MicroSave Briefing Note # 56

Cooperatives - The Flawed Gem of Indian Rural Finance

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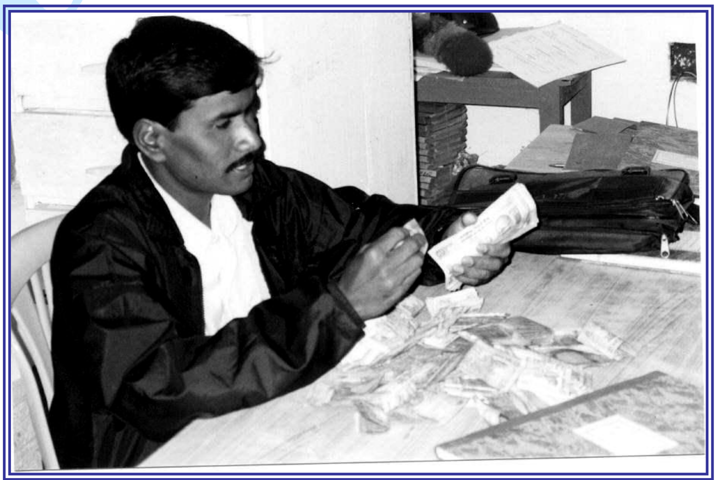
The rural Cooperative Credit Structure (CCS) comprises much of India's rural finance system. With 112,309 Primary Agricultural Credit Societies (PACS), linked to District Cooperative Credit Banks (DCCBs) and State Cooperative Banks (SCBs), the cooperatives have the widest network. It covers every state and union territory in India, with credit cooperatives forming almost 70% of all rural credit outlets.

The cooperative network provides 34% of the total agricultural credit in the country. Furthermore, because of the PACS' small average loan size (Rs.6,637) compared to the commercial banks (Rs.31,585) it may be fair to assume that the cooperative network serves over half the rural credit borrowers in the country. In the main, cooperatives borrowers are also poorer than those served by the commercial banks. The 2005 Union Task Force on Revival of Cooperative Credit Institutions noted that cooperatives also have deep penetration in the market for small deposits, with Rs.19,120 billion in savings. Together with the rural commercial bank branches and the Regional Rural Banks (RRBs), the cooperative system means that an extraordinary average of 5,600 people per branch in India. This is almost unparalleled in the world.

But this gem of a rural financial system is flawed. Many rural banks and cooperatives have excelled at providing financial (and other services) to their clients and members. However, overall the financial performance of RRBs and cooperative banks is weak and only the financial position of the commercial banks can be considered satisfactory. However, the rural operations of commercial banks cannot be analyzed separately as these are subsumed and cloaked in their overall performance. A 2004 World Bank report expressed concern that their performance may not be too much better than that of the RRBs and cooperative banks. So there is a clear case for more effective and efficient delivery mechanisms and financial policies to improve performance throughout India's rural financial system.

Sanjay Sinha, in paper **"**Financial Services For Low Income Families: An Appraisal" in the Indian Institute of Management-Bangalore Review June 2003, noted, "… the entire network of primary cooperatives in the country and the RRBs – both sets of institutions established to meet the needs of the rural sector in general and the poor, in particular – has proved a colossal failure. Saddled with the burden of directed credit and a restrictive interest rate regime, the financial position of the RRBs deteriorated quickly while the cooperatives suffered from the malaise of mismanagement, privileged leadership and corruption born of excessive state patronage and protection." The Union Task Force estimates that only 52% of the 112,309 PACS, 61% of the 604 DCCBs and 55% of the 55 SCBs were profitable. This profit is presumably before adjustments for unaccounted, unreported and/or hidden subsidies. The proportion of rural lending made by the cooperative network has declined from 62% (in 1992/3) to 34% ten years later. The Cooperative Credit Structure is in crisis.

What has lead to these flaws? There is broad consensus that the governance of many of the cooperatives is severely compromised. In the words of the Task Force, "Extensive direct or indirect interference by State Governments have been a major cause for the deterioration of the Cooperative Credit Structure. Interference in the credit cooperative system occurs through directives on deposit and lending rates, lending priorities, investment decisions, taking up non-credit activities etc. or granting interest subsidies, postponing waiver of recovery of interest on loans and repayment of loans given by cooperatives. It is, therefore, important that governments, both at the Centre and in the States, desist from these practices and adopt a firm policy to prevent these practices and introduce appropriate changes in law."



Furthermore, the Task Force notes, "At present, most institutions of the Cooperative Credit Structure restrict membership, with full voting rights to borrowers. Depositors are categorised as nominal members without voting rights, or are not given any membership status. This is not only inconsistent with cooperative principles and democratic functioning. It is also logically inconsistent, as those whose money is intermediated have no say in the management of their own money. It is, therefore essential that all users – depositors and borrowers – be made full members with equal voting rights. This is also essential to strengthen the mechanisms of internal supervision and enforcement of credit discipline." Indeed, the very name "Cooperative Credit Structure" focuses on the lending activities in contrast to the rest of the world where financial cooperatives are typically referred to as Savings and Credit Cooperatives, and (where they are successful) place great emphasis on savings.

Worldwide, savings and credit cooperatives face two key problems in governance. The first is the principal-agent problem. The elected Directors' and contracted managements' interest may diverge from the interest of the members, particularly in India with the involvement and intervention of government at the board level. The resolution of this depends upon clear specification and enforcement of the institutional rules, which define the roles and responsibilities of the actors involved in the governance of the cooperative: including decision making and decision monitoring. This is true of any financial institution. Cooperatives differ in that their owners are simultaneously their clients and that these clients are made up of two groups with different interests: net savers and net borrowers.

The second problem facing cooperatives worldwide is the tendency of borrowers to dominate the board. Solving this problem requires that cooperatives provide balanced services that will attract not only borrowers but also savers. This can also be controlled by restricting loans made available to those who serve on the boards of the cooperatives. The presence of net savers on Boards will lead to a more effective pressure upon cooperative management and directors for the implementation of proper financial management and prudent governance that will protect the interests of savers and help ensure the long run sustainability of the institution.

Perhaps as a result of the Credit Cooperative Structure's focus on credit in preference to savings, the Task Force notes, "Lending rates of PACS are also subject to state set ceilings and are set well below the market rate, despite higher risks. Transaction costs are also high (again owing to business model issues, overstaffing and salaries unrelated to the magnitude of business)." Returning governance and decision-making to all the members, and particularly depositors, would encourage cooperatives to set interest rates at a level that allows them to cover their costs and generate a modest return for their members – thus laying the foundation for a sustainable rural financial system that is able to respond to the needs of the rural poor. Once again, there is a critical need for an independent commercial approach to the provision of rural finance – failure to adopt such an approach means that the institutions and the services they provide are not sustainable.

Clearly there is an urgent need to act on the cooperative network and either to close or to revitalise many of the banks in it. The Task Force believes that reviving the cooperative network is essential, both on functional and ideological grounds. In functional terms, cooperatives already have a wider and deeper reach in the countryside than other financial institutions. Recognising the important role that the cooperative network can play in delivering credit to the rural population, which are unlikely to be reached through commercial and rural banks, all the committees that preceded the Union Task Force were unanimous on the steps needed to realise the network's potential. They emphasised the need to (a) restore democratic management in the societies by holding free and fair elections regularly, (b) reduce the scope for government interference in their management to a minimum; (c) rationalise staff and improve their professional ability; and (d) create a climate conducive to prudent management of resources and efficient management and recovery of dues. The recent Task Force concurred with these recommendations and also suggested "Radical changes in the legal framework to empower the RBI to take action directly in [the] … financial management of banks."

NABARD has been tasked with overseeing the revitalisation of all cooperatives that choose to take a government re-capitalisation rescue package by end of March 2008. This will be a monumental challenge – both to manage the process and to ensure that it becomes as long-term, sustainable success that realises the potential of the cooperative network to serve the poor in India. To do this, it will be essential to improve the governance and management of the cooperative network including its basic systems and procedures. Only that way can it can respond to the opportunity offered by the recommendations of the Task Force (assuming these are to be implemented by the Government). Governance and management are perennial problems in the international cooperative movement and the issues raised by the Task Force echo similar reviews from around the world.

It is therefore essential that the Government invests in capacity development to significantly strengthen the governance and management so critical to the success of the cooperative network. Failure to do so compromises the massive investment in recapitalising it.