Recommendations of the Task Force on Revival of the Co-operative Credit Structure: Implementation Issues

M S Sriram

Phone:++91—79-2632-4891 (O) 2632-5413 (R) **Fax**: ++91-79-2630-6896
Email: **mssriram@iimahd.ernet.in** *Website:***http://www.iimahd.ernet.in/~mssriram**

W.P. No. 2005-12-02

December 2005

INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD-380 015
INDIA

Abstract

The Task Force on Revival of Rural Co-operative Credit Institutions (Vaidyanathan Committee) submitted its final report in February 2005 and there have been a few meetings with the state governments to work out the modalities of the implementation of the report. This paper lists out the issues that are involved in implementing this ambitious financial package of Rs.15,000 crores. It first brings out the historic circumstances under which the co-operative form of organisation came into being, its peculiarities and the principles under which co-operatives operate. The paper then puts the recommendations of the committee in the framework of the principles. Basically we argue that the major issues that would affect the implementation of the recommendation stem out from how in the negotiation between the center and the states some compromises may have to be worked out and the possible implications of the compromises. The observations are based on the recent negotiations and also on the past performance of the sector. The other issues that are raised relate to the logistics of implementation, its endurance over the long run, and concludes with a discussion on the conditions under which the recommendations could effectively work.

Recommendations of the Task Force on Revival of the Co-operative Credit Structure: Implementation Issues

M S Sriram

Introduction

Co-operatives have had more than a century of existence in this country and the State has been involved in the co-operative movement right from the beginning. The involvement of the state comes from the basic assumption that market based institutions cannot take care of the peculiar needs of the poor and the marginal. The institutions operating in the market usually follow the basic operational guideline of profitability and dealing with the poor usually is not profitable. Even if it is indeed profitable, it would not make a great political copy because it would be construed as exploiting the vulnerable. We all have seen that the discussions on interest rates are usually more animated and frequent than the discussions on access to financial services to the poor. We have to see co-operative institutions and the legitimate interest of the state in the sector from this point of view.

It is argued in economics literature that if all conditions of "perfect competition" were met there would be no difference between a co-operative organisation and any other form of organisation. The argument is that each factor of production would get their dues for the services rendered and there would be no rent seeking. However, we all know that perfect competition is a theoretical construct and the new institutional economics literature talks about how the assumption of rational behavior is not appropriate. This argument extends that there are transaction costs involved in switching from one service provider to the other and therefore the assumption of rationality is bounded. We need to understand that the co-operative form of organisation emerges in this context, when the market based institutional forms fail to provide certain services or end up seeking excessive rent.

We all know the circumstances under which the co-operative principles emerged and the historical significance of the principles. However it might be useful to briefly recap the principles and their importance. The roll out of the reform package suggested by the Task Force has to necessarily keep these principles as the bedrock of any further action.

The Indian co-operatives and for that matter the International Cooperative Alliance (ICA) derived the operating principles of co-operatives from the Rochdale pioneers. The setting up of co-operatives in the nineteenth century was directly in response to what could be termed as market failure – that the grocers of England were charging excessive prices from the poor consumers who largely consisted of mill workers. The issue was that the profits of the grocers were largely coming from turnovers – the more the workers bought the more profits they made – while they were being excessively rewarded for capital – that they had enough cash to invest in the stocks that were to be sold. Therefore the pioneers changed the rules of the game by removing the arbitrage opportunities that the grocers had by pooling their requirements. What did it mean to the operating principles of the business? Nothing – the business in its exterior was to be carried out very much like the grocer, but the philosophical principles of the entity were different. The basic differences were as follows:

1. Move the centrality of the business from capital to usage/turnover. This suited the retailing business, because the value add in a consumer business is basically that of storage and delivery and usually not processing.
2. Align the pay offs to suit the centrality of the business – compensate the members on the profits they generate through turnovers rather than compensate their capital contributions.
3. However recognise that capital contributions are important and have a fixed pay off for these very much the way any financial service provider gets interest.

In addition to the above changes which were absolutely aligned with the way they conducted the business they also had other principles which were rooted more in ideology than in business. It is these principles that we need to understand when we actually look at the challenges in implementing any reform package in this sector. These principles actually do not have strong business principles and when superimposed on a business entity create problems. The principles are:

1. Open membership – the principle brought about easy entry and exit into the co-operative enterprise – the logic being that a new member who could be equally vulnerable should not be denied the benefits of the entity that has been set up. However, because of this prinicple there is no natural incentive for retention of profits and accumulation of capital for growth. The early members always lose out on the later members as they get disproportionately higher share of future profits which is based on the accumulations of the past members.
2. Democratic control – the fact that control should be delinked to the capital contribution was understandable because the business model took away the primacy from capital to turnovers. However taking away the management from the basic business logic of turnovers created a complexity that the form of business has to grapple with. Successful organisations have overcome this complexity by aligning shareholding with business turnovers and by restricting the memberships using artificial barriers (like the sugar cooperatives).
3. The other principles of education, cooperation amongst cooperatives and the concern for community stemmed out of the initial association with the trade union movement and were largely developmental in nature. While even market oriented business entities have such objectives, they are more in the nature of ancilliary objectives and do not affect the base business model.

Because of the above philosophy, co-operatives function most effectively when they are small and neighbourhood institutions. As they become larger, they could still function as effective business enterprises, but may lose the extra advantage of being a co-operative. However this loss is replaced by the advantage of being a market driven enterprise that is willing to compete.

When the co-operatives are neighbourhood institutions then they have significant advantages over externally driven institutions such as banks. The advantages pan out because of the very nature of informality, where the people who are making loan decisions being embedded in the local economy know a great deal of information that might not be available to the external institutions. The knowledge could be in the form of local farming conditions, expected yields, the performance of a particular client over a period of time and the inherent knowledge of the orientations of the borrowers. Since most of this information is not available in paper, the banking institutions find it difficult to make assessments about customers to whom the neighbourhood institutions can easily lend. The co-operatives bridge this gap and thus have a great potential to reduce transaction costs.

On this customer segment, the co-operatives will have a significant advantage over the banks because they are able to service the smaller customer, while the bank will find it transaction cost intensive to collect this information and service a small loan. While the microfinance sector – particularly the self-help groups have leveraged this phenomenon very well[1], the co-operative sector has failed to build up on its strength in the past. The recommendations of the task force in making them autonomous and self-sustaining would open up these possibilities for the co-operative sector, make them true neighbourhood institutions and help the state in its stated objective of deepening the availability of financial services.

[1] See for instance Sriram (2005): Information Asymmetry and Trust: A Framework for studying Microfinance in India. Forthcoming in Vikalpa, A Journal for Decision Makers. Ahmedabad: Indian Institute of Management, Ahmedabad.

It is therefore clear that co-operatives are complex organisations and need to be dealt with a great deal of thought and care. Any intervention in this sector is bound to create disturbance and reviving co-operatives with external infusion of funds as envisaged by the Task Force is bound to hit several road blocks, and certainly would not be as simple as reviving banks or financial institutions. In the case of banks (including RRBs) and financial institutions the ownership pattern was clear, the management identifiable and they were all in manageable numbers. In case of co-operatives we are actually dealing with a possible 100,000 autonomous units. The number itself is daunting.

The Recommendations

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

1. Co-operatives should be self-governed, member managed institutions and therefore their future success or failure has to depend on how the members manage their institutions in future. The assistance therefore has to be strictly seen as a one time package to bring them on to a clean slate. The need for the package is based on the premise 2 below.
2. The state has under various regimes promoted, managed and interfered with the working of the co-operatives – both in operational terms and in taking policy initiatives – and therefore is morally responsible for some of the accumulated problems of the sector and therefore it is duty bound to offer this one-time package.

In order to honor the above premises it was important to set some pre-conditions for the financial assistance package. The financial assistance package was seen as an incentive for the states that wanted reform. Reform basically meant putting co-operatives back into the hand of the people, ensuring that the operative environment was conducive for carrying on the business without interference and strengthening and leveraging on the existing base.

The recommendations therefore could be divided into three parts:

1. Legal reform to ensure that co-operatives work as self-reliant, mutually aided, autonomous institutions.
2. Preparing the ground for the co-operatives to clean up their act – starting with assessment of the actual state of affairs in line with generally accepted principles of accounting as applied to the financial services sector, providing basic infrastructure for carrying out the business – including computerisation and software support and providing basic training for the human resources to carry on with the co-operatives as a going concern once the financial package was devolved.
3. Implementation of the financial part of the package with some benchmarks and milestones.

Issues in Implementation

We shall discuss the issues in implementation under some sub-heads. These sub-heads represent the concern about how the recommendations could actually be interpreted, the compromises that the state and centre will have to make and its implication on the basic principles of co-operation and the basic premises of the task force recommendations. As these issues are futuristic in nature, they are obviously not based on data, but largely based on the signals that we have got not only as a part of the interaction with several actors during the meetings of the task force, but also from the concerns that have been expressed in the press and other forums. These concerns also stem from the prior behaviour of the states.

Issue 1: Will the states agree to reform?

We have to admit that the reform package while largely taking the “bottom-up” approach – in addressing the issue of the primaries first and then moving to the upper tiers – starts with a “top-down” premise. This top-down is to do with the regulatory environment which is in the hands of the state governments. The logic behind the first step being top-down is that if the environment does not exist, however much we reform at the bottom, its longevity could be called to question.

If the conditionality of releasing the funds for the revival of the co-operative sector is to carry out reform, then the states have really three options. The first and the most logical option is to agree for the reform and implement the package. The second would be to selectively change whatever they want to, which means that they do not agree to the conditionalities and implement a revival package themselves. The third option would be to ignore the sector and do nothing. As most states do not have their own resources to implement an independent revival package, the second option is almost ruled out. This leaves only two options, either implement the package or ignore the sector. There are no states where the co-operative credit movement is strong on its own and therefore ignoring the package would be at the peril of the state governments as far as this sector is concerned.

The states obviously would have some concerns about the revival package. The major concerns of the states would pertain to two aspects that impinge directly on how they have been dealing with co-operatives in the past and both these come from political considerations.

The first concern would be about “control”. The task force recommends that the states should give up control over co-operatives, not use them as extended arms of the state and their role should be largely confined to framing an appropriate legislation and overall supervision. The legislative framework envisaged by the task force has been explicitly articulated and it is broadly on the lines of the Andhra Pradesh experiment, with further refinements. The bedrock of this legislative reform is in getting the autonomy of the institutions back. The states have been used to exercising control over co-operatives in various forms, including the large scale take over of these grassroots institutions and treating them on par with other political institutions where electoral politics play a role. Therefore the political class would find it difficult to withdraw from this traditional role that they have ascribed to themselves. There would also be some genuine concerns about the way the autonomy is used by the co-operatives. Even in Andhra Pradesh where the parallel, liberal act is in place there were some reservations expressed both by the political class and the bureaucrats that they have not been able to take direct action. However, one has to recognise that in any system there are bound to be violations and that should not be a reason for stalling reform. However the major impediment in reform would come from this angle and the states would bargain for some compromises.

- The leverage of the states have on the co-operatives come from two angles – one as the overall *harta-karta* of the co-operatives, they have some sweeping powers, which would be restricted by reforms. Second because of their investment in the share capital of the co-operative the role of the investor dictates that they have some say in the management – this manifests itself in board membership and participation in the affairs at an operational level.
- While the states might agree to remove the omnibus clause that permits them to take over the management of the co-operative on an en-masse basis, we might find strong resistence to negating the financial role and a resultant management role at an operational level of the state.

Thus the states would seek compromises on the legal reform to the extent of withdrawal of share capital and also a resultant position on the board. While this appears reasonable from a typical investor perspective, we need to remember that co-operatives as organisations are not meant to be investment oriented organisations and therefore any investor, who does not use the services of the co-operative could at best be an agent with a fixed pay off (interest) rather than as a principal or a residual claimant. Therefore any position on the governance of the co-operative will necessarily have to be on invitation and cannot be legislated. This would be one area where the states would first like to retain their investments and then use that as a leverage for a board position. In this case the number of seats or the power of voting for the nominee/s of the state possibly does not matter – their sheer presence could tilt the decisions in a certain manner if they were to be on the board.

The second concern of the states would be on the eligibility norms prescribed by the task force. Many would argue that the eligibility norms prescribed by the task force is stiff and would want a watering down so that a larger number of co-operatives could benefit from the package. The argument would essentially come out of the concern that large tracts could be left out of this financial package and it helps only some of the geographies where co-operatives are having some decent performance. This might also result in some large regions being left out of the reform process. However this is an issue where one would have to take a hard stand on how valid it is to reform something that looks prima-facie beyond redemption versus liquidation. While liquidation is an option, there is nothing that prevents people from forming new co-operatives based on the principle of self-help and mutual aid.

Negotiating these two concerns from the states would be the most and the first significant issues in implementation. Even if it were negotiated, and the reform package implemented it sorts out the issue of access to financial services in areas where these outlets are functioning. The state on the other hand will have to work out modalities of reaching financial services to the poor across all the regions, particularly where neither co-operatives nor banks are functioning.

Issue 2: Is the logistics possible?

The second major issue in implementation would be the sheer enormity of the task involved. Unlike the revival package for financial institutions, commercial banks and regional rural banks, the sheer size of the number of institutions is mind boggling. As the package adopts a bottom-up approach, the delays and frustrations would be more significant. The quality of the secondary data available is not very good and the database has not been updated for a while. The problem actually starts with the number of co-operative institutions. Each of the source seems to be giving a different number, and therefore it would be important not only to identify the primary co-operatives but also carry out the truing of their balance sheets.

Once the institutions are identified – irrespective of whether they will be ultimately eligible for the package or not, 100% of the institutions will have to be audited at least for determining if they are eligible. This is a huge task and needs trained audit personnel. It is not necessary that only qualified chartered accountants need to be pressed into service here, but the team that is to be pressed into service has to be oriented to the purpose and the details of the current and desired accounting practices. It would also be a fairly intensive task of verifying the state of accounts, the health of the portfolio and making appropriate provisions. Finding capable manpower to undertake this task will be difficult.

Indeed once the balance sheets are recast, with proper accounting practices, while the amount of money that has to go as a reform package will increase – with the presumption that the extant accounts do not have sufficient provisions for non-performing assets - the number of eligible institutions might also fall, bringing us back to the concern raised in the first issue. However, by the time this exercise is undertaken the states would already have agreed to the package, but there is a likelihood of further negotiations based on freshly collected data. This would particularly be true if there is a particular political constituency interested in a specific co-operative and the general levels of performance are low-balled to that level universally. It is absolutely essential to keep the eligibility criteria holy and as a result have a smaller more efficient co-operative sector than have a large potentially sick sector. This would be a significant issue to be considered.

Issue 3: Are the upper tiers are assumed to be revived?

One of the issues that the task force has perhaps not examined very closely is embedded in its recommendation of reviving the primaries first. If the balance sheets of primaries are cleaned up, it is correct an natural to assume that the balance sheet of the upper tier will appear better and they would meet their respective eligibility norms. However if it does not happen, at the district level, then the solution provided is that the state co-operative bank itself deal directly with the refinance of the primaries. Therefore in a way the task force is signaling that possibly the middle tier is redundant in the age of technology. Indeed this may have to be the long term view for the sector, and we shall discuss this a little later. However the task force has perhaps not examined to the fullest extent as to what happens if the state co-operative bank itself is found to be unviable. While the recommendations state that the primary should be free to attach themselves to any financial institutions, including the commercial banks, it is unlikely that this would be sustainable in the immediate run in case the state co-operative banks cease to exist. Given that the benefits of revival would pass on to the higher tiers, even if the lower tier entities are liquidated a theoretical possibility of a state without a state co-operative bank cannot be ruled out. In any case these banks come under the supervision of the Reserve Bank of India and it will not be long before the central bank applies stringent norms applicable to banking institutions on such banks as well.

Issue 4: On implementation, would the co-operatives be strong for a long time?

The task force has not specified any viability norms in the revival package. However it would be important to have a sense of the size at which the primaries break even and what should be the spread of activities.

Unlike consumer co-operatives (from where the co-operative principles emerged) financial co-operatives are complex organizations by design. This is because we have a set of savers and a set of borrowers both as members. The role of the same person might change from situation to situation and therefore there is a complex relationship of the people who supply finances and people who demand finances being at the same forum. Till now, largely these have been borrower centric and rightly the task force has seen problems in having a lopsided view. Any borrower centric institution is likely to fail because of sheer conflict of interest. The people who are elected to the body in turn are borrowers and therefore there is no pressure group that is built in that could naturally bring in a repayment discipline. Wherever credit co-operatives have been successful it has been because the promoters had the long term vision to also build in member financial stakes. Therefore the suggestion of the task force that savings should be given due importance with all members (including savers) getting full voting rights is indeed important. However the task force has not made any recommendations on how the member stakes could be built to ensure that these institution sustain themselves for a long time.

Past research shows that solid organisations are built with significant member stakes. In case of co-operatives the theory of capital starvation applies because there are no residual claims on current or liquidated income. Therefore there are no incentives to build in member financial stakes. If the design of the co-operatives through internal mechanisms is not solid, the revival at best could give a temporary relief. A part of the capacity building – training effort possibly has to go in this direction.

It is important to emphasise on getting the co-operatives to start as neighbourhood institutions that can leverage on the informal knowledge base. However as they grow, they may lose the character of informality. But at a mature stage we possibly do not need this character at all. Very much the way the Scandinavian consumer co-operative movement became irrelevant in the era of intense competition and the large format retailing offering the consumer the best choices, the financial co-operatives might also reach that stage of maturity in time to come. We have seen in the co-operative sector in Quebec, Canada that the centrality, over a period of time moved away from neighbourhood networks providing information to technology driven information collection – through borrower transaction history that was available due to computerisation.[2]

[2] See Sriram (2000a): Financial Co-operatives in Quebec, Canada: A Study of the Desjardins Movement in *Journal of Rural Development*, Vol.19, No.2. Hyderabad: National Institute of Rural Development and Sriram (2000b):

Issue 5: How do small and local institutions manage risks – will they slip back into the same state?

In spite of the intervention of the state in this sector and several times, with positive measures these institutions have not remained stable and have looked towards the state for support. How do we ensure that sometime later they do no need further assistance from the state?

One of the reasons why they keep slipping back into the red is because of the riskiness of the underlying activity – particularly agriculture. Indeed when we look at the efforts of microfinance we find that repayment rates are much better in that sector, though most of the clients are a part of the same economic environment – rural areas where the income is based largely on agriculture. One of the possible reasons why they are able to still maintain a healthy portfolio is because of the diversification of the underlying activities for which microfinance has funded and also the regularity of cash inflows from those activities. Unless the clients are covered for risk, the organisation is unlikely to be well covered. Therefore from a long term sustainability point of view, it may be necessary for co-operatives to address risk mitigation products.

Universally comprehensive crop insurance products have not worked well. In India it is even more difficult given the fragmentation of land holdings and the difficulty in loss assessment. Therefore the loss assessment has always relied on crop cutting experiments and has been using larger geographies as a base. Even if we have imaging systems the costs would not justify it. Moreover, there are multiple risks. One way of addressing this is to unbundle the risks and offer incentives to insurance companies to offer these at an affordable premia. For instance, ICICI's rainfall and temperature products address this unbundled risk. Some seed companies were willing to explore the possibility covering the risk of germination in case of high value seeds. Therefore a way to address the problem of risks is to get some interested parties and the state to ensure that any element of subsidy is broken up into various parts rather than lumped in a single subsidized premium. This will also isolate to an extent the moral hazard problem, wherein covariance discounts could be built into the premium.

If the issue of risk is not addressed adequately we might still find the co-operative institutions left with clients that are not serviced by the commercial banks, intrinsically vulnerable and therefore the institutions themselves will turn out to be vulnerable. The problem then would be that of systematic adverse selection much more than that of a moral hazard.

Issue 6: Is the three tier structure necessary?

This is an issue which the earlier committees on co-operation have engaged themselves with, but the task force has taken the view that there is no need to tamper with the extant state of affairs, except that we should give the primaries the freedom to associate themselves with any institution of their choice. With the state of technology available it would be worthwhile to examine if the three tier structure only adds to the pipeline costs and whether the co-operatives are at an unfair disadvantage vis-a-vis their banking counterparts. It is clear that eventually one of the tiers at least may be redundant.

The upper tiers are not really co-operatives in spirit as they are not doing transactions that are central and salient to the members. Following the cooperative principles in spirit, banking should be alien to co-operation as they should be doing business only with members – which essentially means that there would be no concept of a public deposit. However, we know that practically that would not be feasible due to historic reasons. Therefore they would survive as banking institutions and in the long run work in competition with the commercial banks. As envisaged by

Strategies for Financial Co-operatives in the New Millennium in Reddy, Prathap and Katar Singh (Eds) *Designing and Managing Rural Development Organisations* New Delhi: Oxford and IBH Publishing Company the task force, while the three tier structure would continue, in spirit it eventually may not turn out to be an embedded structure as it is now.

Conclusions

While most of the issues discussed above pertain to the long term sustainability of the co-operative structure, the most immediate issue in determining the future course of rural financial co-operation is really 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 co-operatives is bound to get them back to the original fabric and cause damage to the cause of the recommendations. While given the macro-economic situation, the recommendations of the All India Rural Credit Survey Committee Report was appropriate at that point in time and the recommendation of state partnership (the committee had suggested this only for a limited period) was useful, now is the time for the state to fully withdraw from the co-operative sector. This certainly does not mean that the state has to withdraw from the function of facilitating the access to financial services to the poor and vulnerable, but the state has to recognise the partnering with co-operatives is not the only route through which this could happen.