Reviving Cooperative Credit Institutions

Implementation Issues

The task force on the revival of rural cooperative credit institutions (the Vaidyanathan committee) submitted its final report in February 2005. This article lists the issues involved in implementing an ambitious package of Rs 15,000 crore. It argues that the major issues stem from some of the compromises that may have to be reached in negotiations with the states.

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Cooperatives have existed for more than a century and the state has been involved with them throughout. This is because market-based institutions do not take care of the needs of the poor. Dealing with the poor is not profitable. When it is designed to be profitable, it may be construed as exploiting the vulnerable. We see that discussions on interest rates are more animated and frequent than the discussions on access to finance. Therefore the state's interest in cooperatives is legitimate.

It is argued that if conditions of "perfect competition" were met there would be no difference between cooperative and other organisations. Each factor would get its due and there would be no rent-seeking. New institutional economics literature highlights the issue of transaction costs and argues that the assumption of rationality that explains perfect competition is bounded. Cooperatives emerge in a context, when market institutions seek excessive rent. The reform package suggested by the task force on the revival of rural cooperative credit institutions has kept cooperative principles as the basis for its recommendations.

The cooperative movement derived its principles from the Rochdale pioneers. The setting up of early cooperatives was in response to a market failure – that the grocers were charging excessive prices. While the profits were coming from turnovers, they were being excessively rewarded for capital. The pioneers pooled their requirements and directly accessed the market. This did not mean anything to business principles in the exterior, but it was a different system philosophically. The differences were:

(i) The centrality of the business moved to usage. This suited retailing, as the value addition was in storage and delivery.

(ii) Pay-offs were aligned to the centrality of business – turnovers rather than capital were compensated.

(iii) Capital had a fixed pay-off, like any financier getting interest.

Other principles emanated from ideology. These principles do not have business logic and therefore are challenging. They are:

(i) Open membership – this principle brought about easy entry and exit. The logic was that anybody equally vulnerable should not be denied the benefits. However, it created no incentives for the accumulation of capital. The early members lose out as the later members get disproportionate shares of future profits based on the accumulations of the past members.

(ii) Democratic control – delinking control from capital was logical, but not aligning control with turnovers created complexity. Successful (sugar) cooperatives have overcome this by aligning shareholding with turnovers and by restricting the membership with artificial barriers.

(iii) The other three principles stemmed out of the initial association with the trade union movement and were developmental in nature.

Because of these principles, cooperatives are effective when they are neighbourhood institutions. As they become larger, they function as effective businesses, but lose the advantage of a cooperative. This loss is replaced by the advantage of being a market-driven enterprise. As neighbourhood institutions their advantages come from informality. Decision-makers are embedded in the local economy and have exclusive non-documented information pertaining to farming conditions, yields, and borrower behaviour. This is not available to banks. As cooperatives bridge the information gap they reduce transaction costs.

On the small customer segment, cooperatives have advantages over banks. Banks find it cost intensive to collect information and service small customers. Self-help groups (SHGs) have leveraged the neighbourhood phenomenon,[1] but cooperatives have not built this strength. The recommendations of the task force in making them autonomous and self-sustaining would encourage them to become neighbourhood institutions and help in the objective of deepening the access to financial services.

Cooperatives are complex organisations. Reviving them with external infusion of funds is more complex than reviving banks or financial institutions, where the ownership and management is identifiable and numbers manageable. In case of cooperatives, dealing with 1,00,000 autonomous units would be daunting.

Recommendations

The recommendations of the task force were based on two premises:

(i) Cooperatives should be autonomous, self-governed, member-managed institutions. Their future depends on members. The package was to enable them to start with a clean slate. The need for the package is based on premise (ii) below.

(ii) The state having promoted, managed and interfered with cooperatives – in operational and policy matters – is morally responsible for some problems of the sector. It is duty bound to offer a one-time package.

The conditions specified in the report were to honour the above premises. The package is an incentive for the states that wanted reform by allowing cooperatives to go back to members, ensuring a conducive regulation, and strengthening the existing base. The recommendations are in three parts:

(i) Legal reform to ensure that cooperatives work as self-reliant, mutually aided, autonomous institutions.

(ii) Preparation for cooperatives to clean up, starting with an assessment based on accounting norms applied to the financial sector, provision of infrastructure for carrying out the business and training to manage the cooperative as a concern after the package is devolved.

(iii) Implementation of the financial assistance with benchmarks and milestones.

Issues in Implementation

We discuss the issues in implementation under heads that represent the interpretation of the recommendations, the compromises that would be attempted and their implications for the basic principles and premises of the recommendations. These are futuristic, not based on data but on the signals received as part of the interaction during the task force meetings and from concerns expressed in the press and other fora. They also reflect the prior behaviour of states.

Will the States Agree to Reform?

The reform takes the "bottom-up" approach by addressing the primaries first, but starts with a "top-down" step. This step is to provide an appropriate regulatory environment. If a conducive regulatory environment does not exist, the reform would be fragile. The concerns of the states pertain to two aspects. Both relate to their relationship with cooperatives and have political considerations.

The report recommends that the states should confine their role to legislation and supervision. The legislation envisaged has been articulated in an annexe. The states have been treating cooperatives on par with other political institutions where electoral politics play a role. The political class cannot withdraw from this role. There are some genuine concerns on how autonomy is used. In Andhra Pradesh where a liberal law is in place some reservations were expressed because the state was unable to take direct action in certain cases. Any system would have violations and that is not a reason for stalling reform. This is a matter on which the state would seek a compromise.

The leverage of the states comes from their sweeping powers over the sector, which is restricted by reforms. Their role as investors dictates that they have a say in the management – manifesting itself in board positions and participation at an operational level. While the states might agree to remove the omnibus take-over clause, we might find resistance to negating the financial and resulting management role for the state.

The states would want to retain their share capital and a resultant board position. While this appears reasonable for an investor, cooperatives are not investor-owned organisations and therefore any investor not using the services could only be an agent with a fixed pay-off rather than a principal with residual claims. Therefore a board position will be on invitation and cannot be legislated. But states would like to retain their investments and a board position. In such a case the number of seats or the votes of the state's representative do not matter – their presence itself could influence decisions.

The second concern would be on eligibility norms. Many would argue that the norms are stiff and with relaxation a larger number could benefit from the package. The concern will be that large tracts could be left out of this reform and it helps only areas where cooperatives are performing. It may result in some regions being left out. We have to take a stand on reforming something that looks unviable. While liquidation is prescribed, nothing prevents formation of new cooperatives. In implementation, negotiating these concerns is important. The state in particular will have to work out the modalities of reaching financial services where neither cooperatives nor banks are functioning.

Are the Logistics Possible?

The second issue is the enormity of the task. Unlike the revival of financial institutions and banks, the numbers are large. As we adopt a bottom-up approach, the delays and frustrations would be significant. The quality of data available is questionable and the database has not been updated. Identifying cooperatives to carry out the truing of their balance sheets will be a Herculean task.

Once they are identified, all the institutions will have to be audited to determine eligibility. This needs trained audit personnel, oriented to the purpose, with an understanding of current and desired accounting practices. The task of verifying the accounts, assessing portfolio quality and making provisions would be intensive. Finding manpower for this task will be difficult.

Once the balance sheets are recast with proper accounting practices, the money needed for reform may increase. The number of eligible institutions may fall, bringing us back to the concern raised earlier and leading to further negotiations based on fresh data. This would cause concern if a particular political constituency interested in a specific cooperative forces the general levels of performance to be universally lowball. We should not compromise on the eligibility criteria. The result may be a smaller efficient sector than a large potentially sick sector.

Are the Upper Tiers Needed?

One of the issues that the task force has not assessed is embedded in its recommendation of reviving the primaries first. Earlier committees have discussed whether there was a need to continue with the three-tier structure, but the task force has taken the view this need not be disturbed as long as the primaries have the freedom to associate themselves with institutions of their choice.

If the balance sheets of primaries are cleaned up, the balance sheet of the upper tier will appear better and they would probably meet their eligibility norms. If this does not happen at the district level, the state cooperative bank will deal directly with the primaries. Thus the task force is signalling the redundancy of the upper tiers. This may well be the long-term view for the sector. As these banks come under the supervision of RBI, which would apply stringent norms applicable to banking institutions sooner than later, their long-term existence solely depends on merit. However, what happens if the state cooperative bank itself is found unviable? While the recommendations are that the primary should be free to approach any financial institution, it may not be easy in the immediate run. The states will have to think of alternatives.

The upper tiers are not really cooperatives in spirit as their transactions are not necessarily central and salient to the members. Following cooperative principles, banking should be alien to cooperation as they should be doing business only with members without seeking public deposits. However, due to historic reasons cooperative banks exist and they will survive as banks in competition with others. As envisaged by the task force, while the three-tier structure continues, it may not be an embedded structure as it is now.

Would the Cooperatives Remain Strong?

The report does not discuss viability norms. It would be good to have an idea of the size at which the primaries break-even. Unlike consumer cooperatives (from where the principles emerged) financial cooperatives are complex. This is because they have both savers and borrowers as members. The role of a member might shift across time. Members who supply finances and members who demand finances are at the same forum. Till now, the system was borrower centric. The task force has seen problems in this, as any borrower centric institution is likely to fail because governance would be borrower centric and there is no pressure group that naturally brings repayment discipline. Wherever credit cooperatives have been successful it is because the promoters had the vision to build member stakes. The suggestion of the task force that savings should be given due importance with all members (including savers) getting full voting rights is important. However, the task force has not made recommendations on how the member stakes could be built so as to sustain themselves for a long time.

Research shows that good organisations are built around member stakes. The theory of capital starvation applies to cooperatives because there are no residual claims on current or liquidated incomes acting as a disincentive for increasing financial stake. If the design of the cooperatives cannot build in stakes, the revival would only be temporary. A part of the capacity-building effort will be in designing appropriate stake-enhancing systems.

It is important that cooperatives work as neighbourhood institutions that leverage the informal knowledge base. As they grow, they may lose the character of informality. But mature organisations do not need this character. Much the way Scandinavian consumer cooperatives became irrelevant in the era of competition and large format retailing offered the best choices, these cooperatives may reach that stage of maturity. In some places the centrality moved away from neighbourhood networks collecting information to technology-driven information collection – with borrower transactions easily available due to computerisation.[2]

How Do Small Institutions Manage Risks?

Even with the positive intervention of the state these institutions have not remained stable and have looked for support. How do we ensure that some time later they do not need further assistance from the state? A reason why they keep slipping back is because of the riskiness of the underlying activity – agriculture. In microfinance the repayment rates are better, though most of the clients are a part of the same economic environment where income is based on agriculture. Microfinance maintains a healthy portfolio because of the diversification of loan purposes and the regularity of cash flows from those activities. Unless the clients' risks are covered, the organisation will be vulnerable. Therefore for long-term sustainability, it is necessary to address yield related risks.

Crop insurance products have not worked well because loss assessment is complex due to the fragmentation of landholdings. The methodology has relied on crop cutting experiments using large geographies as a base. Costs do not justify imaging technology. The risk triggers have to be unbundled and subsidies have to be targeted at the institutional level. If this is not addressed we may find cooperatives left with clients that are not serviced by the commercial banks and intrinsically vulnerable. The problem then would be that of systematic adverse selection more than moral hazard.

Conclusion

While most of the issues discussed above pertain to the long-term sustainability of the cooperative structure, the most immediate issue in determining the future course of cooperatives is the issue of how the role of the state pans out in the negotiations and the compromises that may have to be worked out. Any let-up on the basic principles of mutually aided autonomous cooperatives is bound to get them back to their original fabric and cause damage to the cause. It is now time for the state to fully withdraw from the cooperative sector. This does not mean the state has to withdraw from the function of facilitating access to financial services for the poor and vulnerable, but that it has to recognise that partnering with cooperatives is not the only route through which this could happen. EPW

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Notes

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1 See M S Sriram, 'Information Asymmetry and Trust: A Framework for Studying Microfinance in India', forthcoming in *Vikalpa*, Indian Institute of Management, Ahmedabad.

2 See M S Sriram, 'Financial Cooperatives in Quebec, Canada: A Study of the Desjardins Movement' in *Journal of Rural Development*, Vol 19, No 2, National Institute of Rural Development, Hyderabad, 2000; and Sriram, 'Strategies for Financial Cooperatives in the New Millennium' in Prathap Reddy and Katar Singh (eds), *Designing and Managing Rural Development Organisations*, Oxford and IBH Publishing Company, New Delhi, 2000.