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Helping to Improve Donor Effectiveness in Microfinance

WORKING WITH SAVINGS & CREDIT COOPERATIVES

Savings and credit cooperatives provide financial services to millions, including poor and low-income people in many countries. Thus, donors who want to increase access to financial services, especially savings, often support savings and credit cooperatives. Working with these cooperatives offers many advantages, but, to be effective, donors must learn how to overcome several unique challenges.

Savings and credit cooperatives are user-owned financial intermediaries. They have many names around the world, including credit unions, SACCOs, COOPECs, etc. Members typically share a "common bond" based on a geographic area, employer, community, or other affiliation. Members have equal voting rights, regardless of how many shares they own. Savings and credit are their principal services, although many offer money transfers, payment services, and insurance as well. Sometimes savings and credit cooperatives join together to form second - tier associations for the purposes of building capacity, liquidity management, and refinancing. Second-tier associations also play a useful monitoring role.

What advantages do savings and credit cooperatives offer for increasing microfinance outreach?

- Savings and credit cooperatives reach clients and areas (e.g., rural) that are unattractive to banks.
- They provide savings services to their members, unlike most microcredit NGOs.
- Savings and credit cooperatives are often started locally, without major external support.
- Their solid base of small savings accounts constitutes a stable, relatively low-cost funding source.
- Well-run savings and credit cooperatives have low administrative costs and may be able to make loans at interest rates that are lower than those charged by other microcredit providers.

What challenges do savings and credit cooperatives face?

Governance weaknesses. Savings and credit cooperatives are usually governed by a volunteer board of directors elected by and from the membership. Small, young savings and credit cooperatives are also often staffed entirely by volunteers. As they grow, more sophisticated and risky operations require professional managers. Problems occur when volunteer board members continue to make operational decisions, after professional managers have been recruited, instead of focusing on monitoring operations. It is difficult for board members to balance the contradictory interests of net borrowers and savers. Borrower domination is unhealthy because net borrowers have few incentives to ensure prudential discipline or profitability, unlike net savers who are most interested in protecting their deposits and earning an attractive rate of return. Although "one person, one vote" decision-making is meant to ensure equality of user rights and responsiveness of service, many members do not exercise their control because they wield little individual influence. As a result, in some cases, community elites or net borrowers are able to dominate the structure for their own benefit. In Kenya, the elected directors of the railroad's SACCO facilitated privileged loans to their supporters to maintain their control of the SACCO.

Inadequate regulation and supervision. Savings and credit cooperative systems in developing countries have a history of instability. Competent external regulation and supervision can identify, avoid, and resolve many common problems. Savings and credit cooperatives are often supervised by the same government agency that is responsible for all kinds of non-financial cooperatives, including agricultural and marketing. Such agencies do not have the financial skills and political independence needed to oversee financial intermediaries effectively. In Latin America, more bank superintendencies are adding supervision departments for savings and credit cooperatives. In West Africa, within the auspices of the BCEAO PARMEC law, central banks have designated a department, such as microfinance, to supervise savings and credit cooperatives. One alternative proposed—delegated supervision to an outside body—does not work if that body is controlled by the savings and credit cooperatives being supervised. Supervising savings and credit cooperatives requires understanding their unique risk profile and adapting supervision accordingly.

Limited menu of products. In traditional savings and credit cooperatives, only one type of loan product—a 3:1 or 5:1 multiple of a member's savings balance—is offered, with no variation according to risk levels (borrower repayment capacity, type of activity financed, and other risk factors). These types of loans are not flexible enough to meet members' diverse credit needs, including short-term working capital for microentrepreneurs and agricultural inputs for small-holder farmers. Many savings and credit cooperatives are introducing a greater variety of credit products, such as housing loans, and use better tools to assess and manage loan risk. Savings and credit cooperatives in Ecuador and Mexico apply credit scoring tools for risk analysis and offer flexible lines of credit to fund working capital needs.

Damage done by external credit. Donors have channeled funds through savings and credit cooperatives to target specific types of clients. Experience shows that this practice tends to harm participating savings and credit cooperatives: external funds decrease the incentive to mobilize deposits, skew incentives toward net borrowers, and are not managed as carefully as the members' own money. External funding does have the advantage of being a resource for longer-term loans, but it should be limited in relation to members' deposits and the internal capacity for managing a larger loan portfolio. Several years ago, FECECAM, a federation of cooperatives in Benin, suffered loan quality and asset deterioration when donor-driven credit increased and was channeled through cooperatives that did not meet prudential standards.

What can donors do to strengthen savings and credit cooperatives?

- *Focus on deposit mobilization first.* Savings and credit cooperatives with this focus tend to be stronger and more durable because savers have the biggest incentive to keep their cooperatives financially sound. Support technical assistance to improve savings products and information systems.
- *Invest in building capacity rather than injecting external funds for lending.* If external funding is provided to finance loans, keep it small in relation to the savings and credit cooperative's savings base.
- *Encourage sound governance policies.* Even if appropriate governance norms are not required by law, insist that they be part of the performance contract for donor support. Train directors in governance standards, as well as in monitoring and business planning tools. In Bolivia and Ecuador, savings and credit cooperative regulations issued by the Superintendencies of Banks set criteria for who can serve as directors, specify oversight responsibilities of directors, and establish strict reporting requirements for directors' loan repayment and related loan concentration.
- *Support savings and credit cooperatives that want to learn new techniques to reach poorer customers.* Donors can fund technical assistance to help savings and credit cooperatives better understand member needs, and develop and manage credit, savings, payment, and money transfer services appropriate for poorer and more remote clients. Such efforts are more likely to succeed in financially solid cooperatives. Savings and credit cooperatives in the Philippines and Guatemala have added solidarity loans for remote rural areas, allowing group members to eventually graduate to individual loans.
- *Keep financial standards at the core of internal management and external supervision.* To fulfill their mission of providing members with high-quality services, savings and credit cooperatives need to run a sound financial business. Donors should help them incorporate international sets of standards, such as WOCCU's PEARLS (www.woccu.org/pdf/pearls.pdf) or DID's TOP SYSTEM, in daily operations. Cooperatives that do not respect financial standards jeopardize their members' hard-earned savings.
- *Support competent, independent external supervision of savings and credit cooperatives* by banking authorities where possible. Banking supervisors may have legitimate concerns about overstretching their supervisory resources. Some savings and credit cooperatives are so small that affordable and effective supervision is impossible. But small savings and credit cooperatives should not necessarily be shut down just because banking authorities cannot supervise them. Members of unsupervised savings and credit cooperatives should be informed that their cooperative is not supervised.
- *Concentrate resources on savings and credit cooperatives that are willing to implement sound policies and standards*, rather than spreading them over all the cooperatives in a country.

Author: Brian Branch of WOCCU, with CGAP staff. **For more information:** Gaboury, Anne, "Developing Community Finance: Some Lessons Learned " (Développement international Desjardins, 2005); Morris, Kelly J., "The Effects of Using Credit Unions as Onlending Agents for External Lines of Credit: The Experience of the International Credit Union Movement," Poverty-Oriented Banking Working Paper No. 14 (Geneva: International Labour Office, 1995); Richardson, David, PEARLS Monitoring System (Madison, Wisc.: World Council of Credit Unions, 2002); Westley, Glenn, and Brian Branch, eds., *Safe Money: Building Effective Credit Unions in Latin America* (Washington, DC: Inter-American Development Bank, 2000); Biety, Monnie, Madeline Hirschland, and Kathleen Stack, "Credit with Education and Credit Unions Strategic Planning Guidelines" (Washington, DC: Pact Publications, 1999).
Web resources: www.did.qc.ca, www.woccu.org, www.cmutuel.com/cicm, www.ffhtechnical.org, www.cgap.org/savings