driven by the financial cooperative sector institutions. Federations or unions have to make a clear case for external support.

Based on past experience, the areas most indicated for external support include: (i) strengthening network integration and consolidation; and (ii) developing network services and common products. Some of the typical measures that might be

supported by external agencies in these areas are listed as illustrations in Box 24.

In addition to the possible activities listed in Box 23, there are four areas where external agencies have a particular advantage, either because the financial and technical implications may be beyond the capacity of a national sector, or because innovation requires the kind of political weight that an external agency may be able to bring to bear. These four areas are discussed in the following paragraphs.

Developing programs to safeguard customers’ funds. In most developed countries, governments or the financial cooperative sector have established deposit insurance programs. In some developing countries, the financial cooperative sector has set up risk sharing mechanisms. As financial cooperative assets and risks grow, each sector needs to develop more formal deposit insurance. Here external partners can bring global experience to

Box 23: Possible Areas of External Support to Strengthen Financial Cooperative Systems

Strengthening network integration and consolidation

- Redefining the role of higher-level institutions and helping them prepare medium- and long-term plans
- Revamping the network constitution, improving vertical integration, and facilitating supervision
- Supporting the merger of small or uneconomical primary cooperatives

Developing network services and common products

- Helping develop and implement uniform accounting and financial management systems
- Implementing prudential norms and monitoring systems (e.g., WOCCU’s PEARLS system)
- Developing units for common services: auditing, printing stationery, manuals, statistics, and M&E

Source: Authors.

Box 24: Sample Areas for External Support of Cooperative Education and Training

There is a strong need for training of staff and committee members at federation and primary financial cooperative levels, and for education of ordinary members. The need is particularly pressing in countries where effective training facilities are not available or are inadequate. External support could help finance:

- Basic investments, such as construction of a cooperative college with a faculty for financial cooperatives
- Technical assistance for developing educational and training programs, developing curricula, and putting on training of trainers courses

- Exchange programs (ideally under a twinning arrangement)
- Specialist training to improve governance and financial management (e.g., training of cooperative auditors serving at apex or regional financial cooperatives)

In the longer run, all education and training programs need to become self-sustaining, and support should be targeted to this goal.

Source: Authors.

bear and can help financial cooperative sectors to agree with the regulatory authorities what is the appropriate mechanism to safeguard depositors' funds and minimize financial risk for the sector.

Developing information technology. There are enormous efficiency gains from a well-functioning information technology system, but the cost and technical challenge of developing and implementing a system are daunting. External partners have a strong advantage in that they can bring cross-country knowledge and systems, and could help pay some of the set-up costs for hardware, software, technical assistance, and training. There are many technological innovations—such as mobile banking—that are still in a pilot testing stage and have the potential to significantly reduce transaction costs, especially for rural areas, and to improve the quality of credit portfolios.²⁴

Financing training activities. The success of financial cooperatives worldwide has been based on human resources—leaders, managers, staff, and educated members. External support can bring expertise, models, and training materials not available locally, and can help support some of the establishment and initial running costs of education and training systems for national sectors. Box 24 gives some examples of this type of support.

Supporting apex organizations. External agencies may have a comparative advantage in this area since they can bring global experience, and can

assist the financial cooperative sector with the dialogue with government and the regulatory authorities. External agencies could also support establishment costs, provided that this does not distort the financial evaluation.

Support could be provided to the policy dialogue, legal changes, and restructuring of the balance sheet.²⁵ External agencies could also help financial cooperative sectors to establish apex units for other services, such as leasing or insurance.²⁶

SUPPORT TO INCREASE RURAL OUTREACH

Improving access to finance is the ultimate objective of external assistance. The objective of external support is to strengthen financial cooperative sectors so that they can sustainably increase their outreach. Thus although assistance, to be efficient, has to be articulated through higher-level structures—federations, unions, apex institutions—the goal is to improve the governance and financial viability of the primary

²⁴ Ivatury 2006.

²⁵ World Bank 2005; IFAD: "Decision Tools." Undated: Available on www.IFAO.org.

²⁶ Good examples of leasing arrangements for the agriculture sector are discussed in World Bank publications: Nair, Kloeppinger-Todd, Mulder 2004; Nair and Kloeppinger-Todd 2006; and World Bank 2003.

financial cooperatives, and so enable them to extend their outreach. This section summarizes the key areas where external assistance can make a difference to outreach at this grass roots level.

External assistance through the network should result in good governance and financial viability at the level of the financial cooperatives.

Ways in which external support would help improve governance and financial viability at grass roots level were discussed above. For governance, a financial cooperative might expect to benefit from improvements in regulation and supervision, from education and training to support sound internal governance structures, and so forth.

For financial viability, a financial cooperative should expect to benefit from support through the network so that it has a set of sound prudential norms; effective performance monitoring including computerized accounting and MIS; and a well-trained board and staff capable of sound financial management to produce healthy profits, rising reserves, and lower bad debts.

Beyond this, external support could also help underwrite the increase in rural outreach at the financial cooperative level.

Activities that would directly increase the rural outreach of primary financial cooperatives could also benefit from external support, which would normally be articulated through the network. This support could include:

- Help for the financial cooperatives in conducting demand assessments and preparing a strategy for outreach.
- Support for the establishment of new financial cooperatives: education, training, technical assistance, material support for office equipment, computerization, refurbishing of offices, and operating costs for a limited time.
- Support for expanded physical outreach of existing financial cooperatives—for example, helping with start-up costs of establishing new branches or service points in rural areas, particularly poorer areas that do not have financial services.
- Underwriting the costs of outreach to poorer or more dispersed clients—for example, by helping develop or improve programs that enable greater outreach. Examples are the “extended outreach” programs in Burkina Faso (women’s solidarity groups, informal service points—see section 3.1) and Kenya’s

informal savings groups, mobile banking units, and “payment points” at markets (see section 3.4).

- Aiding informal groups to grow into financial cooperatives—for example, by helping to upgrade informal savings and credit groups into a “pre-cooperative stage”²⁷ or helping expand the extended outreach programs until they can become branches and ultimately financial cooperatives.
- Supporting the diversification and broadening of the product offer, and so extending and deepening outreach—for example, by underwriting some of the initial offer costs and risks of new products.

SUBSIDY AND LINES OF CREDIT

Any external support can undermine sustainability and outreach and needs to be carefully justified.

The agenda outlined above makes a persuasive case for external support to the development of an autonomous financial cooperative sector characterized by growing outreach and sustainable, self-financed growth. Yet there is always the specter of too much assistance, the fear of creating a dependent sector, undermined by subsidies and crowding out market-based financial sector growth.

Assistance to the financial cooperative sector has to avoid distortions and the possibility of dependence.

A subsidy can be justified where it corrects for market failure and promotes a public interest objective, particularly growth and poverty reduction (see Box 25 for the application of this principle to financial markets).

In the case of financial cooperatives, there can be an economic case made for external support that promotes increased outreach, including that in rural areas. Yet subsidy is inimical to the cooperative spirit. The origins of the cooperative sector were in robust self-help, and subsidies played no role in the classic vision of cooperative development, whether of financial cooperatives or of any other. Hence, assistance has to be demand-driven and designed to avoid distortions and the possibility of dependence. This suggests “rules of thumb”

²⁷ In many developing countries, cooperatives start as pre-cooperatives for a certain trial period. If they prove to operate according to the established rules, they will be registered as cooperatives.

Box 25: World Bank Guidelines on Subsidies in the Financial Sector

World Bank guidelines admit subsidies which help financial institutions in developing countries develop into efficient agencies that operate profitably on a commercial basis and offer products and services demanded by a wide range of clients, including the poor. Any support has to be designed in such a way that it does not distort or inhibit the growth of other participants in financial markets, but instead contributes to development of these markets. In principle, the World Bank applies this “financial systems approach” to all finance-sector projects and programs, including rural finance.

Within these general guidelines, subsidies may be warranted if they are transparent, of a specified quantity, explicitly entered into *government budgets, fiscally sustainable, and economically justified*.

Where a resource transfer is proposed, this has to foster a sustainable flow of financial services to underserved groups (such as the poor, women, and micro-entrepreneurs), and must be accompanied by reforms that correct “market failure” by addressing problems in institutional infrastructure and financial markets.

Source: Adapted from World Bank Revised Operational Policy 8.30; World Bank 2005.

that can be applied to any program under consideration. Programs of external support to financial cooperative sectors should be:

- Driven by demand and requested democratically by the financial cooperative sector
- Focused on institutional development and capacity building
- Targeted towards defined outcomes, with a sunset clause, and with any recurrent costs affordable on the cooperative’s own resources
- Aimed at improving sustainability and outreach
- Promoting—not undermining—the savings-based financial discipline of the sector
- Not directly subsidizing members or clients through interest rate subsidies²⁸

One area where external assistance is often not necessary—and may even be harmful—is credit lines.

The World Bank’s experience has shown that credit lines are a suitable instrument where: (i) liquidity is the primary constraint on financial cooperatives’ ability to reach targeted groups; (ii) funds can be provided at commercial wholesale rates without distorting financial markets; or (iii) there is, for example, a demand for medium- or longer-term financing that a financial cooperative is unable to meet from its usually short-term deposit base. In practice, credit lines are inconsistent with the self-reliant, savings-first approach of financial cooperatives. Credit lines could be justifiable using

the criteria above, and after exhausting every possible alternative.

However, there may also be other mechanisms for financial support which are justifiable and which do not undermine financial best practices.

It may be legitimate to provide seed risk capital for new or expanding ventures. The International Finance Corporation, International Fund for Agricultural Development (IFAD), and donor agencies have successfully provided additional liquidity for rural financial institutions in the form of equity participation in apex institutions, credit guarantees,²⁷ and start-up capital for credit risk and savings insurance and for micro-leasing.

Summary. Whatever the structure and purpose of the aid, two cardinal rules should be observed: (i) assistance should not undermine incentives for members to save; and (ii) assistance should not support regular operational activities that should be paid for through interest and fees. If these cardinal rules are violated, the impact of the assistance will not be sustainable, and may even undermine the institutions it is trying to support.

²⁸ However, there may be circumstances where grants to very poor people are justified to acquire income enhancing assets. Nonetheless, provision of these grants should be fully independent of any support to financial cooperatives. For additional discussion on use of such grants, see ARD Note Number 26: Ritchie 2007.

²⁹ Conditions for credit guarantees are given in World Bank II 2003, p.42.

Financial cooperatives are a significant provider of financial services in rural areas in many countries. In countries where the market potential and other favorable conditions for the growth of financial cooperatives exist, they should be considered as potential means to increase access to rural finance.

The localized nature of financial cooperatives, which keeps their costs and risks lower than many other types of financial organizations, is the primary strength of financial cooperatives as providers of rural financial services. Disadvantages stemming from their localized nature—such as limited pool of financial and human resources to draw upon and a history of excessive government control in many developing countries—are their weaknesses. While in many developing countries the weaknesses have trumped the strengths, in some countries financial cooperatives have built on their strengths, addressed their weaknesses innovatively, and have often become among the largest providers of rural financial services.

Financial cooperatives in developed countries have definitively demonstrated that outreach into rural areas and profitability can go together. However, in many developing countries political considerations are at the forefront and in such cases decision making of financial cooperatives is not based on sound principles for sustainable institutions. In many cases therefore, rural outreach has been achieved at the expense of profitability and, hence, sustainability. Large financial cooperative networks in India and China are good examples. However, financial cooperatives in countries such as Brazil, Ecuador, Senegal, and Kenya demonstrate that this does not necessarily have to be so. These examples suggest that the financial cooperative sector can increase rural outreach in a sustainable manner if they can function as successful financial organizations.

Four key findings from the case studies and conferences are listed below. These and other lessons emerging from the analysis in the previous chapters are discussed in the sections that follow.

- **Availability of a legal and regulatory framework** that regulates financial cooperatives as financial organizations (and not general cooperatives) and an **indirect supervisory system** that uses financial cooperative federations/unions to supervise the cooperatives contribute to the development and consolidation of financial cooperative sectors.
- **Diversification of clientele** is key feature to achieve rural outreach without sacrificing profitability. Case studies commissioned for this report show that geographic diversification of clientele can come from networks having a mix of urban and rural financial cooperatives, and individual cooperatives themselves having both urban and rural clientele. Also important is a mix of members/clients in terms of incomes and economic activities. This is also true of all four case studies.
- **Integration** has contributed to the development of financial cooperatives. Federations or network-owned banks and insurance companies—that provide services such as inspection, internal audit, training, and access to banking and insurance services—improve the functioning of financial cooperatives and make available services to their members/clients that would not be possible otherwise.
- **External agencies can certainly help**, particularly when structured as long-term partnerships between financial cooperatives in two countries and focused at the policy and network levels.

CREATING AN ENABLING ENVIRONMENT—THE CORE GOVERNMENT DOMAIN

As in the case for any other private financial institution, the primary government role in supporting the development of financial cooperatives is to create an enabling environment. Much of this—such as a stable and low-inflationary environment; availability of good physical infrastructure; a legal framework that protects property rights, allows easy creation and execution of security; and allowing the market to determine interest rates—is applicable to overall financial sector development. Others that are more specific to financial cooperatives include *legal clarity on obligations and powers of financial cooperatives and a regulatory and supervisory framework that addresses the special characteristics of financial cooperatives as financial organizations*. Nothing is particularly unique to rural financial cooperatives except that they are mostly small and, hence, regulatory requirements that they have to adhere to and supervisory systems used should be in proportion to the risks they entail to their members/clients. For example, small financial cooperatives that only accept deposits do not require the same level of supervision as large ones that accept deposits from the general public.

Whether laws are specifically drawn up for financial cooperatives or not, or whether one law or several applies, appear to be less important than *clarity on the powers and duties of financial cooperatives and that of the supervisory agencies*. *Legal frameworks should also evolve* with the growth of the financial cooperative sectors. As financial cooperatives grow, restrictive legislation appropriate for early stages of development may have to be changed to allow the emergence of a more developed sector.

Appropriate regulation and supervision are essential to the growth of a healthy and sustainable financial cooperative sector but their level should reflect the degree of complexity and risks that the sector poses to the economy and to the users (members and non-members). A good regulatory framework for financial cooperatives takes into account differences between financial cooperatives and commercial banks. *Regulatory requirements should balance between prudential safeguards and the risk of constraining growth—including rural outreach*. As financial cooperatives and other sec-

tor institutions grow into increasingly sophisticated financial institutions, regulatory requirements applied to financial cooperatives should progressively align with that for the commercial banking sector.

While practices vary even among countries where financial cooperatives have performed well, *good practice appears to be a tiered supervisory system*. Such a system involves indirect supervision for smaller “closed” financial cooperatives (by an agency other than the Central Bank, most often affiliated with a network but this is not a requirement), and direct supervision when financial cooperatives are large and open and essentially offer banking services. Supervision by ministries of cooperatives, a case in many developing countries, often deals inexpertly with prudential regulations, and imposes unnecessary constraints on the growth of financial cooperatives.

A key issue in the development and performance of financial cooperatives in the developing countries has been governments’ roles that have gone beyond their core role of creating an enabling environment—often by supporting expansion of outreach through channeling of subsidized funds to the end-customers and directives on who should receive such funds. Financial cooperative networks that have achieved significant outreach and profitability show that, on balance, they grow in a sustainable manner when government intervention is kept to a minimum and is declining over time. Where governments intervene more, a sustained open dialogue with sector institutions is essential. In any case, safeguards have to be written into financial cooperative governance against inappropriate or corrupt political interference.

GOVERNANCE, MANAGEMENT, CLIENTS, AND SERVICES—THE CORE PRIVATE DOMAIN

All key factors in this domain are applicable to all financial organizations: good governance; organizational systems and processes that are effective and evolve as the organization grows; a diversified clientele; and a service mix that meets the demands of clients and is competitively priced. However, achieving these is a bigger challenge for financial cooperatives in developing countries.

The cooperative organizational structure creates certain governance challenges that have been discussed in detail elsewhere.³⁰ However, the ability of most developed country financial cooperative sectors to achieve a large and growing outreach and profitability demonstrates that the basic governance structure is workable. Financial cooperatives in developing countries face additional governance and management challenges because of top-down nature in which many cooperatives were started, continuing excessive government interference, and general resource constraints.

Nevertheless, some financial cooperative networks have achieved relatively high levels of performance. *Wherever they have been successful, financial cooperatives have sustainable business models.* This involves providing products and services that their members and other users demand at reasonable costs. Their proximity to clients, knowledge of local circumstances, a savings-first approach, and prudent financial management of members' resources has often allowed them to do this. Most well-functioning financial cooperatives continue to depend primarily on members' resources, with some call on financing from elsewhere, primarily within the cooperative network.

Integration into a federated structure appears to strengthen governance, improve quality of management, allow diversification of clientele, and make it feasible to provide a broad array of services. The SICREDI case in Brazil demonstrates the value of having well-developed and clearly articulated governance processes and human resource policies and practices that are standardized across a network. Federations (as in Brazil and Burkina Faso) or creation of banks owned by cooperatives or by cooperative members (as in Brazil, Kenya, and Sri Lanka) have allowed financial cooperative sectors to offer an increasing array of services and products over time. The cooperative banks in Brazil, Kenya, and Sri Lanka offer services as advanced as any other type of retail financial institution. They have also been successful in many countries in spreading risk, pooling liquidity, and in linking financial cooperatives into the wider financial market.

Lastly, *successful financial cooperatives have followed a cautious, step-by-step approach* to outreach expansion, including rural outreach, and expanding the product range and the client base.

THE WAY FORWARD

The unmet demand in rural finance is large and there is considerable potential in many countries for financial cooperatives to play a role in sustainably meeting this demand. However, this requires that an enabling environment be available and that the key factors in the private domain are strong. Furthermore, it also requires that the financial cooperatives and their members are willing to take a significant portion of the risks and costs associated with increasing rural outreach.

Given the strengths of financial cooperatives as providers of financial services in rural areas, development assistance should consider them as a key institution in their strategy to increase access to financial services in rural areas. However, such assistance should be conditional on key enabling conditions being available or the willingness and commitment of stakeholders to create such conditions. When provided, *support should primarily focus on areas where it is likely to be most beneficial—supporting the creation of an enabling environment and assisting sector integration and development.* Direct support for increasing outreach, including rural outreach, can be provided, but only subject to having adequate safeguards that ensure that the expansion of outreach does not come at the expense of sustainability. Such support should be for specific purposes, be for one-time expenditures or capacity building and institution-building—in fact, should be regarded as kick-starting a potentially profitable business line, and diminish over time.

Lines of credit often have a weakening effect and can undermine the financial self-sufficiency and savings-first approach. Therefore, they should only be considered for specific purposes such as longer-term financing that cannot be obtained from the usually short-term deposits or in order to encourage and support activities that initially a financial cooperative would be reluctant to undertake out of its own funds but that do have a high potential for the future. Direct subsidies of members—for example, through subsidy of interest rates—are detrimental to the development of efficient rural financial markets.

The best mechanism for providing development support is from network-to-network, twinning financial cooperative networks/sectors in countries with weak

30 Cuevas and Fisher 2006.

financial cooperatives with partners from countries with advanced financial cooperative networks. Sustainability should be a prime consideration before embarking on assistance. No assistance should undermine the financial profitability and savings-based business model of financial cooperatives. Whatever the structure and purpose of the assistance, two cardinal rules should be observed: (i) assistance should not undermine incentives for members to save; and (ii) assistance should not support regular operational activities that should be paid for through interest and fees. If these cardinal rules are violated, not only would the impact of the assistance not be sustainable, but it will undermine the institutions it is trying to support.

NEXT STEPS

In addition to dissemination through World Bank's online and offline channels, this report will be disseminated through presentations at workshops and conferences, both organized by the World Bank and by others.

Operational steps should be to identify particular windows of opportunity in collaboration with *international financial cooperative networks*. Possible actions could be:

- Set up partnerships to carry out regional and country analyses to pinpoint the areas for potential growth and the likely catalysts
- Develop country action plans where external support is indicated
- Identify areas for interventions and the catalytic inputs that would be most beneficial
- Set up country agreements for sustained partnerships

In all this, mechanisms for coordination between external partners and other stakeholders are critical. Equally critical in all cases is that the respective financial cooperatives and their networks and federations remain "in the driver's seat" and that solid principals of good governance, financial sustainability, and client orientation be respected.

Annex I: Selected Key Concepts Relating to Rural Finance

The key concepts and terms used in the context of rural finance, financial cooperatives, and rural outreach are commonly understood, although there appears some variation in different documents and sometimes even attempts to introduce new terms in this field acquired from other sources than cooperative literature. The following paragraphs present the concepts and terms as they are used in this paper. They are essentially based on the most common usage at the World Bank and among the cooperative practitioners. The following descriptions also show how the financial cooperatives are placed within the different concepts.

Rural finance. Rural finance deals with financial intermediation outside of major urban areas. It covers a range of financial services to rural individuals, households, and enterprises—both for the farming and nonfarming communities—on a sustainable basis. The financial services offered may include deposits, loans, payment and money transfer systems, trade credit, and insurance.

Financial cooperatives. These are financial institutions providing financial services both in urban and rural settings. Financial cooperatives are member-based organizations.³¹ In general, they do not focus on specific income groups, in contrast to specialized microfinance institutions (MFIs). However, the cooperatives do provide microfinance services as part of their general activities, not only lending but also a variety of other services, always including savings collection.

Microfinance. Microfinance refers to the provision of small loans to low-income households and micro-enterprises, commonly using character-based methodologies for selecting borrowers. Microfinance lending is commonly based on NGO or other external financing, and it is usually short-term and rarely provides agricultural and term finance that are important in rural finance.

Microfinance institutions (MFIs). Especially in the 1990s and after that period, large numbers of specialized, NGO-initiated MFIs were founded in developing countries, transition economies, and even in developed countries. The majority of them provide only short-term loans from their own funds. Nearly all MFIs operate either in urban and peri-urban areas, although some of them are gradually extending their outreach to less densely populated rural areas and agriculture-sector operations.

Microfinance institutions are evolving and the industry is no longer dominated by NGO-operated MFIs, nor do MFIs only provide short-term working capital loans. Product development has come to the forefront, with many of the more mature and larger MFIs diversifying their loan products, adding savings products (if they are allowed), insurance, and payment services, including remittances. Many MFIs are using new or modified laws to transform into nonbank financial institutions in order to be able to add some of these products, especially savings, to their service range.

FORMAL, SEMIFORMAL, AND INFORMAL PROVIDERS OF RURAL FINANCE³²

Formal financial institutions. These organizations are subject to general laws and regulations, and are regulated and supervised by financial authorities of the countries. Formal financial institutions

³¹ The World Bank's "Assessment of Financial Sector: A Handbook of 2005" separates microfinance institutions, "cooperative financial institutions", and "credit cooperative organizations" (pages 198 and 201, respectively) into different groups.

³² "Meeting Development Challenges: Renewed Approaches to Rural Finance." World Bank 2005.

include public and private commercial banks, state-owned agricultural and rural development banks, cooperative banks, banks established to support microfinance institutions, and special purpose financial institutions such as leasing, housing, and consumer finance companies, and providers of payment services.

Semi-formal institutions. These organizations are registered in an official registry and supervised by some ministry of the countries (that is, by non-financial authorities). They are subject to all relevant general laws, including commercial laws, but, with few exceptions, they are not under bank regulation and supervision. NGO-initiated and operated microfinance institutions, that grant only small and short-term loans from their own funds, and in some countries unregulated village banks, are considered semi-formal institutions. Financial cooperatives, whether savings and credit cooperatives or associations or credit unions, also belong to this group, while a cooperative's apex bank (if there is one), usually belongs among the formal financial institutions.

Informal providers of financial services. These are generally not referred to as institutions and are not regulated by the bank laws or general commercial laws. Their operations are also informal in the sense that disputes arising from contact with them often cannot be settled by the legal system. However, it can be said that the informal providers of financial services are not uncontrolled, but they are controlled by the customary laws and peer pressure. Informal providers of financial services include small groups that rotate internally-generated savings as loans to members, self-help groups, money lenders, pawn shops, and businesses that provide financing to their customers such as stockists, traders, and input suppliers.

Outreach. Outreach or "coverage" measures the scale and depth of penetration of services (the extent of services and number of clients in certain categories or areas) by formal and semi-formal financial institutions, and informal providers to targeted clientele—generally, the poor. Rural outreach measures the penetration of these services in rural areas.

The recommended measurement of outreach is relatively simple. It is the number of clients or accounts that are active at a given point in time in the

portfolio of an institution or service provider.³³ This indicator is more useful than the cumulative number of loans granted or clients served during a period of time. For instance, if the number the cumulative loans were used as the indicator of outreach, the institutions offering short-term loans would look better than those providing longer-term loans that may be more suitable for clients in certain circumstances.

In addition, because some members may be inactive for long periods of time, it is better to measure the active clients rather than members (in financial cooperatives) in order to reflect actual service delivery. However, because the members are the basis of financial cooperatives and their longevity, their numbers should also be recorded and reported.

Expanding the number of clients is an ultimate goal for most financial institutions and providers of financial services.

Sustainability. In the context of financial cooperatives, sustainability means that the financial cooperative has the ability to survive over the long term. Although the concept contains the permanency or stability of ownership, governance, and management, the critical aspect for sustainability is the financial viability. That is, the cooperative must be "adequately" profitable over a longer period. However, because financial cooperatives are service institutions, not aiming at maximizing profit, some ratios used for other types of businesses—such as return on assets (ROA) or return on equity (ROE)—have little meaning in the context of financial cooperatives. The measurement of their performance needs to be found from balancing the cost of services to members and creating a profit that allows maintaining the legally or otherwise determined prudential ratios.

When considering cooperative service agencies such as their apex organizations, one can talk about institutional sustainability (commonly used for universities and "public goods" agencies).

³³ See the World Bank's "Rural Financial Services" 2003 appendix on financial indicators, and other World Bank publications on rural finance.

Institutional sustainability does not necessarily require that an institution makes a substantial net profit (measurable as ROA or ROE) from its key operations on the short run, but that somebody (the government, donors, benefactors, etc.) appreciate its services sufficiently to continue financing its operations. Understanding this concept may

justify external interventions to help financial co-operatives and request that they carry out special assignments, such as expansion of outreach into areas where they would not otherwise go. Even in these cases, the long-term plans must indicate how the activities can be made sustainable on the longer run.

Annex II: Origins of Financial Cooperatives and Cooperative Laws

START OF FINANCIAL COOPERATIVES

As explained in Chapter IV, the earliest cooperatives had been established already in 1760 for shipwrights in Chatham and Woolwich in Great Britain and in 1826 in Brighton, where Robert Owen, commonly acknowledged as the father of cooperatives, had initiated establishment of cooperatives. Similar institutions have appeared in other parts of the world under different names. The most important impact in the history of cooperatives was provided by so-called Rochdale pioneers, who in the 1840s established the first consumer cooperatives and established the original principles and rules for cooperatives.

Over the years following the first consumer cooperatives, many other types of cooperatives were founded. These included agricultural, housing, workers, health, fishing, electricity, and insurance cooperatives. Perhaps more popular than any other types of cooperatives were the various types of financial cooperatives.

The founder of rural credit banks, Friedrich Wilhelm Raiffeisen, was the “buergermeister” (mayor) of small groups of villages in Neuvied, Germany. In his work, he witnessed the great farming distress in 1848, resulting from a nearly total loss the year’s potato crop. Raiffeisen first responded by establishing a society for distributing potatoes and bread to the poor. Subsequently, with the support of rich philanthropist and following an example from towns—where another inventor Hermann Schulze-Delitzsch had established “friendly societies” for people helping each other and even a loan society for town artisans—Raiffeisen founded a loan society for small farm-

ers. It took several years for him to notice that the philanthropic approach (rich persons providing funds for loans) was not sufficient but that the farmers had to rely on their own self-help. On this basis in 1862, he founded in Anhausen a society in which the farmers were the members. This society in general followed cooperative principles codified on the basis of the principles from the Rochdale cooperatives in England nearly two decades earlier although by no means copiously. The loan capital was made up from the members’ small savings and deposits. Originally, the members were not required to buy shares in their society, but this was changed under an 1889 law that required all members to own a share in their society. However, the value of a share was nominal and it had no right to the dividend. The members had unlimited responsibility for the society’s liabilities. They were able to use their farms, stock, and farm implements as the guarantee of their commitments.

Raiffeisen’s strategy for developing loan societies was to rely on leadership of local priests, and to limit each society to one village, thus stressing the moral and communal character of the society. On the financial side, the accumulation of reserves was important and thus the profits were not distributed but were retained in the society. Because the societies were small, only one salaried employee, an accountant, was needed.

Raiffeisen’s strategy worked well and by 1905 there were 13,000 “rural credit banks” in Germany which was the new name for the loan societies. However, by then many of the approaches and rules had changed, and were to change even more before the loan societies had developed into the large Raiffeisen banks in Germany and elsewhere.

COOPERATIVE LAWS

The first cooperative law was enacted in Germany in 1867, initiated by the other great German cooperative founder, Hermann Schulze-Delitzsch. It had a great influence on credit societies, both of the artisans in the towns and of the farmers in the countryside. The law required that all members own a share in their society, the value of which was fixed as high as the people could afford to provide the society with working capital. Liability was unlimited, and the profits, after payment of at least 20 percent into reserves, were to be distributed to members as dividends to their share capital.

The German cooperative laws were enacted to give legitimacy for financial cooperatives and their self-governing structures that were built to facilitate conditions that allowed growth and expansion much beyond the villages where the cooperatives originated.³⁴

The German laws on cooperatives had much influence on later laws covering cooperatives in nearly all developed countries where credit and savings cooperatives were established.³⁵ However, in developing countries it was the Cooperative Societies Act of 1904 in India by the British Colonial Government that was generally the model for cooperative laws, especially within the British Empire. In India, the colonial officers had identified indebtedness to moneylenders as the main reason holding back agricultural development. The 1904 Act supported Raiffeisen-type agricultural credit cooperatives.³⁶ However, while the German model was a self-help grassroots movement, the British colonial system developed completely differently.

Because there were very few indigenous cooperatives in India at that time—and the Colonial Government strongly wanted credit cooperatives to spread—the law authorized a special agency, headed by a registrar, to promote cooperatives. However, the registrar's powers far exceeded the task of registering cooperatives. The main reason was a wish to protect “small people” from the potential mismanagement of the cooperatives. This fear resulted from a lack of confidence in the integrity of elected leaders and in the people's ability to control the finances of their cooperatives, since most of the people were illiterate.³⁷ Thus the law authorized developing a system that was very much a “top-down” approach, based on an imported concept with no knowledge whether the

form of organization introduced would work in the socioeconomic conditions prevailing in India at that time.

In 1912, a second Act extended the same approach to all types of cooperatives. It also introduced limited liability for members as a new important feature (today it is hard to find cooperatives with unlimited liability), and allowed the formation of secondary and tertiary societies to support the primary cooperatives. All in all, the promotion activities and the confidence provided by the cooperative laws were successful: by 1915 there were 15,000 small rural credit societies in India. However, they often were weak and seen by their members more as stage agencies granting loans rather than as the members' own enterprises. Indeed, nearly all governments in developing countries (and most foreign development agencies) saw the cooperative organizations as a means to better the life of poor people and spent a lot of manpower and funds to advance this approach. It was felt that somebody had to accelerate cooperative development by promoting these institutions, and in the absence of others to do it, it was natural for the governments to undertake this task. At the same time, it was apparent that control and supervision were necessary and, in those circumstances, there did not seem to be an alternative for the government involvement. While the government officers were not always fully competent to supervise their subjects effectively, they were far more knowledgeable and better trained in cooperatives

34 World Bank IV, p. 22 (Cuevas and Fischer 2006). The original source is HIV/AIDS Münkner's “100 Years Cooperative Credit Societies Act India 1904: A worldwide applied model of cooperative legislation.” Marburg 2005.

35 For instance, in Finland and Sweden in the beginning of the 20th century. For credit unions that came later into the “family of financial cooperatives” the governing laws are a couple of decades younger (for instance in Ireland). In some countries, there are no specific laws on financial cooperatives. For instance, in the United States, laws for other purposes also concern credit unions (i.e., Reserve Requirements Act, Privacy for Consumer Privacy Act; and Equal Credit Opportunities Act).

36 “The father of Indian cooperation,” Sir Frederick Nicholson, was sent in 1890s to study the Raiffeisen system in Europe, and his report of 1897 was “a bible with which the Indian cooperatives worked for many years.” (Johnston Birchall 1997, p. 166; the original source was C.R. Fay: “Cooperation at Home and Abroad,” London 1938).

37 Both reasons turned out to be justified in India and elsewhere time and time again, even with the supervision of the registrars.

than the layman committee members or even society secretaries. On the positive side, it is necessary to acknowledge that for decades hundreds of thousands of cooperatives provided services to millions of farm families in the developing countries and these services were rarely available elsewhere at the same cost.

During the past two decades, and in limited way for even longer, there have been extensive discussions, arguments, and criticisms about the value of the Indian model for cooperative legislation and its implications for cooperative development. In retrospect, it is easy to criticize it, especially the fact that it granted far too large powers to the governments' cooperative departments and ministries of cooperatives. However, in view of the very low level of education in the farming areas—including difficulties finding literate persons for the management committees, and the gap in the professional knowledge between the society secretaries (and other staff) and the committee members on the one hand,³⁸ and between the committee members and ordinary members on the other hand—the cooperative laws based on the Indian model were not necessarily bad, when they were implemented reasonably. Apparently, besides promotion, some control was needed over the cooperatives. One problem was that the cooperative laws also allowed the registrars and their staff the opportunity for excessive use of their powers, and in practice to take over the management of cooperatives. Another related problem was that, once the registrars had started using their powers to the maximum allowed under the law, they had great

difficulties in relaxing their grip on cooperatives even when they performed well and needed little supervision. Thus, in many developing countries it was not possible to create autonomous and self-reliant cooperatives of the Rochdale or Raiffeisen type. They did a lot of business, but because the governments saw them as tools for economic and social development, they were in a protected environment, having in many cases a monopoly position. Many cooperative systems became dependant on this monopoly situation as well as various forms of subsidies, and they were easy targets for political manipulation and corruption by politicians, their committee members, and sometimes even their managers.

While serving their members, these problems troubled the cooperative credit societies for 70-80 years until the 1980s and 1990s. As a result, when the structural economic adjustment policies with full exposure to market forces—especially deregulation of trade, fiscal, and monetary policies, and currency devaluations—“hit” the cooperatives in developing countries, they were ill prepared to deal with these changes. It became obvious that in order for the cooperatives to survive and adapt, the cooperative laws had to be rewritten and adjusted for the demands of the new economies.³⁹

38 What Carlos Cuevas and Klaus Fischer call “member-manager conflict” is partly that, although they mainly mean that members' and managers' desires and benefits are different, which is not necessarily the case in most modern cooperatives (Cueva and Fischer 2006, p. 9).

39 The changes and reasons are explained in the main text of this report under Chapter IV.

Annex III: Summary of Case Studies

The World Bank commissioned case studies in four developing countries known to have financial cooperative systems with extensive rural outreach to learn how key elements of cooperative development and outreach have been organized. The case studies were carried out in Burkina Faso, Brazil, Sri Lanka, and Kenya. A synthesis paper of the case studies has been published separately.⁴⁰ The case study reports have been published as Agriculture and Rural Development Internal Papers.⁴¹

This Annex expands the factual information presented in the case studies.

CASE STUDY COUNTRIES

Burkina Faso

Burkina Faso is a landlocked country in West Africa, with a population of almost 14 million. More than 80 percent of the population is rural, but this ratio is decreasing rapidly as young people move to the cities. With a per capita income of US\$424 per year (2004), this is one of the poorest countries in the world, ranking 175 among the 177 countries listed in the report of the United Nations Development Program of 2002. Some 46.4 percent of the population live under the poverty threshold, most of them in agro-pastoral occupations. The climate is tropical but rainfall is very uneven and so low that of the country's 274,000 square kilometers, only 90,000 can be cultivated. Only one-third of this cultivated area is annually exploited. In addition, some 2,300 square kilometers can be irrigated. French is the official language.

The banking services in the country are very limited outside the urban areas. All the formal financial institutions are in cities and towns and only 23 of the country's 45 provinces have at least one

branch of a bank or other formal financial institution. An interesting feature of the financial sector is that the main commercial bank, "La Banque Agricole et Commercial du Burkina" (BACB), has developed a "linkage banking" system with commercial companies, NGOs, and microfinance institutions, and it is among the leaders in using this system in West Africa. Under the linkage banking system, BACB operates as a wholesale bank for NGOs and microfinance institutions, lending them money and facilitating expanded onlending to their individual clients or beneficiaries. Thus, the outreach⁴² for loans is larger than the statistics of formal banking would indicate. However, because there are only 93 of these NGOs and microfinance institutions, plus special externally-financed projects with credit components, many of these institutions operate in only 49 "communes," leaving the vast majority of the country's 350 rural communes—encompassing 8,000 villages—uncovered or only partially covered by Burkina Faso's extensive network of financial cooperatives.

Brazil

Brazil, which has a population of 177 million, is the largest country in South America. Its economic growth has been slow and in 2005 the GDP per capita increased only 0.8 percent. However, at US\$8,584, the per capita GDP in Brazil is the fourth highest in Latin America—much higher than the

⁴⁰ Nair and Kloeppinger-Todd 2007.

⁴¹ Aeschliman 2007; Brusky 2007; Owen 2007a, "Rural Outreach and Financial Cooperatives: SACCOs in Kenya"; Owen 2007b "Rural Outreach and Financial Cooperatives: SANASA, Sri Lanka."

⁴² The term "outreach" is defined in Annex 1.

GDP in the other case study countries. Yet Brazil is ranked 63rd in the world by the United Nation's Human Development Report. This indicator improved in 2002–2004, thanks to improvements in health and education, but has subsequently stagnated. Socioeconomic inequality remains pervasive, with the richest 20 percent receiving 56.8 percent of national income. The Gini Index, used to measure inequality, is 0.57 for Brazil (0.0 being perfect equality and 1.0 being maximum inequality), which is one of the highest levels of inequality in the world. The official language is Portuguese.

Brazil is organized on a federal model. The 26 Brazilian states and the one federal district enjoy significant autonomy in government, lawmaking, public security, and taxation. The country is divided into five regions. Roughly 21 percent of the population lives in rural areas. According to the International Fund for Agricultural Development (IFAD), almost 80 percent of rural Brazilians live in poverty. The northeast region of the country is particularly disadvantaged, whereas only 5.2 percent of inhabitants in the southeast region lived in extreme poverty in 2002. The figure for the northeast was 25.2 percent.

Brazil's financial system is the largest in Latin America. Heavy investments in the sector in the 1980s produced a large and sophisticated financial structure, consisting of national private banks (39.4 percent of the deposits), foreign banks (19.9 percent), federal banks "Banco do Brasil" (17.1 percent), "Caixa Econômica Federal" (15.6 percent), public banks (6.6 percent), and financial cooperatives (1.4 percent). Yet the outreach is limited and the Central Bank estimates that only one-third of the population has a bank account. Since the late 1990s, however, this financial landscape has been changing, thanks to the government's commitment to improve the situation and private sector and nongovernmental initiatives that have expanded financial access through microfinance. These efforts include regulatory changes to stimulate financial institutions to help the poor, an increase in budgetary funds earmarked for development of microfinance, and simplified accounts to reach people who lack banking services.

Financial cooperatives are more important than their share of deposits indicates. An increasingly favorable legal environment has enabled coopera-

tives to expand as financial service providers. They already provide 2.3 percent of all credits, and their influence is fast expanding in areas and for populations that are of little interest for the other institutions in the sector.

Sri Lanka

Sri Lanka is an island state of 65,610 square kilometers, with a population of 19.4 million. It is very densely populated, with about 295 persons per square kilometer. Most of the country is still considered to be rural (72 percent), while 21.5 percent is urban and 6.3 percent is made up of estates. The per capita Gross National Income was US\$1,010 in 2005. About 8 percent of the country's GDP is agriculture-based. About 20 percent of Sri Lankans live below the official poverty line.

Sri Lanka has nine provinces, of which the western province has the largest population (5.5 million) and the highest population density at 1,583 persons per square kilometer. The eastern, Uva northern, and north central provinces have the lowest average population density (141) because they are larger, rural, lack industries, have lower populations, and are affected by the civil war (except for Uva).

For a developing country, Sri Lanka has a high literacy rate (92.5 percent) which is on par with more prosperous countries such as the Philippines and Thailand. The literacy rate for women is 90.6 percent. About 41 percent of the population has attended secondary school, and 21.2 percent have tertiary education. The official languages are Sinhala, Tamil, and English.

Two state banks, Ceylon Bank and Peoples Bank, dominate the commercial banking sector, which is made up of 22 commercial banks. Ceylon Bank has branched out to rural lending using a Grameen approach, including mobile bank units. Hatton National Bank has the largest microfinance portfolio, with 125,500 borrowers in 2005. In addition to the commercial banks, there are 14 licensed specialized development banks, including Sanasa Development Bank, Ltd. (the cooperative central bank), six regional development banks, and 28 registered finance companies.

Bank branches and finance companies are located in all of the large regional cities and there is

significant scope for financial deepening. Lending to the private sector is very low: about 35 percent of the total lending in 2004. As in many developing countries, there is a net flow of funds from rural areas into urban areas. The formal banking sector has limited involvement in rural finance other than through mobilizing deposits. In the cooperative sector, the multipurpose cooperatives have 1,539 rural branches dealing with financial services.

Rural sector financing is characterized by substantial subsidized competition and direct government interventions, including direct ownership of development banks, interference in multipurpose cooperatives (essentially quasi-government institutions), and setting up funding conditions for financial institutions to access the government's credit lines.

Kenya

The Republic of Kenya, in East Africa, is bordered by Ethiopia to the north, Somalia to the east, Tanzania to the south, Uganda to the west, and Sudan to the northwest. The Indian Ocean runs along the southeastern border. Kenya enjoys a tropical climate, hot and humid on the coast, temperate inland, and very dry in the north and north-east parts of the country. Kenya covers an area of 582,646 square kilometers. Inland water bodies, dominated by Lakes Victoria and Turkana, cover 11,230 square kilometers. Kenya comprises eight provinces, each headed by a centrally appointed provincial commissioner, and 71 districts, subdivided into 262 divisions.

Kenya has a population of 32.8 million, of which nearly 80 percent live in the rural areas. The majority of Kenyans depend on agriculture and forestry as their principal means of livelihood. Kenya is among the poorest countries in the world, with GDP per capita of USD\$497 in 2005. Although poverty is found in both urban and rural areas, 75 percent of the poor are in rural areas. Poverty is also higher outside the central and Nairobi Provinces, which are economically the most important in Kenya.

Kenya has great ethnic diversity. The ethnic groups are as follows: Kikuyu (22 percent); Luhya (14 percent); Luo (13 percent); Kalenjin (12 percent); Kamba (11 percent); Kisii (6 percent);

Ameru (6 percent); other Africans (15 percent); and non-African (Asian, European, and Arab) (1 percent). The official languages are English and Kiswahili. The religious affiliations are as follows: various Protestant groups (35 percent); Roman Catholics (33 percent); Seventh-Day Adventists (10 percent); Muslims (10 percent); and traditional religions (10 percent).

After several miserable agricultural years at the beginning of the century, the economy began to grow rapidly. Real GDP growth was 4.9 percent in 2004 and 5.8 percent in 2005. Since independence in 1963, the cooperative sector has been very important for agricultural marketing and other rural services. Recognizing that rural development is the key to sustainable national economic growth, the government is committed to cooperative development as one of the key sectors in wealth and employment creation, and in 2003 it recreated a separate ministry for cooperative development, which had been closed down in the late 1990s.

The banking sector, which is composed of 45 banks, is dominated by Barclay's Bank of Kenya, Ltd., Standard Chartered Bank, Ltd., and Kenya Commercial Bank, Ltd. The Cooperative Bank of Kenya is the fourth largest in Kenya. Gross domestic savings have grown over the past seven years by 9.9 percent to 13.9 percent per year in nominal prices, reaching US\$5.15 billion equivalent in 2005. Inflation varied from 2 percent to 11.6 percent during the same period. Domestic credits were of about the same magnitude as the savings.

The Kenyan formal banking sector has traditionally had a competitive advantage over cooperatives, because banks have been able to attract savings at lower interest rates than the latter institutions due to the confidence people have had in formal banking institutions. From the customers' point of view, commercial banks' interest rates on savings have been negative in real terms in most recent years, or only slightly positive. The banks' interest rates for loans, averaging 13 percent, have generally been positive in real terms.

The microfinance sector has played a significant role in outreach because it serves customers who are different from those of commercial banks. Specialized microfinance institutions (that is, not including financial cooperatives) are a relatively new phenomenon in Kenya, with a few agencies

starting about 20 years ago. A new microfinance law is being discussed in Parliament and may be passed before the end of the year. The new law would call for supervision of MFIs by the Central Bank of Kenya. In turn, larger regional and national MFIs would be allowed to mobilize savings. The Association of Microfinance Institutions (AMFI) was registered in 1999 with funding from U.S. Agency for International Development (USAID). It currently has a membership of 31 institutions; by far the largest of them is the Post Bank. The total number of savers in microfinance institutions, not counting the financial cooperatives, exceeds 2 million, most of them with the Post Bank. However, because the number of borrowers is as high as 493,000 (and the amount of loans US\$219 million equivalent) and the Post Bank is not a major lending institution, the other MFIs, which operate mainly in urban areas, are also important.

The financial cooperatives (SACCOs and the Cooperative Bank of Kenya)—which reach even more clients and are important in both rural and urban areas—have been discussed under Chapter VII.

STRUCTURES OF FINANCIAL COOPERATIVES IN THE CASE STUDY COUNTRIES

Burkina Faso and FCPB

There are three networks of cooperative financial institutions in Burkina Faso.⁴³ The largest network is formed by the “caisses populaires,” affiliated under the Fédération des Caisses Populaires du Burkina (FCPB). The others are the Mutuelles d’Épargne et Crédit (MEC) and the Coopérative d’Épargne et Crédit (COOPEC). In addition, there are a number of independent, unaffiliated savings and credit cooperatives. Altogether, the financial cooperatives have 276 offices or service places, and they represent more than 70 percent of the microfinance market in the country.

All the financial cooperatives and their networks have been developed by using models imported from Europe and Canada—typically, savings and credit societies of the Raiffeisen type of cooperatives.⁴⁴ However, FCPB is not a member of the international Raiffeisen organizations, such as

the International Cooperative Banking Association and International Raiffeisen Union. The Canadian cooperative apex organization, Desjardins, which is a member of these organizations, has a current assistance program with Burkina Faso, in particular with FCPB.

The World Bank commissioned a case study focused on FCPB. At the top of the structure is the Federation, which has four regional unions as members. These, in turn, have local financial cooperatives (“caisses populaires”) as their members. Individual cooperators are members of the primary-level financial cooperatives, as are new, village-level pre-cooperatives with named “caisses villageoises” (these are explained in detail in the “Outreach” section, Chapter VI). In regions where there are too few primary financial cooperatives that can pay for running a union (a substantial part of union income comes from fees it charges to member cooperatives), FCPB has established branches (“antennes techniques”), which provide the same type of services to the local financial cooperatives as the regional unions. In these cases, the primary-level financial cooperatives are direct members of the Federation. In 14 of the country’s 45 regions, there are no “caisses populaires.”

The financial cooperatives in Burkina Faso follow the general principles of cooperation, especially inasmuch as the member/client is a co-owner of the “caisse populaire”. Therefore, the cooperative is in business not to make a profit but to provide service. Membership is open to all persons, and joining the cooperative or leaving it is voluntary, but governed by the rules of the cooperative. Voting in the organs of the cooperative is on the basis of one person, one vote. The main objective is to make sure that the members’ savings are secure, and typically only 50–70 percent of the savings are used for loans.

Administrative and management structures are essentially the same at every level of the network (i.e., primary financial cooperatives, unions, and the Federation). They consist of: a General

⁴³ The reasons for three different networks of financial cooperative are several, but the main reasons are because there have been different promoters (donors, NGOs) and they have had slight differences concerning the approaches to be used.

⁴⁴ The concept of “Raiffeisen type” of cooperative is explained in Chapter IV.

Assembly as the highest decision-making body; a seven-person Board of Administration; a Credit Committee of three persons; and, theoretically, a Supervisory Committee also of three persons. Most supervisory committees are dormant, partly because inadequate attention paid to them.

As mentioned, the field-level financial cooperatives join regional unions and national federations to get cheaper goods and services than what they would get from the private and less specialized markets. They also expect direct support for their operations, including guidance and technical assistance.

Roles of higher-level cooperatives and agencies in Burkina Faso. In general, the network of the financial cooperatives is strongly directed and controlled by the national Federation, its branches (“antennes techniques”), and the member unions.

The regional unions and branches of FCPB act as the technical and financial support, supervision, promotion, and representation organizations for the “caisses populaires” that have affiliated with them. The following activities and services are typically provided:

- Coordination of the activities of the “caisses populaires” located within the area of the regional union and FCPB branch
- Organization of new “caisses populaires” and service points in the region
- Periodic supervision, inspection, and control of the “caisses populaires” and service points in the region
- Assistance to the FCPB inspectors in preparation of annual accounts and their inspection of the “caisses populaires”
- Support to and advice in all activities of the “caisses populaires”
- Negotiation and preparation of contracts with partner agencies (see below)
- Provision of cooperative training and education in the region and provision of materials and information to the “caisses populaires”
- Carrying out of regional promotion and public relations programs, and representation of the “caisses populaires” in the region and nationally
- Management of liquidity on behalf of the “caisses populaires” (movement of surplus savings and supply of funds for loans exceeding the liquidity limits of the individual “caisses populaires”)
- Processing of staff salaries, advances, and repayments for the “caisses populaires” in the region

At the national level, FCPB provides technical and financial support, supervision, promotion, and representation for the member organizations and agencies affiliated with it. The activities and services of the Federation resemble, to a large extent, those of the unions and include the following tasks:

- Carry out research to identify the problems and opportunities for the network and prepare the policies and plans necessary to meet them
- Coordinate the activities of the member unions, its branch offices (“antennes techniques”), and the “caisses populaires”
- Periodically supervise, inspect, and control unions, “antennes techniques,” and primary financial cooperatives
- Assist the unions and “antennes techniques” to prepare the annual accounts for the units under them
- Print the accounting and administrative stationery and supply it to the network units
- Provide technical advice in all financial and operational activities to all network units
- Negotiate and prepare contracts with partner agencies
- Develop the national training, education, and information programs for the activities of the network units and deliver them to these units
- Develop and carry out national promotion and public relations programs
- Manage the liquidity situation of the network (place surplus savings and supply funds for loans exceeding the liquidity limits of the network units)
- Manage the statutory and contingency funds of the network
- Manage the national service of transferring funds between the network units
- Represent of the RCPB network nationally and internationally

Auxiliary (partner) agencies. Along with five similar organizations in West Africa, the Federation partially owns an agency named Centre d’Innovation Financière, which researches, develops, tests, and implements new systems and services that individual member organizations would not be able to do on their own,

such as clearing checks and issuing and managing debit and credit cards. Another support agency is the Centre Financier aux Entrepreneurs (CFE). It is expected to contribute to the development of the private sector, particularly small- and medium-size enterprises. The larger “caisses populaires” which, along with the Federation, are the shareholders of this company, can send to CFE the larger loan requests (between FCFA10 million and 30 million) for review. During 2005, its first year of activities, CFE handled 218 loans totaling to FCFA1.7 billion. Yet another auxiliary agency is the Centre Financier aux Agriculteurs, also already mentioned, and intended to handle large agriculture-sector loan requests. They both were originally financed by donor contributions and shares owned by financial cooperatives, but aim at self-sufficiency through charging fees for their operations.

Brazil and SICREDI

Brazil's financial cooperatives have had a long and checkered history. The Sistema de Cooperativa de Crédito (SICREDI) network dates back to 1902 with the founding of the first Brazilian credit cooperative (Raiffeisen type) by a Jesuit priest, Theodor Amstad. He has been credited with founding several Raiffeisen credit cooperatives in Brazil. The set up of financial cooperatives grew gradually, and in 1961 a total of 511 financial cooperatives of several types were in the cooperative register, some of them distributing profits to members. However, when the military took power in 1964, it became illegal to distribute profits among members and only two types of cooperatives became acceptable: those with the objective of providing credit for rural production (still essentially the Raiffeisen type) and those composed solely of employees of a public or private entity (typically, credit unions). The result was a drastic reduction in the number of financial cooperatives, especially in urban areas.

Following strong lobbying efforts by cooperative leaders, the first regional union (actually covering several regions) for financial cooperatives, called “Central”, was established in 1980. Despite some setbacks, such as the closing of the National Credit Cooperative Bank in 1990 by executive order (for political reasons when the government changed its attitude toward cooperative development), rural credit cooperatives gained strength

and expanded their membership throughout 1980s and 1990s. In 1995, again as a result of lobbying by “cooperative fathers,” the Central Bank of Brazil authorized the creation of private commercial cooperative banks controlled by individual cooperatives. In 1992, the first Central and its affiliates took an important step toward unification: all member cooperatives adopted the name and logo for SICREDI. This move was considered a way to strengthen their position in the market, and it began an intense standardization process that is today one of SICREDI's defining characteristics. At the same time, legislation that had been moving forward slowly since the 1988 constitution (marking the end of the military era) advanced rapidly, producing a favorable regulatory environment for financial cooperatives by the end of 2005.

The SICREDI network of financial cooperatives now has a three-tier structure, administered by 8,000 technical staff and elected representatives. At the base are the 130 financial cooperatives, which serve members through 890 branches and service points. At the secondary level, five regional Centrals coordinate and supervise the activities of the cooperatives, with an emphasis on controls and institutional development. Their branches are called “regional units,” and each regional unit serves two or more cooperatives. A Confederation of financial cooperatives and a Cooperative Bank form the tertiary level (their roles are explained below). In addition, the central organizations own four auxiliary companies, operating in the fields of insurance, credit cards, logistics, and computer hardware, and administering rotating savings funds. The total membership of the SICREDI cooperatives exceeded 1 million in early 2006.

The General Assemblies—at the cooperative, Central, and Confederation levels—hold their meetings each March. An important element in the structure is the “deliberative committees,” which are another name for boards of administration at the cooperative and Central levels, and a separate deliberative committee at the Confederation level. They consider most corporate decisions, such as changes to operations, structure, products, and internal policies. At the Central level there is also a Technical Advisory Committee that is responsible for testing the viability of any new ideas or proposals before they are presented to the deliberative committee at the Confederation. Rejected proposals must be returned to the lower level, but may be

presented again. SICREDI concedes that the decision-making process for any new ideas is slow, as proposals must go up and down the whole pyramid in order to reach a two-thirds majority in voting before a proposal is approved.

Each primary cooperative has an elected president and vice president who direct the board of administration and supervise the day-to-day management of the cooperative. Six elected “fiscal advisers” sit on the fiscal committee, which meets monthly and supervises the board of administration (which is elected by the membership using the one-person, one-vote principle). Depending on the size, a branch office of a primary cooperative is composed of one manager, one or more “business consultants,” or “relationship manager,” and one or more tellers. Currently, 71 percent of the branches have a staff of no more than five. Each branch office has a credit committee—composed of a manager, one or more of the business consultants, and a teller—which meets at least once a week.

Roles of higher-level cooperatives and agencies in Brazil. As in Burkina Faso, the SICREDI network of financial cooperatives is strongly directed and controlled by the national federation (Confederation) and its branches (Centrals). The authority for “auxiliary supervision” provided by the Central Bank gives the higher-level cooperative organization additional justification to enforce strict supervision and controls over the primary cooperatives.

The Centrals are located in the capital city of one of the two states where each of the five Centrals oversees the activities of cooperatives in these states. A special feature are the numerous regional units, which, despite their rather grandiose names, are small units or branch offices that support and supervise two cooperatives each. They are often located in the same premises as one of their cooperatives. The regional units are currently being restructured to gain efficiency through a larger scale. The new structure, to be called a regional superintendency, will be managed by a regional superintendent. This structure is practically the same as the existing one, the main change being that one regional superintendency will provide services to an average of three cooperatives.

The Centrals and their regional units are financed through charges issued on member cooperatives. In 2005, this charge was 20 percent of the net income of the cooperative, but it was divided be-

tween the Cooperative Bank and the Central in the ratio of 3:2. The Centrals carry out the following functions in relation to their member cooperatives:

- Internal auditing
- Legal assistance
- Performance evaluation
- Advice in organizational matters
- Human resource management and recruitment
- Training

At the tertiary level, the SICREDI network has two apex structures, the Confederation and the Cooperative Bank. The Confederation was created in 2000 to provide leadership and represent the SICREDI network domestically and internationally. It is responsible for developing corporate policies, developing technological tools to implement these policies, and putting these policies into effect. The Confederation finances its operations with: (a) contributions from the cooperatives; (b) fees for its services; and (c) service agreements with other institutions for the supply of IT services. The operational expenses have increased dramatically since 2002 because an increasing number of services have been centralized to the Confederation (accounting, human resource services, paycheck processing).

More specifically, the Confederation performs the following functions:

- Legal advisory services for entire network and associated companies
- Elaboration of projects for initiating or restructuring new companies
- Performance evaluation of the Cooperative Bank, Centrals, and other SICREDI-companies
- Auditing of the Cooperative Bank, Centrals, and other SICREDI-companies
- Accounting for entire network
- Paycheck processing for entire network
- Administration of HR (benefits and incentive packages)
- Operation of a Web site and intranet for the network of cooperatives
- Operation of a help desk for the cooperatives and Centrals
- Development of new software for the network
- Organization of training (either directly or through third parties) for staff of entire network and associated companies

The Cooperative Bank was founded in 1996 to enable cooperatives to access financial markets and credit lines and to administer the network's resources. It is responsible for: (a) financial planning of the entire network; (b) marketing and communication policies for entire network; (c) defining credit policies; (d) setting parameters for financial management; (e) accessing credit lines from government and banks; and (f) making broker agreements with government entities and private utility companies for payment services.

The Cooperative Bank is controlled by the Centrals, which have 52 percent of shares and the right to vote. Interestingly, the primary cooperatives, which hold 48 percent of the shares, do not possess the right to vote. The bank receives its income as a share of the net income of the primary cooperatives and the fees it charges on its various services. It has been profitable for the past five years. The profits were substantially up in 2005, reaching R\$11.1 million (US\$5.4 million). However, the bank has always had a low profitability, primarily because it is not designed to be a for-profit company.⁴⁵

The SICREDI network also owns four auxiliary institutions. They are for credit cards, administration of insurances, administration of a consortia, and supply of computer hardware and software for the units of the financial cooperatives' network.

Sri Lanka and the Sanasa financial cooperatives. The Primary Thrift and Credit Cooperative Societies (PTCCSs) of the Sanasa cooperatives are located throughout Sri Lanka. Sanasa—with its 8,440 primary societies—has the largest rural outreach of all nonbank and bank financial institutions in the country.

The Sanasa set up of financial cooperatives is based on independent PTCCSs that own the secondary and tertiary structures, including Sanasa businesses. There are 25 district unions, a national Federation of Thrift and Credit Cooperatives Societies, Ltd. of Sri Lanka (Sanasa Federation) and five businesses, of which the Sanasa Development Bank, Ltd. (SDBL) and the Sanasa Insurance Company are the most successful. The others are the Sanasa Educational Campus, the Sanasa Engineering and Development Company (SEDCO), and Sanasa Producer Consumer Alliance (SANEEPA). SDBL is licensed and supervised by the Sri Lankan Central Bank.

The Sanasa PTCCSs, an organization that dates from 1906, is the oldest cooperative set up in Sri Lanka. In 1978, the Sanasa cooperatives—having received new leaders—began to transform its societies from small savings clubs for the rural elite into financial cooperatives offering more savings and microfinance products to a wider membership. The number of Sanasa societies has subsequently increased more than eight-fold.

Some of the societies have remained more as small community organizations with very few services than effective financial institutions, but the top tier of Sanasa PTCCSs are viable financial cooperatives providing a wide variety of products and services to members and non-members. In addition, Sanasa premises and resources are used for community activities.

As mentioned, the secondary level is composed of district unions owned by their respective PTCCSs. The Sanasa Federation—the tertiary level—has traditionally has been owned by the district unions, which have a strong representation on the Federation board. In recent years, however, PTCCSs have been allowed to purchase shares and become directly members of the Federation. In contrast to the practice in some other countries, the district unions and the national Federation provide services to PTCCSs but have no authority to control or regulate them.

Smaller PTCCSs—generally, those with fewer than 100 members—are managed and governed by their boards with special committees for internal audit and credit. As the membership of PTCCSs increases to more than 100, the organizations usually hire their first staff and create special committees. The top one-third of PTCCSs has the resources to hire professional managers and bookkeepers with degrees and experience in business and accounting. Each district union has a management board made up of the chairmen of the member PTCCSs. They also have a general manager and other managers and staff. However, many district unions are now dormant, as explained later.

The Sanasa Federation has a board consisting of chairmen or chairwomen of the district unions. The Federation has a small administrative staff. In

⁴⁵ Because the equity is low and assets high, the low profits gave a relatively high ROE of 13.1 percent and low ROA of 0.39 percent in 2005.

addition to his responsibilities at the Federation, the Federation's general manager has recently become the chairman of the SDBL, which is governed by an 11-member board. Eight board members are representatives of Sanasa PTCCSs and the rest are professionals with extensive experience in their respective fields. All members of SDBL's management team have extensive banking experience.

Roles of higher-level cooperatives and agencies in Sri Lanka. At the secondary level, there are 27 Sanasa district unions. The traditional mission of Sanasa district unions has been to mobilize equity and to provide savings and credit services, training, managerial services, and representation for their PTCCSs at the district and national levels. They operate almost like commercial banks since they also mobilize nonmember deposits, and they can invest their capital in business activities outside their core financial activity. When the district unions expanded their services in the 1980s, most of their expenses were funded by external (technical assistance) sources. When these sources were withdrawn, the district unions had to learn to rely on credit and savings margins and diverse sources of income. Some succeeded in doing so, but several of them are now having serious difficulty surviving. As mentioned, seven of the district unions are dormant. Some of the other reasons for their difficulties are: poor performance in their core credit activities; lack of uniform prudential standards; weak internal controls and risk management systems, resulting in overdue loans and inadequate follow up of the delinquents; and poor investments in revenue-generating activities (such as hotels and expensive office buildings). In addition, they suffer increasingly from direct competition from the SDBL and other auxiliary cooperative companies, which have moved to their areas of operations.

Obviously, the Sanasa district unions are at a crossroad and need to redefine their roles. While the Sanasa network's senior management and board members are aware of the problem, no global strategy has been developed to resolve the problem and to address underlying weaknesses in the system, partly because the district unions are independent and do not need to listen to their Federation.

The Sanasa Federation is the apex body of the Sanasa cooperatives. The role of the Federation has been to support its members by providing services,

resources, advice, and training, and even by mobilizing external resources for the network. However, it has never carried out the role that many similar organizations have done—that is, supervision, control, and audits of the member district unions and PTCCSs.

More specifically, the key activities of the Sanasa Federation have included the following:

- Refinancing district unions, including channeling and sometimes managing the flow of international financial resources for special credit programs
- Acting as the national and international representative for the Sanasa cooperatives, interacting with the government of Sri Lanka and being affiliated with different international cooperative organizations and other institutions
- Providing a forum for the cooperative network to develop consensus on new strategies, and to resolve issues and difficulties within the network of financial cooperatives
- Formulating policies and procedures for PTCCSs' operations (which they are free to implement or ignore)
- Training PTCCS staff and committee members, operating the Sanasa Education Campus, and participating in coordinating training programs at the national level
- Publishing the "Sanasa" newsletter and producing and distributing stationery and books to the district unions and PTCCSs
- Collecting national statistics on the PTCCSs
- Initiating establishment of "auxiliary" companies for the Sanasa network, organizing their investments and governance, and ensuring their financial sustainability

In recent years, there have been a number of very important changes in the Federation's role and responsibilities, partly as a result of establishment of new cooperative organizations and companies, and partly because some district unions and PTCCSs are becoming so strong that they do not feel that they need the Federation's services. These changes include shifting the refinancing of district unions to the SDBL; separating the Sanasa Education Campus from the Federation and making it an independent company; and transferring the mobilization and coordination of international

funds to the SDBL. With these changes, the Federation faces a challenge to redefine its role and key activities if it is to be relevant to the Sanasa cooperatives, primarily because the Sanasa network—or parts of it (district unions and the smaller PTCCSs)—needs to focus on the sustainability and increased integration of the main activities.

The “auxiliary” companies owned by the Sanasa cooperatives are, as already mentioned, SDBL and the Sanasa Education Campus. The other three are the Sanasa Insurance Company, SEDCO, and SANEEPA. Only SDBL and the Sanasa Insurance Company are profitable.

Kenyan Financial Cooperatives and Their Apex Organizations

The financial cooperatives are structured as follow:

- At the national level there are two unions (federations) for financial cooperatives—the Kenya Union for Savings and Credit Cooperatives (KUSCCO) and the Kenya Rural Savings and Credit Cooperative Societies Unions (KERUSSU)
- Also, at the national level there is the Cooperative Bank of Kenya, Ltd., serving all kinds of cooperatives, including financial cooperatives (and, more recently, private individuals)
- At the primary level there are rural savings and credit cooperatives and credit unions, both called SACCOs, usually affiliated to the national-level federations and the Cooperative Bank of Kenya

The larger network is the KUSCCO, which was established in 1973 for the credit unions and assisted by USAID at the time. It has 1,776 affiliated financial cooperatives, mainly working-place or trade-based credit union types (also today called SACCOs like the rural savings and credit cooperatives). Since the early 1990s, rural SACCOs—originally based on marketing cooperatives dealing with major produce such as coffee, milk, pyrethrum, cotton, and sugar⁴⁶—have joined KUSCCO. There are now about 70 rural SACCO member cooperatives, with a total membership of about 1.2 million.

The second national structure of financial cooperatives is the KERUSSU. It has 46 SACCOs as its members, with a total individual membership of 1.2 million.

In addition, there are nearly 1,000 independent, unaffiliated savings and credit cooperatives in Kenya, almost entirely credit-union types. Altogether 2,700 financial cooperatives operate in Kenya, with a total individual membership of 2.5 million.

The Kenyan financial cooperatives and their networks have been based on models from other countries. The rural SACCOs originally were departments of the marketing unions and called Union Banking Sections. The first ones were established in 1970 (some credit activities started in 1969) and were based on the Raiffeisen approach. The first credit unions, now also called SACCOs, had been established a few years earlier. Their central organization, KUSCCO, has been a member of the World Council of Credit Unions (WOCCU) since its establishment in 1973, but now that it has rural SACCOs as members, it is also a member of the international Raiffeisen organizations, such as the International Cooperative Banking Association and International Raiffeisen Union. KERUSSU is a member of WOCCU and the International Cooperative Banking Association.

KERUSSU is a relatively new national union for rural financial cooperatives. It was established in 1998 and opened its office in 2001. The structure of the network is simple: the union has one office with two permanent staff in Nairobi and 46 member cooperatives around the country. The membership consists mainly of tea and other farmers’ financial cooperatives, but also some older, produce-based SACCOs. The member SACCOs have opened so-called Front Office Service Activities (FOSAs) that serve customers outside the membership of the respective SACCO.

Throughout the network—that is, the primary SACCOs and the national unions—the administrative and management structures are essentially the same. They consist of an Annual General Assembly or Meeting (AGM) as the highest decision-making body; a seven-person Board of Management (or a Board of Directors); and a Credit Committee. KUSCCO has a Board of Directors consisting of 12 representatives of member SACCOs, and KERUSSU has a board of 14

⁴⁶ The design of the cooperative credit and savings programs was based on the Indian “Ryan” model, modified for Kenya by a prominent Swedish cooperative banker, Sven Lindquist.

members. In both organizations, the board members are elected by the delegates during the AGM to represent the provinces, and one board member represents the Commissioner of Cooperative Development. In addition, the larger SACCOs may have a system of delegates to represent the different parts of their area of operations and sections of membership.

Roles of higher-level cooperatives and agencies in Kenya. In contrast to the situations in Burkina Faso and Brazil, and similarly to Sri Lanka, the financial cooperative network in Kenya is not strongly directed and controlled by the national apex organizations. The Kenyan apex organizations, KUSCCO and KERUSSU, see their role as service agencies for their member SACCOs, and they do not have responsibility for, or claim to supervise them. The regulatory and supervisory agency for SACCOs is the Ministry of Cooperative Development and Marketing, in particular, its Cooperative Finance and Banking Department (see below).

The larger apex organization for financial cooperatives, KUSCCO, provides the following services to its member SACCOs, some of them for a fee, some free of charge:

- Representing and advocacy for SACCO cooperatives
- Operating a Central Finance Program, in which SACCOs can make savings and obtain loans for onlending to their members (750 SACCOs participate, and the savings as of September 2006 were US\$17.8 million equivalent)
- Operating a Risk Management Program to provide SACCOs with a fund that will protect them against losses of loans and even savings (especially for paying off the outstanding balance of a dead member's loan or funeral costs) and to provide support in the case of adversity to KUSCCO committee members and staff (675 SACCOs participate in the program)
- Carrying out research on SACCO issues, particularly on management problems and on how to integrate nonemployee-based SACCOs, with no common bond, into the SACCO family
- Providing education and training to conduct national and regional conferences and in-house programs for the delegates, committee members, and staff of SACCOs

- Providing consultant services to SACCOs under a Corporate Affairs and Marketing Program

KERUSSU, the newer apex organization that concentrates on rural SACCOs, aims at gradually providing similar services to its member SACCOs, including: advocacy and lobbying; training programs (25 seminars since 2002); advisory services; and a revolving fund similar to KUSCCO's Central Finance Program. These services of KERUSSU, except for the revolving fund, are provided largely through outsourcing. In addition, KERUSSU has started an inspection program with the endorsement of the Ministry of Cooperative Development and Marketing (five inspections done by date of this report). KERUSSU is apparently hoping to gain the position of a delegated or auxiliary supervision agency on behalf of the Ministry. However, replacing the supervisory or other functions of the Ministry is a great challenge for both KERUSSU and KUSCCO because of their limited finances and the huge size of the cooperative financial network in Kenya. KERUSSU also collects savings from member SACCOs into a revolving fund and lends them back to member SACCOs.

The Cooperative Bank of Kenya, while serving as the central banker for a large number of SACCOs, has opted not to assume general responsibility for the SACCOs. It chooses the SACCOs that it accepts as its clients and reviews from time to time whether its SACCO clients are viable and continue to be creditworthy.

REGULATORY FRAMEWORK AND SUPERVISION MODELS

Burkina Faso

Since 1994, MFIs, including savings and credit cooperatives, in Burkina Faso have been operating in accordance with a law that applies to all countries within the West African Economic and

47 For the name of the project that developed it, viz., "Projet d'Appui à la Réglementation des Mutuelles d'épargne et de Crédit." It was financed by the Coopération Canadienne.

48 The other laws partially applicable to financial cooperatives are the banking law, laws dealing with usury interest rates and money laundering, and the decree concerning the payment systems in the West African Economic and Monetary Union.

Monetary Union. This law, called PARMEC,⁴⁷ aims at establishing a high level of ethics and ethical norms in microfinance systems.⁴⁸ A complementary decree of application specifically for financial cooperatives was issued in 1995. This law and the accompanying decree provide clear guidelines to help financial cooperatives integrate their strategies with the financial and economic activities, as follows:

- Bringing the sector under uniform formal arrangements, allowing for harmonization of the practices used in operations
- Bringing all the MFIs under the supervision of the same ministry
- Establishing ethics and ethical norms in the systems of microfinance, together with norms and professional qualifications for management
- Improving the protection of depositors and security for the business operations
- Providing fiscal benefits for MFIs, including cooperatives

The legal regulations are still deficient in some aspects. For instance, they do not: require uniform methods in accounting and combining the accounts for the entire networks of cooperatives; provide clear explanations for the fiscal benefits accorded to microfinance institutions; or explain clearly enough that the limit on loans to a single member—10 percent of the portfolio—does not indicate a member's right to that percentage. Also, according to local opinions, there should be a limit for the (usury) interest rates.

Some of the objectives of the PARMEC are to be considered practical only in the long term, such as having staff with professional qualifications in the countryside. In addition, while bringing all the MFIs under the same ministry for supervision would be, in principle, a welcomed arrangement, it may not be practical. The units supervising the financial cooperatives are the Banque des états de l'Afrique de l'Ouest and the Monitoring Unit of the Système Financier Décentralisé of the Ministry of Finance. The supervision system thus qualifies as direct supervision, but none of these agencies have the human and financial resources or all the necessary equipment to carry out their tasks. Their statistical data are scanty. For instance, they cannot provide comprehensive information on

memberships, savings, and loans of the different microfinance networks. None of the financial cooperatives investigated by the consultant preparing the Burkina Faso case study had ever been inspected by the formal supervisory agencies. However, the internal control in the Réseau de Caisses Populaires du Burkina (RCPB) apparently compensates to some extent for the missing supervision, although it may not be under the arrangement of the regional unions and branches of the Federation. (See section above on the *Roles of higher-level cooperatives and agencies in Burkina Faso*.)

Because government supervision is weak, the cooperative network has organized an extensive internal supervision system. At the Federation level, the "Direction de l'Inspection Générale" (DIG) has good work plans and competent inspectors, but they are not enough to carry out inspections and audits of the different units of the network with the regularity and thoroughness needed. They also have little time to check and control the different types of risk, especially those in lending, that the financial cooperatives face. Similarly, the unions and the Federation's branch offices have inspectors, but their skills and experience are often too limited for their broad tasks and inadequate to evaluate the risks of the financial business. A computerized and integrated management information system, with an appropriate ratio and rating system, for the network would greatly facilitate inspection and risk management.

Brazil

Over the past 20 years, the atmosphere for expanding the operations of financial cooperatives in Brazil has improved greatly. For example, new legislation has authorized collecting "rural savings" by semiformal institutions and permitting 65 percent of them to be used for loans, reducing the capital requirement for individual cooperatives in line with the degree of the risk of the portfolio structure, and allowing creation of "open admission" (to allow the serving nonmembers) financial cooperatives in regions where there are up to 300,000 inhabitants.

Since 2005, financial cooperatives have been supervised by a specialized department within the

Central Bank, DESUC,⁴⁹ which oversees cooperatives and other nonbank financial institutions and takes action, at least in principle, whenever there are complaints about their actions.⁵⁰ DESUC is responsible for authorizing operations, evaluating economic and financial capacity, and enforcing sanctions if the norms are ignored by the financial cooperatives. To be able to carry out its supervision duties, DESUC examines, in the case of Centrals, business plans, assesses the capacity of proposed leaders, verifies documentation, and evaluates the capacity to supervise. It also conducts field inspections via its regional offices and monitors liquidity situations and credit risk. DESUC directly supervises the Centrals and, in theory, individual cooperatives that have not affiliated into the SICREDI network. However, in practice, DESUC relies largely on auxiliary supervision by the Centrals. The Centrals are expected to audit their rural credit affiliates yearly and the open admission and micro-entrepreneur cooperatives twice a year. The quality of supervision by the different Centrals is said to vary with the levels of maturity of the Centrals, partly due to different level of professionals in each of them. The Centrals themselves must be audited by external auditors yearly.

Cooperative membership has grown dramatically over the past decade, while irregularities have decreased. This is as much the result of a maturing cooperative sector as it is the increasing knowledge and familiarity with cooperatives within the Central Bank. The main problems detected by DESUC have to do with poor management of credit risk, inadequate competition in procurement of goods, irregularities in distributing surpluses, operations with non-members, and accounting problems.

Sri Lanka

The Sanasa PTCCSs, district unions, and the Federation fall under the Cooperative Law (enacted in 1972 and amended in 1983 and 1992) and are regulated by the Ministry of Cooperatives, and, within the Ministry, by the Cooperative Development Department. This department has significant powers over all the cooperative societies. Its responsibilities are as follows:

- Carrying out yearly audits of registered cooperative societies

- As of 1992, replacing the board of a troubled credit union with an interim board; the Registrar may, under certain conditions, dissolve a credit union
- Approving any requests to expand PTCCSs' activities geographically, including authorization to merge

Several problems hamper the operations of the Cooperative Development Department. Although PTCCSs are private, member-owned financial cooperatives with their own boards and by-laws, the Cooperative Development Department intervenes in much of their decision making. Moreover, the department lacks the skills needed to carry out proper audits for financial cooperatives. For example, cooperative auditors may even object to PTCCSs writing off bad loans. The requirement that the Cooperative Development Department must approve geographic expansion or consolidation of PTCCSs has greatly impeded the natural consolidation of Sri Lankan PTCCSs. It is apparent that the Cooperative Development Department continues to perceive Sanasa PTCCSs as village institutions that should not expand beyond the village boundaries.

In medium-size and large PTCCSs, internal audits are carried out by a board-selected audit committee. In smaller PTCCSs, internal audits are often carried out by the board. The Department of Revenue and Taxation has recently passed a regulation stating that cooperative societies (including the district unions and the Federation) with assets valued at more than LKR5,000,000 (approximately US\$50,000) must be audited by Certified Public Accountants. The new Microfinance and Cooperative Law coming out in 2007 is expected to further modify the external audit requirements.

The SDBL that belongs to the cooperative family, but separate from the Federation, is licensed and supervised by the Sri Lankan Central Bank as a Specialized Development Bank. SDBL can make loans and mobilize savings, including fixed deposits. Since 2005, all banks, including development banks, have been required to increase their

⁴⁹ Departamento de Supervisão de Cooperativas e Instituições não Bancárias e de Atendimento de Demandas e Reclamações.

⁵⁰ Before 2005, supervision of financial cooperatives was in the same unit as the banks.

capital from US\$200,000 to US\$15 million. This regulation is being implemented over a two-year period. Without a full banking license, SDBL would not be able to offer current accounts and foreign exchange services. However, with the support of the cooperatives in Sri Lanka, SDBL is expected to be able to raise the required capital to obtain the banking license.

Kenya

The Cooperative Bank of Kenya is supervised by the Central Bank, but the SACCOs, as well as their national unions, fall under the Cooperative Societies Act (revised in 1997 and 2004) and are regulated by the Ministry of Cooperative Development and Marketing. During implementation of economic liberalization policies in the late 1990s, the Ministry was closed and the budget of the Cooperative Department—in the new ministry it was placed in, the Ministry of Agriculture—was slashed. SACCOs were left more or less to their own devices with disastrous results. It soon became evident that the cooperative members and management were not ready for “auto-control.” Many cases of mismanagement and misuse of funds were reported, endangering the reputation and even the future of the cooperatives. In 2003, the Ministry of Cooperative Development and Marketing was re-established and again given substantial powers over all cooperative societies, including financial cooperatives. However, care was taken to give the cooperatives operational freedom (in contrast to the situation under the Cooperative Societies Act of 1967). The Ministry’s current mission is “to provide a legal and policy framework to accelerate the growth of a viable cooperative sector for sustainable socioeconomic development in Kenya.” The government gave the following powers to the Ministry of Cooperative Development and Marketing:

- Formulation of cooperative policy
- Mainstreaming of corporate governance in the cooperative societies
- Registration of cooperative societies
- Inspections and inquiries
- Regulation and provision of audit services, including provision of audit certificates
- Promotion of cooperative ventures and value addition

- Promotion of cooperative marketing and research
- Settlement of cooperative disputes
- Regulation of cooperative institutions
- Provision of cooperative education and training

The Ministry has tried to address some of the weaknesses in the cooperative sector by enforcing the rules and regulations established, but several problems still confront the Ministry and cooperative leaders:

- Inadequate legal, regulatory, and supervision framework, considering that many SACCOs offer near-banking products and services. The Cooperative Societies Act does not address the specific features of financial intermediaries.
- Lack of adequate prudential norms for the core business of SACCOs. For example, SACCOs are permitted to tie large parts of their portfolios to business buildings and other poorly earning assets. These assets lack control by SACCOs’ membership or any formal supervision body and create liquidity problems and a shortage of funds for member loans.
- Although SACCOs are required to develop strategic plans and to have yearly audits (by the Ministry of Cooperatives or competent audit firms), audit reports often are weak and, in fact, certify financial results for SACCOs that lack provisions for handling bad debts or for writing off loans.
- Inadequate rules of governance (or ineffective implementation) that: (a) allows persons who lack knowledge of financial affairs or sometimes integrity but who have great popularity (because they allow slack lending conditions) to continue on the management boards from election to election; or (b) fail to facilitate efficient management because the division of labor between the board and professional management has not been established and the lay board members and chairmen involve themselves in daily operations of the SACCOs.
- Inability of many SACCOs to employ high-caliber management staff and, especially in smaller SACCOs, the practice of leaving important financial decisions to lay members

who have too little education to understand them fully.

A new Savings and Credit Societies Regulatory Act is now being considered in the Parliament. The act will respond to at least some of the problems, including: establishing higher liquidity requirements for SACCOs and limits of investments; defining new prudential norms and the means for their enforcement; strengthening audit requirements; and perhaps also setting up a new, independent regulatory body that would supervise at least the larger SACCOs.

FINANCIAL AND OPERATING PERFORMANCE

The cooperatives are service organizations, established to improve members' economic position by providing reasonably priced services. As a result, profit making cannot be a goal as such. However, because the cooperatives need to survive and be sustainable for long periods, they must make some profits.

How much the profits must be depends on several factors:

- Current financial position of the individual cooperative and the potential need to improve it
- Objectives set by the management committee for the solvency⁵¹ of the cooperative for the security of depositors' funds
- Insurance arrangements for insuring deposits (although governments do not insure deposits as in many developed countries, many federations of financial cooperatives and central cooperative banks have created internal insurance funds for this purpose against a small annual fee charged to member cooperatives)
- Laws that state the minimum prudential ratios (for cooperative banks)
- Prudential ratios recommended by their apex organization in each country (for semiformal financial cooperatives)

There are several sophisticated methods to assess the financial performance of financial cooperatives (such as the Scores Aspects, Planet Rating, and PEARLS,⁵² and they are useful in comparing financial cooperatives in similar situations or in

identifying areas in which cooperatives should improve their performance. Existing case studies have not collected sufficient data for computing the ratios used under these methods.⁵³

Because it is difficult to generalize about the financial performance requirements for all situations, it is suggested for the purposes of this study that, at minimum, the following conditions prevail:⁵⁴

- The solvency of the cooperative (ratio of own funds to primary liabilities)⁵⁵ is more than required by the banking laws or the apex organization's recommendation
- The financial cooperative makes a profit each year
- The profits grow at least as fast as savings and deposits each year
- Profits are sufficient to allow maintaining or increasing the ratio "own funds/primary liabilities" to the level required by the banking laws or apex organization's recommendation.

Burkina Faso

Network as a whole. When the profits and losses of all the units in Burkina Faso's largest financial cooperatives network—RCPB and its member organizations—are totaled, the structure, as a network, is profitable. Its surplus grew from FCFA151 million (US\$0.3 million) in 2002 to FCFA1.224 billion in 2005 (US\$2.4 million).⁵⁶ In the RCPB network, the different units (Federation, unions, "caisses populaires")

51 In general, the ratio between the own capital to the commitments of the financial cooperatives. Each country has its own rules about what is included in the own capital and commitments, and they often differ to some extent.

52 PEARLS stands for Protection, Effective Financial Structure, Asset Quality, Rates of Return and Costs, Liquidity and Signs of Growth. PEARLS is a set of standards and indicators developed by WOCCU. For details see www.woccu.org/pearls/pearls_tech.php.

53 Except for the case study on Burkina Faso, whose annexes contain extensive computations using the summarized "caisses populaires" data and the Scores Aspect method (see the reference document in Internet).

54 The authors' recommendation.

55 The composition of "own funds" may vary from country to country, but usually these funds contain the share capital, various reserves, and annual profit. "Primary liabilities" also have different definitions, but they at least include savings and deposits.

56 Unfortunately, the accounting system of the FCPB was not able to produce the global accounts for the network, but they were combined by the consultant preparing the case study from individual accounts of the "caisses populaires."

have responsibility for each other's debts and failures. In individual cooperatives, such mutual responsibility between the members is now considered outdated. In most cooperatives, members are responsible only with their share capital.

Regional level. All the regional unions and FCPB branch offices ("les antennes techniques") were able to cover their annual expenses and make a surplus through their charges to the local "caisses populaires." However, their own capital (reserve funds, other funds, and not-distributed profits) was rather weak, varying from nearly zero to 4.18 percent of the liabilities (actives). In one union, however, it was 16.5 percent. The consultant preparing the case study was not able to find out the profitability or efficiency ratios for the FCPB, a fact that may indicate that the Federation has: too few staff to respond to queries; an inadequate management information and accounting system; or is not well organized to supply information and data on its own operations or those of network units on short notice.

Primary financial cooperatives. Although the RCPB network as a whole is profitable enough to cover its expenses, most of the rural "caisses populaires" had a loss in 2005. This situation, mainly caused by too low interest rates for loans, is especially worrisome when the aim is to expand outreach in rural areas. The interest rate for most types of loans is only 10 percent (or actual interest income—which is only 7 percent on the total portfolio because of late payments and loan losses). This is substantially lower than elsewhere in West Africa.

Brazil

Network as a whole. The SICREDI cooperatives have maintained very satisfactory financial and operating performance over the past five years. Most profits are obtained from credit operations, although the network seeks to keep fees lower than those of the banks in order to show their service nature and to differentiate the network from the for-profit financial sector. However, the network's policy is not to emphasize low interest rates or fees in order to gain new members but rather tout this aspect as one of the many advantages of member-owned cooperatives.

Primary financial cooperatives. The case study did not look into the individual profitability of the 230 primary cooperatives, but profits for the global network have grown steadily over the past

five years, from R\$61.2 million (US\$30 million) to R\$149.4 million (US\$74 million), although in relation to the equity and assets they have slightly decreased.⁵⁷ The profits are distributed inside the system: 50 percent are added to the members' shares, 45 percent go to reserves, and 5 percent to a Technical Assistance and Educational Fund. The portfolio quality is excellent, with default rates at less than 1 percent.

Operational costs (including fixed, variable, and promotional expenses) are around 11 percent of total assets, slightly higher than the recommended levels in WOCCU's PEARLS system (which is less than 10 percent). The network calculates a special efficiency indicator based on administrative expenses (operational income minus operational expenses). The objective is to stay below 0.60. Data from April 2006 show that 73 percent are above 0.60 and 27 percent of the cooperatives maintain a rate that is less than 0.59. The Centrals follow closely those primary cooperatives that have not met the targets.

SRI LANKA: FINANCIAL PERFORMANCE OF THE SANASA COOPERATIVES

National level. The Sanasa Federation has been running at a small loss during each of the past five years (LKR163,000—US\$1,680—in 2005), mainly because of losing business to new cooperative structures it has helped to establish. Of them, the SDBL, has been regularly profitable, recording its highest-ever pretax profit—LKR58.6 million (US\$600,000)—and declaring a 12 percent dividend for the year 2005. SDBL's largest source of revenue is the interest income that it receives mainly from its loans to district unions and PTCCSs. Also in 2005, SDBL reduced its nonperforming loan ratio to 6.18 percent, down from 7.8 percent in 2004. SDBL posted impressive returns—15.9 percent—on average shareholders' funds, an increase of 28.5 percent from 2004. Return on average assets increased by 21.4 percent, to 1.4 percent in 2005.

⁵⁷ As mentioned, the common profitability ratios—such as ROE and ROA—are not very important for service organizations as such and without qualifiers. However, they have been calculated for the SICREDI network. In 2005, ROE was 14.95 percent and ROA, 2.27 percent.

Of the companies owned by the Sanasa cooperatives, the Sanasa ALMOA Assurance Company is profitable, but the Sanasa Education Campus and the SANEEPA are not.

Regional level. Although some district unions are well-managed and profitable, seven (28 percent) of the 25 district unions are dormant. As a result, the situation is disastrous for the PTCCSs of these district unions. They stand to lose their deposits, their ownership stake in their unions, and become as dormant as are their district unions. Some other district unions also face serious problems with overdue loans by their PTCCSs, thus losing part of the revenue and endangering their own financial sustainability.

Primary financial cooperatives. There is no centralized information on the financial performance of the 8,440 Sanasa PTCCSs at either the district union or the Federation level. Because Sanasa primary- and secondary-level units are independent, it has not been possible to establish prudential targets or a common rating system for either PTCCSs or district unions.

The Federation annually collects from PTCCSs only basic information on fixed assets, savings, loans, and interest rates.

Fixed Assets. Between 2000 and 2004, the composite Sanasa PTCCSs fixed assets fluctuated between Sri Lankan Rupees (LKR)727.99 million (US\$9.13 million) and LKR646.32 million (US\$6.18 million). Fixed assets of a typical PTCCS averaged LKR81,770 (US\$878) during this period.⁵⁸ The tsunami that struck Sri Lanka at the end of 2004 affected more than 200 PTCCSs and may be at least partly responsible for the decline in fixed assets.

PTCCSs Savings and Loans. In 2004, the total savings in Sanasa PTCCSs were LKR3.1 billion (US\$33.0 million) and the loans LKR3.730 million (US\$35.7 million). After a large increase in 2000, total savings decreased, possibly because of competition from formal banks and from operational difficulties at the PTCCS level. The average loan portfolio per PTCCS during the period was LKR451,828 (US\$4,839).

The total loans in the PTCCSs almost doubled between 1998 and 2004, going from LKR1,362.5 million (US\$14.4 million) in 1998 to LKR2,770.8 million (US\$26.5 million) in 2004. In the years 2002, 2003, and 2004, the overdue loans (from three months to multiple years) were 25.1 percent, 22.7

percent, and 23.5 percent, respectively. Because the vast majority of the Sanasa PTCCSs do not have provisions for bad debts, write off loans, or make no reservations for deposits that they may not recover from failed district unions, the profits and assets in their books are overstated.

As for interest rates, between 1998 and 2004 the interest rate on savings steadily declined from 14 percent to 6.5 percent, for a total decline of 7.5 percentage points. Interest rates for loans declined by only 3 percentage points. Therefore, the interest rate spread rose from 4 percent in 1998 to 8.5 percent in 2004, providing a stronger basis for improvement of PTCCSs' finances.

Because of the serious financial position of 27 percent of district unions, the government's Cooperative Department should take urgent action to review their potential revival or, if necessary, to close them down. Also, to obtain updated financial situation, the Cooperative Department should encourage the financial cooperatives to correct their accounts rather than to object to write-offs as they have done in the past.

Kenya

Network as a whole. The total assets of all SACCOs in Kenya increased 107 percent between 2000 and 2004, indicating better-than-average growth among the financial institutions. The number of SACCOs grew at the same time from 2,389 to 2,767, and their combined membership nearly doubled from 1.12 million to 2.11 million. The share capital and savings increased from US\$532 million to US\$1.2 billion, and outstanding loans from US\$498 million to US\$1.0 billion (more than doubling in both cases).

National level. Of the two national unions, KUSCCO has made an after-tax profit in each of the past five years, reaching USD\$137,990 in 2005. KUSCCO's turnover has increased by 39.4 percent in the same period, while expenses have increased at a slower rate. KUSCCO has issued yearly dividends to its members, increasing the total amount annually to US\$126,000 in 2005. The two main revenue sources are the Central Finance Program and the Risk Management Program. The other central union, KERUSSU, has had a minor loss in each of

⁵⁸ Source Sanasa Statistical Review.

the years after its opening in 2001 (varying between US\$1,700 and US\$376). Its main sources of income have been revenue from conferences and subscription fees from member SACCOs.

The Cooperative Bank of Kenya, Ltd. has grown fast since it was renovated after the 1998 terrorist attack that was aimed at the neighboring American Embassy but which also nearly totally destroyed the head office of the Cooperative Bank (the attack did not affect the branch network). Customer deposits grew from US\$593 million in 2001 to US\$593 million in 2005. New loans grew at the same rate, but only to US\$399 million, leading to a strong liquidity position for the bank. Because of the terrorist attack, the bank with its subsidiaries (Cooperative Investment Trust Services and Cooperative Bank House) had a loss of US\$8.3 million in 2001, but fully recovered after that and has shown sound profits every year, with a record high US\$6.1 million in 2005 (11% return on own capital and 0.9% return on assets).

Primary financial cooperatives. The case study did not examine the financial results or profitability of individual SACCOs. However, as their reserves totaled US\$60.1 million equivalent in 2005, indicating a 6 percent solvency ratio, the financial position for most of the SACCOs is likely to be satisfactory. Because averages can be deceiving, many SACCOs give cause for concern because the Ministry of Cooperative Development and Marketing accepts their annual audits even though some do not contain provisions for handling bad debts or write-offs, or even include interest on them as income in the profit and loss statement, thereby overstating revenues and assets. To ensure the survival of even the weaker financial cooperatives, the central unions KUSCCO and KERUSSU offer SACCOs an opportunity to join their Risk Management Programs to partially share the lending risks. However, many of the problem-plagued financial cooperatives—most of them credit unions and many not even affiliated to the central unions—are not members of these two funds. The Ministry should take urgent action to review the real financial positions of the financial cooperatives and use its powers to enforce corrective actions.

PRODUCTS AND SERVICES

Although they may have problems and there are gaps in their performance, all the cooperative networks in the four case studies are seasoned organizations that have had time to adapt their services and products to the needs of their clientele. Table 4 shows the extent of the financial services available in typical financial cooperatives belonging to the four cooperative networks included in the case studies (but not necessarily available in branch offices or through Service Points). Many services and products are available through the regional and central organizations.

The SICREDI network in Brazil provides all the same products that banks do, including some 64 loan products, 11 types of savings products, and 22 insurance products. If all the variations are counted, SICREDI has close to 160 products.

The Sanasa cooperative set up in Sri Lanka also sees itself as a social institution. Various PTCCSs are involved in activities such as transportation; farm input supply, and marketing of produce; preschools; agency services; welfare services; and children's clubs.

TECHNOLOGY AND PROCESSES USED AT DIFFERENT LEVELS

RCPB in Burkina Faso

Computerized technology is broadly used at the Federation, its branches, and member unions, as well as in the larger "caisses populaires." However, the management information system at the Federation is either not fully used or is incapable of producing all the financial and statistical information that the management (and external observers) would benefit from.⁷⁸ A new system is being developed and installed with the help of Canadian expertise.

⁷⁸ The software programs in use are SAARI and SAGE; the statistical software is SIG DID 2.0. The next software to be adopted for use is SAF 2000.

Table 4. Financial Services Available in Typical Financial Cooperatives

Savings Products/Services	RCPB Burkina Faso	SICREDI Brazil	SANASA Sri Lanka ⁵⁹	SACCOS Kenya
Voluntary savings				
– Sight savings	X	Primary cooperatives offer a variety of savings products, including passbook savings and time deposits	X	X
Term deposits	X		X	X
Special savings accounts (for education, funerals, retirement, etc.)	X		X	X
Compulsory savings				
Savings account as guarantee	X ⁶⁰		X	X
– Regular compulsory savings	X ⁶¹			
Investment funds		X		X ⁶²
Loan services/products				
<i>Consumer loans</i>	X	Primary cooperatives may offer 28 forms of credit, all financed with network resources.	X	
– Salary advances	X ⁶³		X	
– Social loans (for marriage, funeral, etc.)	X ⁶⁴		X	X
– Loans for furniture	X ⁶⁵			
– Loans for transport	X ⁶⁶			
– Loans for housing	X ⁶⁷			X ⁶⁸
– Microloans			X ⁶⁹	
<i>Agricultural loans</i>				
– Credit for farm inputs	X			X
Credit for equipment and labor	X			X
<i>Commercial credit</i>				
Loans for inventory/investments	X			X
Prefinancing of produce offered	X			
Loans for equipment	X		X	
<i>Community credit</i>				
– Group loans	X ⁷⁰		X	
Advances for the “Caisses Villageoises”	X ⁷¹			
Advances to “Associations de Crédit Intermédiaire” (Service Points)	X			
Loans for rural infrastructure			X ⁷²	
Insurance products				
Insurances	For loan repayment (in case of death)	Basic forms of life, car and accident insurance, the overall property and equipment insurance, several forms of agriculture insurance, to protect against hail, poor harvests ⁷³	Agency services for for life insurance, loan insurance, vehicle and property insurance (on behalf of Sanasa Insurance Company, Ltd.)	
Other financial services				
Salary transfers to domicile area	X	X		X
Cashing of checks	X	X		X
Withdrawal by checks	X	X		X
Credit cards	X			X ⁷⁴

(continued)

Table 4. Continued

Savings Products/Services	RCPB Burkina Faso	SICREDI Brazil	SANASA Sri Lanka ⁵⁹	SACCOS Kenya
Foreign exchange services	X			X ⁷⁵
Rotating savings and credit services		X		X
Nonfinancial services				
Evaluation of commercial feasibility studies and loan applications	X ⁷⁶			
Evaluation of agricultural feasibility studies and loan applications	X ⁷⁷			
Preschool, post office and phone services, community projects			X	

59 The services mentioned here are provided by many of the PTCCSs that have permanent staff, about one-third of the 8,440 PTCCSs. The remaining two-thirds, which only have volunteers (nearly 57,000 of them), provide mainly the basic savings and credit services.

60 25 percent of the loan amount.

61 1 percent of monthly salaries (for members only).

62 Through the Cooperative Bank of Kenya Ltd.

63 Maximum 25 percent of the monthly salary.

64 Maximum FCFA5 million.

65 Maximum FCFA5 million.

66 Maximum FCFA5 million.

67 Maximum FCFA5 million.

68 Through KUSCCO's Housing Fund.

69 Probably for the same purposes as consumer loans at RCPB.

70 Max. FCFA250,000 per group member, up to FCFA5 million per group.

71 For income-generating activities in agriculture; max. FCFA250,000.

72 For solar energy, biogas, sanitation.

73 Insurance policies are administered by SICREDI Insurance along with two major insurers, MAPFRE and Icatr Hartford.

74 Through the Cooperative Bank of Kenya.

75 Through the Cooperative Bank of Kenya.

76 In two Centres Financiers aux Entrepreneurs.

77 By several Centres Financiers aux Agriculteurs.

SICREDI in Brazil

The network uses modern information technology. All operations at the primary cooperative level are registered online through the "Sistema de Atividades de SICREDI" (SAS), an integrated system developed by the Federation. Various network programs are used (Linux, Oracle, Microsoft), depending on the application. By the end of 2006, all the cooperatives will be trained in using teleconferencing technology, as the telecommunication structure in their region permits. All cooperatives and branches also will be able to communicate using Voice-over-Internet Protocol (VoIP), as the local infrastructure permits.

Credit policies for the SICREDI network are defined by the Cooperative Bank and formalized in a credit manual. Loans are individual and generally require the same guarantees as those required by banks. Most activities take place at the local branch offices (each of the primary financial cooperatives has on average eight branch offices.) The branch offices' credit committees can approve loans of up to US\$20,000. Beyond that, the loans must be approved by the regional unit of the respective Centre. For risk management, no individual loan can exceed 15 percent of the cooperative's own capital, and the total loan balance of the 10 largest borrowers may not exceed 70 percent of the cooperatives' own capital or 40 percent of the total loan portfolio.

Sanasa in Sri Lanka

As mentioned, most of PTCCS are very small units, with no staff. Only 60 of the larger ones have been partially computerized, using an Access-based loan management software created by the Federation. The vast majority of PTCCSs (8,380) use manual systems for their accounting and loan management.

The Federation has been licensing software to PTCCSs and assisting them with installation and troubleshooting for a fee. The Federation has now ended this program, because the cost of providing support and troubleshooting on a national basis proved to be too high. Whenever help with the systems was needed, the Federation had to send a staff member from Colombo, which was not cost-effective. Now a private company of former Sanasa employees is offering a similar software package to PTCCSs. This “outsourcing” approach may turn out to be a viable solution. The key challenges still remain, that is, that the number of those PTCCSs that have portfolios large enough to justify a computerized system is limited and, in general, the computer equipment and software are difficult to maintain in rural areas.

Kenya and SACCOs. The larger, produce-based SACCOs started computerizing in the 1970s (as Union Banking Sections). At that time there was no standardized, off-the-shelf software or programs available, and the programs had to be tailor-made for each SACCO. The Cooperative Bank also began to computerize its routine operations in the late 1970s and now has the software, equipment, and a management information system that would be expected of the country’s fourth largest bank with several branch offices. KUSCCO entered the information technology age at about the same time, and soon recommended to larger credit unions software packages that were suitable for their savings and credit operations. KERUSSU computerized its activities when it began operations in 2001.

Much of the software developed earlier is now outdated, and many of the larger and more progressive SACCOs have spent great sums of money for information technology (IT) without finding re-

ally viable solutions. Some SACCOs are using off-the-shelf software such as WOCCU’s Microbanker, and a few SACCOs have hired IT engineers/consultants to develop their own software. However, the vast majority of SACCOs are using either a manual paper system or IT systems limited to Excel and similar common software. A couple of problems need to be resolved soon: (a) the flow of information and accounting between the front and back offices and branches needs to be integrated; and (b) SACCOs must find effective ways to deal with the savings and loan accounts of a client base that can range from several thousands to 100,000 clients, and with a wide variety of products and services.

The simple savings system that was developed in the rural SACCOs and later spread to urban SACCOs was largely responsible for the success of the rural financial cooperatives, and especially for the great accumulation of savings. Under this system that is still in use, members of the marketing cooperatives agreed that the payments for their produce, once it was sold, would be credited directly to their savings accounts from which they could withdraw funds as needed, or they could transfer funds to accounts that paid better interest. The same approach was later employed with salaried employees using a credit union, except that sometimes only part of their salaries were deposited into members’ accounts, representing shares that were required to obtain loans.

Rural and urban SACCOs took different approaches to lending. The former provided members with automatic input advances up to a certain percentage of their expected produce receipts, and the management committees granted short-term and later even medium-term loans against guarantors’ signatures and other types of guarantees. Urban SACCOs used the traditional credit union approach, granting loans that could be two or three times the size of the same member’s share deposits. Both of these systems have further evolved over time, especially as the range of products and services and the size of the SACCOs has expanded (see the previous section on products and services).

Annex IV: Summary of Selected Findings at the 2004 and 2005 Regional Conferences

GENERAL

The World Bank recently organized four conferences on four different continents to discuss practical cases of development financial cooperatives in advanced and developing countries with the people who are daily engaged in cooperative finance or are dealing with financial and economic development in developing countries. The conferences took place in: Washington, D.C., (March 4, 2004), Recife, Brazil (June 21, 2004); Baku, Azerbaijan (November 10-11, 2004), and Bagamoyo, Tanzania (June 8-9, 2005).⁷⁹

This annex does not contain information about conference topics covered extensively in the main text, that is:

- Themes and objectives of the conferences
- Rural outreach of financial cooperatives
- Products and services provided by financial cooperatives
- Sustainability of financial cooperatives

Instead, the annex concentrates on expanding the following topics on which extensive materials had been prepared for and discussed at the conferences:

- Supervision models and regulatory frameworks
- Institutional arrangements
- Role of higher level financial cooperatives
- Special topics prepared for the conferences and related to financial cooperatives or rural financial services

SUPERVISION MODELS AND REGULATORY FRAMEWORKS

Washington, D.C. Conference

The conference took it as a constant that financial cooperatives must be supervised because they accept redeemable resources (shares or savings) from members or from the public at large. Depositors in these entities deserve the same protection as depositors in banks and other financial institutions. However, supervision of financial cooperatives often proves more difficult (and authorities find it less important) than supervision of banks because financial cooperatives often are geographically dispersed, have small memberships, represent a small share of the financial markets, and have limited impact on the economy.

As for the regulation of financial cooperatives, the conference concentrated on Latin American countries, which have little or no capital requirements for licensing savings and credit cooperatives (SCCs), the most common form of financial cooperatives. However, some countries specify capital requirements for financial cooperatives while authorizing a higher level of operation, such as the receipt of deposits from nonmembers. Several countries require SCCs either to maintain solvency ratios equal to or above the 8 percent required for banks under the international "Basel I standards" or to specify maximum leverage ratios (Mexico requires 40:1 for some financial cooperatives and Costa Rica 10:1).

⁷⁹ The full conference reports are available at the World Bank Web sites.

Also in the legal framework and responsibilities for supervision, the Latin American countries have different requirements for financial cooperatives, often reflecting their different historical and sometimes colonial backgrounds. For instance, in Argentina, Chile, and Ecuador the line ministry departments are responsible for supervision while in Colombia, Costa Rica, and Venezuela independent cooperative institutes have the responsibility. In both cases, there are too few skilled personnel for financial supervision, and conflicts exist between fostering development of the sector and supervising it. Less than 40 percent of financial cooperatives in Latin America are supervised by a central bank or independent “superintendencies” that have the required skills for financial supervision.

All four forms of supervision are used in Latin America and, at least in principle, they all examine issues such as auditing, good governance, accounting, payment systems, deposit protection, and regulations on mergers and acquisitions. Direct supervision is used in Argentina, Bolivia, and Uruguay, where supervision of financial cooperatives is carried out by a central bank or a specific superintendency. Although commonly regarded as the best approach to supervision, it is not economically viable in most countries. Accordingly, auxiliary supervision—that retains supervisory responsibility with the superintendency or the central bank, but allows a cooperative apex federation or an auditing firm to carry out the supervision—is practiced in Chile, Ecuador, El Salvador, and Mexico. Delegated supervision—in which the superintendency or central bank fully delegates supervision to a private agent, such as the cooperative federation—is used in Peru where the federation of financial cooperatives (FENACREP) is the delegated supervisory agent. Numerous countries (El Salvador, Guatemala, Honduras, the Dominican Republic, and Colombia) use the fourth solution, self-regulation, under which a federation of cooperatives performs certain control functions of its members based on a regulatory framework and monitoring process voluntarily accepted by the cooperatives. There are no formal supervision arrangements for financial cooperatives in Venezuela, Nicaragua, and Panama.

Recife, Brazil Conference

The resource persons for this conference prepared extensive papers on the conference topics, most of which were based on experiences in Latin America. In addition, WOCCU described the supervision systems recommended for credit unions in general.

A practical legal foundation for financial cooperatives has been found in a combination of laws and acts. Financial cooperatives can be covered under the cooperative societies acts and the banking acts (as in Bolivia, Brazil, Uruguay, and Argentina) or the cooperative societies act and a special act for financial cooperatives (as in Mexico, Guatemala, Honduras, and Nicaragua). Many countries have enacted sufficiently broad laws or decrees for financial cooperatives that they do not consider other acts necessary (e.g., Chile, Colombia, Costa Rica, El Salvador, and Peru). These acts prescribe the responsibility for supervision (described under the Washington conference summary above).

An interesting feature in some laws or legal bases is that they take a stand on the clientele that the financial cooperatives are permitted to serve. In some countries, all members of cooperatives must share a common bond, such as being employees of the same firm or members of the same profession. In others, such as Costa Rica, there is no common bond requirement but cooperatives can provide services only to their members. Columbia and Uruguay permit cooperatives to accept deposits also from nonmembers. Brazil permitted the creation of similar “open cooperatives” in 2003.

Several Latin American countries have attempted to support the modernization of the financial cooperative sector by amending existing cooperative laws or introducing new laws. For instance in 2001, two laws were introduced in Mexico to strengthen the legal foundations of the nonbank savings and credit sector: (a) The Savings and Credit Law designates the Banking and Securities National Commission as the financial authority responsible for authorizing formation of new savings and credit institutions and regulating the savings and credit sector; and (b) the National Savings and Financial Services Bank Organic Law sets up the National Savings and Financial Services Bank (BANSEFI), which promotes a savings culture, operates as a bank of the savings and credit sector, and coordinates temporary federal government aid

for developing the savings and credit sector. Together, these laws provide the foundation for a financially and institutionally sound savings and credit sector that is integrated into the formal financial sector and regulated by Mexico's Central Bank (CNBV).

A new law in Columbia establishes the legal framework for financial cooperative activities by authorizing three categories of institutions: (a) financial cooperatives; (b) savings and credit cooperatives; and (c) multi-activity cooperatives with a savings and cooperative section. Financial cooperatives are open cooperatives and are subject to a higher level of regulation than the latter two categories, which are closed cooperatives.

The experiences discussed at the Recife conference suggest that the legal framework governing cooperatives should provide for regulation and supervision of financial cooperatives by institutions that have the requisite capacity to do this task properly. Financial cooperatives are both cooperatives and financial institutions; hence, their regulation within the overall regulatory framework of the financial sector would help strengthen their capacity to deliver financial services to their clientele.

Participants at the Recife conference agreed that financial institutions, including financial cooperatives that collect deposits, need more regulation than nonfinancial institutions and financial institutions that do not collect such resources. Financial cooperatives should be regulated and supervised regardless of whether they are closed (accept deposits only from members) or open (accept deposits from nonmembers as well). All deposits should be protected. In addition, many members of cooperatives are small depositors who lack the information or the capacity to monitor the level of risk taken on by their financial cooperatives.

The regulations should involve, in principle, four key responsibilities:

- Authorizing the start up of activities of any financial institution interested in doing business in finance, including the right to suspend or cancel its registration, legalize the merger of institutions, and order the dissolution of any of them.
- Establishing standards and general regulations on the operations that financial institutions are allowed to engage in, and the interpretation of these arrangements.
- Inspecting and auditing activities related to the safety of banking operations; observing the laws, regulations, or policies; recommending corrective measures; and ensuring the adoption of corrective measures, if required.
- Protecting the stability of the banking system and offering a certain degree of protection to small savers by taking action, in the event of an institution's failure, to provide a maximum amount per saver.

Regulatory requirements for financial cooperatives should also specify, among other things, the minimum qualifications for board members, minimum responsibilities of the boards, capital adequacy requirements, sources and uses of funds, services, and audit requirements. These requirements aim to ensure prudent use of depositors' funds and to minimize the risk associated with loss of funds.

The Recife conference provided information in addition to what was provided at the Washington conference. Supervision involves enforcement of the regulatory requirements, carried out through on-site and off-site inspections, as well as examination of reports and financial statements. However, in Latin America more than half of financial cooperatives are not supervised (about 4,500 of the total 7,500). In some countries, only certain types of financial cooperatives (usually open cooperatives) are supervised, while in others, only financial cooperatives with assets over a particular threshold are supervised. This is not a desirable situation because smaller financial cooperatives are more likely to need supervision.

At the conference, there was a consensus that financial cooperatives need to be regulated and supervised as financial institutions, but the differences between formal banks and financial cooperatives need to be taken into account because these two forms of institutions are unequally exposed to risk. For example, the risk of a portfolio composed primarily of personal loans is much lower than that of a portfolio based on commercial loans. Cooperatives affiliated with a network may benefit from the network's advisory and financial support, thereby limiting the risks facing depositors. In addition, the profit orientation of banks compared to the service orientation of financial cooperatives should make a difference in their regulation.

An element of risk arises from the key prudential requirements of initial capital and solvency ratios. Most countries have very low capital requirements for licensing financial cooperatives. Some countries specify higher capital requirements for financial cooperatives that are authorized to receive deposits from nonmembers, the highest requirements being in Argentina, Bolivia, and Mexico, where the cooperative banks must have capital above US\$1 million before they can be licensed. However, as mentioned in the report of the Washington conference above, most countries in Latin America require financial cooperatives to maintain solvency ratios equal to or above the 8 percent required for banks in the Basel I standards.

Another key issue is whether there should be explicit insurance for deposits in financial cooperatives. In Latin America, deposit insurance systems for financial cooperatives are the rule rather than the exception, but there are a few countries where no deposit protection is offered.⁸⁰

Baku, Azerbaijan Conference

Participants at the Baku conference also expressed a clear consensus that adequate regulation and supervision of the financial cooperatives are essential for ensuring the safety of poor people's savings. Yet regulation and supervision of financial cooperatives in Eastern Europe and Central Asia are still in an embryonic stage, and standardized approaches are not available.

Each of the transitional economies of the Eastern Europe and Central Asia theoretically uses one of four types of supervision systems for financial cooperatives:

- Direct supervision, in which a state supervision mechanism has been set up by law and supervision is performed by the central/national bank (Albania, Azerbaijan, Lithuania, and Uzbekistan)
- Direct supervision, in which a state supervision mechanism has been set up by law and is performed by the finance ministry or a special supervisory body (Moldova)
- Auxiliary or delegated supervision, in which a state supervision mechanism has been set up by law, but supervision is delegated to the national or regional association/federation (Romania)

- Self-regulatory approach, under which supervision is performed by the national or regional association/federation (Russia)

In practice, however, financial cooperatives in many East European and Central Asian countries are not yet subject to effective supervision. Regulatory issues, including prudential standards, have been widely discussed in regard to the traditional banking sector, but they are relatively new in the microfinance debate and have only recently become "hot topics" for financial cooperatives. Obviously, adequate expertise and resources are crucial for the regulatory body. Similarly, it is necessary to build up supervisory capacity, organize training, provide field exposure, construct adequate organizational structures—and back up all of these tasks with sufficient budgets. The following questions must be answered: What are the costs of regulation and supervision to the cooperative financial institution and the supervisory authority? Who pays? Is it possible to find a reasonable cost-benefit ratio between different approaches to supervision?

Most financial cooperatives in Eastern Europe and Central Asia are credit unions and all of these countries have their own legislation on credit unions. In developing their legal frameworks, different countries used different approaches. Nonetheless, the practices in the East European and Central Asian countries show many similarities, including a set of common challenges for the future:

- Amending credit union laws to eliminate impediments to future development (for different business models, including development toward general banking organizations, vertical integration, and product range, etc.)
- Developing a legal framework for insurance to guarantee the safety of deposits
- Modifying the legislation to allow memberships of both individuals and legal entities
- Improving the legislation on collaterals, including movable property

⁸⁰ The Recife conference dealt more extensively with supervision of financial cooperatives, including some practices in advanced countries. However, these were the same as discussed at the Washington conference or are explained in Chapter IX of this paper.

- Developing mortgage and leasing legislation
- Preparing a comprehensive legal framework that covers all forms of microfinance agencies

Bagamoyo, Tanzania Conference

In most English-speaking African countries, the savings and credit cooperatives (SACCOs) are regulated by a ministry in charge of cooperatives. If the cooperative financial institution is a bank (such as the Cooperative Bank of Kenya), then the regulating body is the central bank or both the ministry in charge of cooperatives and the central bank. Often a special law for cooperatives identifies minimum requirements for licensing, for by-laws (including the establishment of governing bodies), and for fiduciary reporting. In addition, the central bank may be involved with larger SACCOs, issuing prudential regulations for them as in Tanzania.

Having dual regulating authorities (i.e., both the central bank and a line ministry) can cause confusion and lead to multiple reporting requirements. For instance, in Ghana, credit unions are registered with the Department of Cooperatives, while the Bank of Ghana (BoG) retains the regulatory and supervisory functions as authorized in the law on Nonbank Financial Institutions. The Credit Union Association (CUA) is a self-regulatory apex body that registers and supervises the member institutions, but it also must report to the Department of Cooperatives. A new legislative initiative attempts to streamline the situation, bringing the CUA under the full purview of the BoG.

Prudential regulations used in some countries establish a maximum percentage of equity at risk and regulate the types of permissible investments, as well as of obligatory investments in a security fund. Where federated networks exist, they often set prudential norms and regulations to promote sound management. A case in point is the CUA of Ghana, which institutes the prudential norms by using WOCCU's PEARLS monitoring system for its member organizations.

In general, regulations should remain simple and not so detailed as to prevent the development and growth of cooperatives. This is particularly important for new cooperatives, where prudential regulations should address the main risks, including capitalization, asset structure, concentration of credit risk in one sector, and concentration of

shares and deposits to few members. In Tanzania, the Ministry of Cooperatives has recognized the need to simplify regulations and to translate them into local languages to ensure that all members and managers of SACCOs understand them.

Supervision includes both inspection and auditing, in order to ensure compliance with the law, evaluate the internal control system, ensure the reliability of financial records and statements, as well as issue recommendations about the quality of internal control systems and soundness of management. In English-speaking African countries, the term external supervision is commonly used rather than direct supervision. The term internal supervision is used for auxiliary and delegated supervision that also can be called or indirect supervision (see Chapter VI). Where both external and internal supervisions are linked, the result is called integrated supervision. Parallel supervision occurs where internal and external systems are not linked.

Like elsewhere in developing countries, supervision of rural financial cooperatives often proves difficult for authorities such as the Central Bank or the ministry responsible for cooperatives. The large number of small entities to be supervised and their geographical dispersion make them difficult to reach; as a result, supervision costs are very high. Most countries in the English-speaking African region report that inadequate staff, training, transport facilities, and office equipment are major obstacles for conducting both direct and indirect supervision of cooperative structures in the participating countries.

INSTITUTIONAL ARRANGEMENTS

Washington, D.C. Conference

Discussion on institutional structures at the Washington conference centered on theoretical studies about two conflict situations in credit unions that are assumed to be applicable to other financial cooperatives. These are the so-called principal-agent and borrower-domination problems. Members of a credit union are, simultaneously, savers and borrowers, as well as clients and owners. The governance structure of a credit union comprises the general assembly and the board of directors. The general assembly, which is made up of all members (owners), elects the board of direc-

tors, which establishes strategic direction, makes policies, and monitors, hires, and fires managers.

A principal-agent problem occurs in a credit union because owners (members) do not participate in managerial decisions, which may go against the interests of the owners, while owners also are required to monitor, and supervise management's decision making.

The borrower-dominance problem occurs because a credit union has two groups of owners: net savers (members who have savings in excess of borrowings) and net borrowers (members who have more borrowings than savings). The dominant objectives of these two groups are often contradictory. The borrower-dominance problem arises when a credit union's board of directors is dominated by borrowers who support a policy of easy loans, low interest rates, and lax discipline in recovery of loans. Net savers, in contrast, would prefer policies producing high returns, strict discipline on loans, and high-interest savings. These problem areas require governance rules and regulations that deal with: conflicting objectives of management, borrowers and savers; control of management decisions; and compromises between borrowers and savers. The challenge is to educate the general assemblies and boards, usually laymen, become sufficiently interested in the matters of their financial cooperative and help them become competent so that they can develop appropriate governance rules and regulations to control the management of their cooperative.

The conference reviewed a special case of organizational arrangements in the West African countries of Mali and Senegal, where financial cooperatives have used a federated system to achieve sustainability and good governance through economies of scale. The main features of the arrangement are a sharing of resources and partnership in the network, and highly integrated supervision of the base units, the primary financial cooperatives. A federation is an ascending model of organization, in which the member cooperatives are owners and, in principle, control the shared unit of their union or federation. The more the primary financial cooperatives develop relations with the second-tier or higher-level institution, the faster the network will develop into an effective federated model.

The conference concluded that federated networks encourage integration of their member orga-

nizations through the creation of a shared image, mutual solidarity associated with self-control and discipline, standardized operations, and harmonized internal governance. The wide array of products and services that the federated networks can provide help produce financial stability. Standardization extends to operational systems, policies, norms, products, and the institutional image. Contractual solidarity brings control over the opening of service outlets, rationalizing the size of the base units, and providing internal security mechanisms within a central agency. Corporate and internal governance implies a democratic structure with representation and centralization of power.

Recife, Brazil Conference

This conference did not concentrate on cooperative structures although, in the context of dealing with Brazilian and Mexican cases, some organizational and structural aspects were discussed (the Brazilian banking and financial cooperatives system are covered in Annex III and will not be repeated here.)

In Mexico the government has promoted the federation, formalization, and institutional strengthening of nonbank savings and credit institutions in accordance with two laws issued in June 2001: the Savings and Credit Law and the National Savings and the Financial Services Bank Organic Law.

The Savings and Credit Law maintains the traditional structure of the Mexican nonbank savings and credit sector, with its vertical structure of savings and credit institutions that take deposits and offer loans to the population. Some of these savings and credit institutions have provided financial services for more than 50 years. They are integrated with federations—the government has authorized 12 of them—that carry out representational functions and provide technical assistance, training, and auxiliary supervision services. The federations are secondary-level institutions and they are grouped at the national level into confederations. The confederations manage the savings protection funds for the sector.

The Banking and Securities National Commission is the governmental authority responsible for issuing secondary regulations under the Savings and Credit Law. It also authorizes establishment of new savings and credit institutions, federations, and confederations.

A Mexican government project—supported by a loan from the World Bank and the Inter-American Development Bank—finances the Banco del Ahorro Nacional y Servicios Financieros (BANSEFI or National Savings and Financial Services Bank) to implement the project. BANSEFI is a development bank that, under the project, has three main tasks to: (a) promote a savings culture; (b) operate as the central bank of the savings and credit sector, and (c) coordinate temporary aid provided by the federal government for developing the savings and credit sector. The project also aims to strengthen the federations and confederations, by upgrading their supervisory capacity to international standards and helping them adapt to the new legal framework.⁸¹

Baku, Azerbaijan Conference

As mentioned, participants in the Baku conference came from very disparate cooperative circumstances. The models were given from financial cooperative organizations such as Desjardins of Canada, Rabobank of the Netherlands, the German Cooperative Confederation (DGRV), the Credit Union League of the Republic of Ireland, and BANSEFI of Mexico. They all have vertically-integrated, federated structures. The participants from Eastern Europe and Central Asia represented cooperative networks that are still very young. Their financial cooperatives remain poorly federated and, although the assistance agencies promote vertical integration, the individual financial cooperatives still often have relatively weak links, limiting integration to representation, lobbying, and public relations.

Financial cooperatives that begin at a small community or closed-group level often depend on volunteers for governance and representation of membership. Using volunteers helps small financial cooperatives keep their initial operating costs low before the institution has acquired enough funds for getting enough income to employ staff. Boards dominated by volunteer nonprofessionals can be very responsive to local community social issues, but they seldom have the financial and business expertise required for a financial institution in a later stage. However, evolution of the cooperative network depends on the stakeholders' ability to strengthen their competence level and move to more advanced cooperative structures.

As financial cooperatives become larger and engage in more sophisticated operations, they need to hire a full complement of professional staff. However, hiring new staff does not necessarily ensure having the capacity to manage the new credit technology (credit screening, ongoing credit monitoring, and loan recovery methods).

As development in Eastern Europe and Central Asia accelerates, the need for federations to provide centralized services for financial cooperatives will increase. Among the countries participating in the conference, all except Uzbekistan have a national lobbying body, federation, or association. Several of the financial cooperative networks also have other common facilities or services. For example, Albania, Lithuania, Moldova, Russia, and Ukraine have training centers for financial cooperatives. Albania and Moldova have a central finance facility or liquidity pool, and Lithuania and Ukraine have a clearing center for their financial cooperatives. Lithuania even has a deposit insurance fund to help secure the members' savings and Ukraine has linkages with an insurance company, to ensure that members' other assets and lives are protected.

Bagamoya, Tanzania Conference

As was the case at the Baku conference, in Bagamoyo advanced models or examples from mature financial cooperative networks were presented by Desjardins of Canada, Rabobank of the Netherlands, and BANSEFI of Mexico (see the Recife conference summary above). The presentations concentrated on analyzing alternative structural models for financial cooperatives.

There are two general institutional models for financial cooperatives and their networks: (a) an atomized-competitive model and (b) a federated model. The first model describes a network of cooperatives where each cooperative is, in principle, a stand-alone unit, sometimes with networks formed for the purpose of advocacy, lobbying, and representation, as well as perhaps capacity-building services, such as training. The second model consists of a network in which member units share

⁸¹ For details of the project, see World Bank Internal Report. Mexico Study Tour: BANSEFI and Other Institutions. 2006.

resources and, thereby, achieve a high level of integration. Resource sharing stimulates mutual monitoring and leads to the provision of support services that ensure the best use of shared resources. The development of second- and third-tier institutions of the network is a logical step in integration. In that model, the apex institutions are collectively owned by the member cooperatives, and provide support services, including oversight, emergency liquidity funds, or deposit insurance funds where individual financial cooperatives are the shareholders. Resource sharing also leads to the standardization of operating systems, including management information systems, that enable member units to share data as they monitor each other. Further economies of scale can result regarding investments and maintenance of uniform technological systems.

Except for Ethiopia, Ghana, Uganda,⁸² and a few other countries, most of the English-speaking countries in Africa have adhered to the atomized-competitive model. Conference participants observed that, given the challenges faced by financial cooperatives in most African countries, the development of strong federations could contribute to their solution. Resource sharing among financial cooperatives would allow smaller units to achieve sustainability and realize economies of scale in offering services. Resource sharing would also lead to stringent monitoring and supervision by the federation, often in addition to government regulation. This, in turn, would foster good management, improve human resource development, and improve operational performance through the establishment of uniform accounting and management information systems.

ROLE OF HIGHER-LEVEL COOPERATIVES AND AGENCIES

The main speakers, and other persons with extensive cooperative experience, at the four conferences were from apex organizations of the cooperative networks in their own countries or from development agencies closely associated with federated, vertically-integrated cooperative networks. Accordingly, the discussions emphasized the benefits that such networks can bring to individual cooperatives.

Washington, D.C. Conference

The conference concentrated on presenting a few case studies and suggesting some key services that the cooperative federations and other apex organizations can provide to their member cooperatives. As mentioned in the main report, the German cooperative organization DGRV⁸³ began to support the rural savings and credit cooperatives (RSCC) in the Volgograd region after the banking crisis in Russia in the 1990s. The DGRV project also supported establishment of the Oblast Savings and Credit Cooperative (OSCC) as an apex body, and helped the regional federation provide audit and other services. By 2003, there were 44 RSCCs with 113 commercial banks and 23,400 members in this region of Russia.

The case study of the West African countries Mali and Senegal, both of which have federated structures for financial cooperatives, emphasized that a federated network of financial cooperatives contributes to sustainability through economies of scale and better governance. The main benefits are derived from sharing resources, organizing partnerships, and organizing highly integrated supervision of the primary cooperatives, including audits. Furthermore, federated networks promote greater integration of the network of financial cooperatives through the creation of a shared image, mutual solidarity associated with self control and discipline, harmonized internal governance, and standardized operations.

A federated structure provides several other benefits. Standardization extends to operational systems, policies, norms, and products. Mutual solidarity brings control over the opening of service outlets and providing internal security mechanisms for all units of organization, for instance,

82 The Ghanaian Cooperative Credit Union Association (CUA) and the Tanzanian Cooperative Rural Development Bank (CRDB) date from the late 1960s. In Ethiopia, the second-tier unions have only been established since 2004, and there are no third-tier federations. In 2005, the Cooperative Bank of Oromia was launched in Ethiopia.

83 Deutscher Genossenschafts-und Raiffeisenverband e.V. (DGRV) is the German Cooperative and Raiffeisen Confederation—the national apex organization of the German cooperative sector—comprising all cooperatives in agriculture, savings, credit, small-scale industry commodity and services; regional and national cooperative institutions, federations, and associations; and specialized cooperative enterprises.

through various insurance schemes and undertaking responsibility for financial and other problems of each cooperative involved. Centralization of representation brings more power for the network from financial cooperatives than what the individual units can accomplish if they did not federate. Financial stability and efficiency result from a wide array of products and services, even new and innovated products (such as new types of loans and automated teller machines), and these can be more readily provided with the help of the federations. Existence of federations is also a condition for effective self-regulation, under which a federation performs certain control functions of its members based on a regulatory framework and monitoring process voluntarily accepted by the cooperatives.

Recife, Brazil Conference

As described earlier, most financial cooperatives in Brazil (some 80 percent) follow the federated model rather than the atomized (stand-alone) model. There are 36 central, regional, or state-level cooperatives and four confederations. The central and national cooperatives advise interested parties on how to establish cooperatives and provide training to staff and members of new cooperatives. As a result, new cooperatives almost automatically join the vertically integrated system, although it is not obligatory. Affiliation with a federation allows new cooperatives to take immediate advantage of the federation's brand identity and use its resources, such as information technology systems and technical advice.

In Mexico, the savings and credit cooperatives are integrated with state-level federations that handle representational responsibilities, as well as provide technical assistance, training, and auxiliary supervision services. The federations are grouped on a third level into confederations which, by law, also carry out representational responsibilities and manage the savings protection funds for the sector.

Under the earlier mentioned BANSEFI program—supported by the government, the Inter-American Development Bank, and the World Bank—a specialized consulting company will, for two years, help each federation classify its financial cooperatives into four categories (A, B, C, D) according to criteria such as the size, performance level, and supervision needs. The experts and their

federations help implement specific plans for each financial cooperative, facilitating their transition from a lower category to a higher one in compliance with the Savings and Credit Law. In Mexico, federations are permitted to manage preventive supervision and early warning systems that protect the financial cooperative sector against a systemic risk such as insolvency, and to apply for corrective programs.

In a discussion about the role of the federations as supervising agencies and about appropriate supervision methods, conference resource persons noted that credit union leagues (federations) in many countries have sought to remedy inadequate supervision by attempting to supervise some or all of the credit unions that are members of the league.

Because of the danger of slackness when the supervising federation is formally owned by the cooperatives that it supervises, it might be wise to adopt the German model, under which supervision is delegated to two or more specialized regional supervision federations that do nothing but auditing and supervision. The board of directors of each regional federation consists of representatives of that region's financial cooperatives. The advantage of having at least two such federations is that a regional federation never supervises the financial cooperatives to which that particular federation's board members belong.

The Canadian (Desjardins) model favors a two-tier cooperative structure (local cooperatives and a federation) in which the federation has two separate roles: supervision and technical assistance (consulting) services. The consulting services would make it possible to foresee and correct any problems the supervisory and monitoring system have detected.

Baku, Azerbaijan Conference

As mentioned, the cooperative networks in Eastern Europe and Central Asia are still very new, and the primary role for cooperative federations is seen as that of supervision. Because the governments' control over financial cooperatives is very limited or partially unregulated, the role of the national federations as self-regulatory and internal control bodies appear important. In addition, a well-functioning representation of the cooperative network would be beneficial in many areas, especially in

setting up common standards and for lobbying in favor of cooperative organizations and members. Dissemination of the best practices to transform the apex representation bodies into real self-financing and sustainable institutions can be another step for consideration by cooperative networks in different countries.

Not only must the national federations become self-financing and sustainable institutions, but also the following actions need to be taken for financial cooperatives:

- Provide a broader range of services and diversify the loan portfolios
- Incorporate both rural and urban areas into financial cooperatives
- Transform the central finance facility into a fully operational commercial (cooperative) bank or establish cooperative banks in countries where they do not now exist
- Establish a cooperative insurance company by financial cooperatives and other microfinance institutions
- Establish savings insurance agencies to insure savings of cooperative members

It is also important to establish specialized apex institutions for selected support activities such as liquidity pools, deposit guarantee schemes, and central finance facilities. However, before these activities begin, they should be analyzed with a view toward developing them in such a way that they could be replicated throughout Eastern Europe and Central Asia.

Bagamoyo, Tanzania Conference

As in the other conferences, the resource persons emphasized the need for a federated structure for financial cooperatives in Africa, along the lines of Desjardins in Canada, Rabobank in Holland, and BANSEFI in Mexico. In addition to providing advocacy, lobbying, and representation, federations can ensure sustainable development of the financial cooperative sector and improvement of effectiveness of financial operations, as well as train cooperative staffs, committee members, and members.

In addition, federations or apex organizations such as cooperative banks provide opportunities to share resources. Thus, on the financial side the role of apex organizations includes central bank func-

tions for cooperatives including holding excess and liquidity funds, and providing supplemental funds for loan-starving cooperatives, or organizing these activities through other banks. The resource-sharing role also allows the apex organizations to influence the policies and practices of member cooperatives in areas such as standardization of the operating systems and introducing uniform management information systems, enabling common monitoring by the federation, and sharing data and information within the federated network of financial cooperatives. Federations also facilitate common purchases and maintenance of uniform technological systems, including uniform accounting practices.

Where federated networks exist, the apex organizations (federations and cooperative banks) often set prudential norms and regulations in addition to government regulation in order to promote sound management. A case in point is the CUA of Ghana, which institutes the prudential norms of the PEARLS monitoring system for its member organizations. Networks such as Desjardins in Canada also set up their own security fund, where there is no deposit insurance or guarantee by the government. Such a security fund can increase the public confidence in the sector, particularly if fraud has been found in some of the financial cooperatives.

DISCUSSIONS AND RECOMMENDATIONS ON OTHER TOPICS/ISSUES

Recife, Brazil Conference

Taxation of financial cooperatives. An important topic at the conference, not directly linked to cooperative outreach, was the question of whether financial cooperatives should be exempt from taxes. In most of Western Europe, including the Scandinavian countries as well as Russia and several countries of the previous Soviet bloc, the net profit of the financial cooperatives is fully taxed. The same applies to several African and Asian countries such as Kenya, Rwanda, Uganda, South Africa, Indonesia, Sri Lanka, and Uzbekistan. Other countries—Great Britain, Zimbabwe, the Philippines, South Korea, Trinidad & Tobago, Guatemala, and Uruguay—tax financial coopera-

tives at reduced rates. Financial cooperatives are not taxed in the United States, Caribbean countries, Ireland, Poland, Romania, and Ukraine, or in many countries of Africa, Asia, and Latin America.⁸⁴

In countries where cooperatives, including financial cooperatives, are exempt from taxation, the rationale is that they are nonprofit entities serving a social purpose. They primarily serve a low- or middle-income clientele, especially in rural areas, and provide services that banks either do not provide or provide at a higher cost. Tax exemption allows financial cooperatives to offer services at a lower cost than the commercial banks do, and strengthens their capital through higher retained earnings. The argument against providing a tax exemption in countries where it is not allowed is that other financial institutions serve the same clientele and that the same tax status should apply to all because competition is necessary to enhance the quality of services to all clients.

With respect to a decision about whether financial cooperatives should be taxed, implicit taxation needs to be assessed. In many countries, financial cooperatives pay an implicit tax not paid by other financial institutions because they are subject to certain regulations that are not applicable to other financial institutions. These regulations often have the effect of reducing the income of financial cooperatives. The most common such regulation concerns the requirement that financial cooperatives maintain higher levels of reserves or liquidity than other financial institutions are required to do, or cooperatives are not allowed to deal with the general public.

Therefore, there are both advantages and disadvantages with providing tax exemption to financial cooperatives. An advantage is that tax exemption allows financial cooperatives to build capital, thereby reducing their risk of failure. This may be an important advantage, especially in the early stages of building up the financial cooperative sector. A disadvantage is the lost tax revenue to the state, although this is unlikely to be significant when financial cooperatives are at an early stage of development. The decision on whether to tax financial cooperatives, and, if so, how much, is essentially a political question that needs to be addressed through consultation with all the stakeholders.

Bagamoya, Tanzania Conference

New business models—Beyond cheap credit for agriculture. In Kenya, an NGO, Kenya Rural Enterprise Program (K-REP), has set up so-called Financial Service Associations (FSAs).⁸⁵ FSAs are not cooperatives but financial institutions that combine the features of community organizations in which members are shareholders who can access the services of their organization. FSAs also possess features of company models because they use risk capital and aim at achieving profits to be shared among capital owners. Voting rights are proportional to the ownership of shares, unlike the principle of one-member, one-vote in financial cooperatives. Proportional voting rights are believed to ensure that major shareholders monitor their FSAs intensively and thus contribute to improved governance and financial management.

Because FSAs give poor people in rural areas access to a range of financial services in a profitable and thus sustainable manner, interest rates for loans are higher than in the cooperatives, particularly until the individual FSA has become profitable. With initial rates of up to 10 percent per month, the loans cannot be repaid by income from agricultural activities alone. As is the case with financial cooperatives, FSAs mobilize and reinvest savings in rural areas to promote general economic development of the region. Individual shares can be purchased in installments, thus ensuring that poor people are able to participate in the institutions. At the same time, richer shareholders are mobilized to invest in FSAs for the benefit of the local economies.

FSAs share some of the problems faced by financial cooperatives, including fraud by employees, managers, and board members, as well as weak governance and management capacities. In addition, in Kenya, FSAs seem to be less profitable than financial cooperatives. Only 45 of the 70 Kenyan FSAs (64 percent) were profitable in 2005,

⁸⁴ For a more comprehensive list of countries that tax or exempt financial cooperatives, see the World Bank web site on the Recife conference (www.worldbank.org/recifecoop).

⁸⁵ FSAs have also been introduced in Benin, Congo, Gabon, Guinea, Mauritania, South Africa, Tanzania, and Uganda. The concept and legal form vary from country to country. In Kenya, FSAs are registered as social welfare organizations with the Ministry of Culture and Social Services.

and only 20 percent of them have been profitable for five successive years. K-REP has responded to the various problems, some of them certainly due to the newness of these institutions, by establishing companies that manage services and oversight for FSAs.

Risk management for farmers. Smallholders face a range of risks, particularly lower-than-expected sales prices for their produce and bad weather, including too little or too much rainfall. In Africa, farmers also fear health risks, particularly in the wake of the HIV/AIDS pandemic, which has increased demand for emergency loans for health care and funeral expenses, as well as increasing withdrawals of savings for such expenses. In developed countries, farmers have access to insurance products to cover the health risk, but in African countries such products are rarely available or used by smallholders, thus increasing demand for emergency loans for health and funeral expenses and putting strains on the liquidity of financial cooperatives as the members need to withdraw their savings. Because of these uncertainties, financial institutions are unwilling to lend to farmers, particularly smallholders, or agricultural cooperatives, since their capacity to repay is uncertain. Some NGOs and financial cooperatives have started to offer health and life insurance products to their clients and members.

In developed countries, financial markets have developed instruments to cover price risks, and governments offer protection against weather or yield risks. In developing countries, insurance products are rarely available to farmers.

In the past, marketing boards, particularly in African countries, set a guaranteed price for produce, mitigating the price risk to farmers. When the guaranteed price was set above the international price for a specific commodity, governments had to cover the difference, with negative consequences for the countries' budgets. Since economic liberal-

ization in the 1990s, most of these boards have been abolished, exposing farmers to the high volatility of prices on international commodity markets. To mitigate the price risk for farmers and lenders, the World Bank's Commodity Risk Management Group (CRMG) has developed market-based instruments that can be purchased by farmer organizations or lenders.⁸⁶

In principle, two instruments are available on international commodity markets to limit the price risk: futures and options. Futures are forward contracts that specify the sale of a commodity at a specific future date for a specified price. Futures markets exist for only a few commodities and are not easily accessible to cooperatives because they require a credit line with a brokerage firm. Options are contracts that give the right to sell or buy a futures contract within a specified time at a specified price level.

Many traditional crop insurance schemes have failed because of adverse beneficiary selection, moral hazard problems, and inefficient insurance companies. An index-based weather insurance may be more practical. Such an index is based on measuring rainfall in a certain region, comparing the actual rainfall in a given period with historical data, and establishing a relationship between rain quantity and yield for a specific crop for different phases of the crop cycle. The index would measure the impact that bad weather can have on yield and therefore on revenue. Indexed-based weather insurance can be designed as a stand-alone product for farmers if a local insurance company is willing to develop and offer the product.⁸⁷

⁸⁶ CRMG currently works in Tanzania, Uganda, and Kenya with price-risk instruments, and in Malawi and Ethiopia with index-based weather insurance.

⁸⁷ For more information and real-life examples, see the Bagamoyo conference report at the World Bank Web site (<http://go.worldbank.org/MHPVIF5RX0>)

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Agriculture & Rural Development Department
World Bank
1818 H Street, N.W.
Washington, D.C. 20433
<http://www.worldbank.org/rural>