Duvvuri Subbarao: Leveraging cooperative advantage

Inaugural address by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the International Conference on “Leveraging cooperative advantage” as part of celebrating the International Year of Cooperatives at the College of Agricultural Banking, Pune, 16 November 2012.

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1. Thank you very much for inviting me to inaugurate this two day International Conference on “Leveraging Cooperative Advantage” organized to celebrate the International Year of Cooperatives declared by the United Nations (UN). This is an opportunity to which I attach a lot of value.

2. The year-long celebration of cooperatives all over the world gives us an opportunity to revisit “the strengths of the cooperative business model as an alternative means of doing business and furthering socio-economic development.” I am delighted too that the Reserve Bank’s College of Agricultural Banking is hosting this Conference. When it was first set up, this College had a specific mandate for capacity building of personnel in rural and cooperative sectors. Hosting this Conference is therefore an opportunity for the College to broadbase its expertise in this area by learning from international experience.

3. There is a common perception around the world that the original rationale for cooperatives has ebbed away, and that in today’s complex, globalising world, there is no meaningful role for cooperatives. That is clearly a misperception. Indeed I will argue to the contrary – that precisely because today’s world is complex and globalising, there is a more meaningful role for cooperatives to play. But let me first attempt to outline what exactly is meant by a cooperative.

Defining cooperatives – an aggregation of power for business goals

4. There are several formal definitions of the cooperatives, but at the very core, cooperatives are member-owned businesses. Their rationale draws from the strength of aggregation. Cooperatives aggregate the power of people who, on their own, would find it difficult to achieve their business goals. They are thus unique entities in the sense that they are member- owned, member-driven and member-controlled businesses.

5. The way cooperatives are organized, they provide a third alternative with free market organisations at the one end (which provide goods and services through exchanges in the market) and the state owned organisations at the other (which provides goods and services through state control). Without going into the details of the theoretical exposition, I can safely say that cooperation emerges when it either reduces the cost and / or increases the benefits to the prospective members by undertaking an activity of common interest. In case of financial cooperatives, this translates to increasing the return on savings and reducing the interest on loans to members after making sure that there are adequate margins to plough back surpluses for future sustainability and growth.

Rationale and relevance of cooperatives today

6. Let me now return to the question of the rationale of cooperatives in today’s world. As I mentioned at the outset, cooperatives have a very meaningful role to play in today's complex, globalising world for at least two important reasons.

7. Over the past 60 years, we have seen several episodes of economic growth in different parts of the world. One clear lesson of this experience is that growth is sustainable only if it is inclusive. A growth process that increases inequity lacks durability, and indeed even legitimacy, eventually threatening economic and social stability. Evidence in support of

this is overwhelming – the “Occupy Wall Street” movement of last year being just the latest manifestation of the discontent associated with inequitable growth. Governments around the world are therefore anxious that even as they pursue economic growth, they must make that growth process inclusive. There are many ways of understanding inclusive growth: the way I understand it is that inclusive growth is a process where the poor contribute *to* growth and the poor benefit *from* growth. From this perspective, the cooperative system can become an effective instrumentality for inclusive growth and a powerful platform for enfranchising the less privileged.

8. There is a second and equally powerful argument that reinforces the importance of cooperatives. The recent financial crisis has taught us some very important lessons. The general disenchantment with “casino banking” in certain developed economies underscored the dangers of over-financialization of the real economy.

9. In comparison, the cooperative business has been more resilient. Its source of stability is the inclusiveness embedded in its very structure: “as owned by members and for the members.” This structure ensures that cooperatives are not enterprises run just for short term profits, but are a business model for long term sustainability and inclusive growth.

10. In case of financial cooperatives, they do basic banking and do not indulge in investment banking or trading; they are not dependent on bulk or wholesale markets for funding. They buy and hold, and in their lending, they depend more on their knowledge of the borrower rather than on the collateral that can lose value rapidly. They bring in bio-diversity in the financial landscape. Hence the cooperative philosophy is an excellent example of a value based business model. As the UN Secretary General Ban Ki-moon put it, *“Cooperatives are a reminder to the international community that it is possible to pursue both economic viability and social responsibility.”* Quite understandably, the experience of the global financial crisis has generated serious thinking about cooperatives as a bulwark for financial stability.

Are cooperatives on the decline?

11. Notwithstanding the above arguments in support of the rationale of cooperatives, there is a stereotype view that cooperatives are on the decline. Evidence, however, is to the contrary. A recent study by ILO[1] cites evidence that the cooperative business model is a sustainable form of enterprise that is able to withstand a crisis. The study also addresses questions like whether cooperatives only succeed at a time of economic crisis. Are they a business model that people turn to when needed, only to return to the dominant investor-owned model when the crisis is over? The study concludes that there is no evidence in support of this. In fact, it is the strength built up by cooperatives during the good times that helps them tide over a recession.

Evolution of cooperatives – global experience

12. Globally, the cooperative movement covers over one billion people generating economic activity, resources and jobs. Countries with the most significant numbers of people in cooperative membership are India, China and the United States. Countries with significant presence of cooperative banks are Germany, France, the Netherlands and Italy.

13. Experience from around the world shows that cooperatives have been strong in countries where they have received definitive policy support from the respective governments in the initial stages. How they later evolved differs from country to country. Two main factors have worked in their success viz., the degree of government control and the

1 Resilience of the Cooperative Business Model in Times of Crisis, Johnston Birchall & Lou Hammond Ketilson, 2009.

extent of member participation. In today's technology driven globalised environment, it also matters whether and to what extent they are prepared to face competition.

Evolution of cooperatives – Indian experience

14. The growth of cooperatives in India has been impressive and covers a wide array of activities including credit & banking, fertilizer, sugar, dairy, marketing, consumer goods, handloom, handicraft, fisheries, housing etc. The Indian cooperative movement, comprising around six hundred thousand cooperatives is arguably the largest cooperative movement in the world, providing self employment to millions of poor. There are stellar success stories like "Amul" owned by the Gujarat Cooperative Milk Marketing Federation (GCMMF) and Self Employed Women Association (SEWA), Gujarat. Among consumer cooperatives, the trail blazer has been Warana Bazaar, Warananagar, Kolhapur. Beyond these high profile success stories though, the story of Indian cooperatives has been varied. There are heart warming successes as also disappointing, if not dispiriting, failures.

Cooperative movement – driven by state policy

15. In India, state policy and support played a major role in the development of the cooperative movement. Historically, the passing of the Cooperative Credit Societies Act in 1904 and a more comprehensive Cooperative Societies Act later in 1912 marked the beginning of state policy of active engagement and promotion of cooperatives. Further impetus for state support came from a study by Frederic Nicholson, followed by the Edward Law Committee on Cooperative Legislation. In 1915, the Maclagan Committee reiterated and advocated that "there should be one cooperative for every village and every village should be covered by a cooperative".

16. In the subsequent decades, the Reserve Bank of India played a vital role in the development of the cooperative movement in the country. There were specific provisions in the Reserve Bank of India Act, 1934 both for the establishment of an Agricultural Credit Department (ACD) in the bank and for extending refinance facilities to the cooperative credit system. A seminal landmark in the history of cooperative credit and banking was the All India Rural Credit Survey in 1954, conducted by the Reserve Bank. Based on the experience of India and several other developing countries, the Committee stressed that: "no form of credit organisation at the rural base will be suitable except the cooperative society". The integrated scheme of rural credit, introduced pursuant to the Committee's recommendations, gave a big boost to the country's cooperative movement.

17. As the planning process by way of the five year plans took root in the post-independence period, "building up a cooperative sector as part of a scheme of planned development" became one of the central aims of national policy. The planning process was driven by the principle that: "Cooperation should become, progressively, the principal basis of organization in branches of economic life, notably agriculture, minor irrigation, small industries, processing, marketing, distribution, rural electrification, housing, construction and provision of essential amenities for local communities. Even in the medium and large industries and transport sectors, an increasing range of activities could be undertaken on cooperative lines."

18. Over the years, the importance of cooperatives increased well beyond a business form to a more broad based development philosophy to fulfil the common economic aspirations of the poor and disadvantaged. This narrative suggests that growing state faith played a critical role in evolution of cooperatives.

Cooperatives also driven by the land holding pattern

19. In addition to state policy, the changing pattern of landholding in India aided the spread of cooperatives.

20. During the 50s and 60s, more than a fourth of the total cultivable land was held by large farmers. By the year 1995–96, this picture changed significantly with large farms yielding ground to small and marginal farms whose share increased both by way of number of operational holdings as well as operational area. As per the latest agricultural census (2005–06), small and marginal farmers, having less than 2 hectares of land, accounted for 83 per cent of the total number of operational holdings and 41 per cent of the operated area. It is this class of "small" farmers, operating at the margins – socially as well as financially, with low income base and limited market orientation, vulnerable to climate changes and facing considerable risk in their agricultural operations – that define the profile of the clientele of cooperatives. The average size of loans disbursed by the cooperatives works out to about ₹30,000, as against ₹1,38,000 disbursed by the commercial banks (2010). The difference evidences the nature of the cooperatives and their clients.

Still they seem to be losing out – problems in the rural cooperative credit system

21. As indicated above, the cooperative movement in India has had the support of state policy and also the landholding pattern. Yet, cooperatives seem to be losing out on business share. The market share of rural cooperative banks in India has been continually receding – from 7.2 per cent in 2001 to 3.7 per cent in 2010[2]. If the share of cooperatives declines further, they may lose their role as an important player in rural credit. This raises an important policy question. Can a process such as the cooperatives be driven entirely as a top down process? Isn't bottom up support a necessary condition for the cooperative movement to thrive?

Why is the cooperative system faltering?

22. There are several reasons for the disappointing performance of cooperatives in the country calling into question their viability and sustainability. I will reflect briefly on the more important ones.

(i) The Short Term Cooperative Credit Structure (STCCS), which once played a major role in the growth of agriculture by supporting small and marginal farmers, seems to be on the decline. Until the early 1990s, cooperatives provided almost 62 per cent of the agri-credit in the country, but over the years, their share has declined, going down to 16 per cent by 2009–10.

(ii) Several factors have led to the deceleration of credit flow to agricultural and rural development activities. State intervention into and politicization of these primarily democratic and member governed cooperative institutions has impaired their governance both on managerial and financial fronts. Examples of governance impairment include non-conduct of elections, frequent supersession of boards, delay in audit and states' intrusion into administrative and financial management.

(iii) The Task Force appointed by Government of India (GoI) for revival of the cooperatives noted that impairment in governance was deep. The State often combined the role of the dominant shareholder, manager, regulator, concurrent supervisor and auditor creating severe conflicts of interest. Cooperatives were also required to function by administrative boundaries and were often divided into smaller entities just because of division of panchayats, districts or states.

(iv) Weak finances, growing NPAs and poor resource base are factors contributing to the declining performance of the cooperatives at the bottom level. These grass root institutions mostly depend on the higher agencies, i.e. central cooperative banks

[2] The story of decline is similar for urban cooperatives which saw their share drop from 6.3 per cent in 2001 to 3.5 per cent in 2010.

(CCBs) which, in turn, have to borrow from the next higher agencies. There is thus, a chain of dependency at all levels of the cooperative credit structure for resources from the outside.

(v) The cooperative structure is biased in favour of borrowers, and depositors get an unequal treatment. Only borrowers can become members of the cooperative. Depositors are either non-members or "nominal" members with no voting rights. First, this goes against the concept of mutuality (thrift and credit going hand in hand). Second, it is not fair to depositors that their money is being intermediated by the cooperatives without their having any say in the management.

(vi) There are other developments that have constrained the growth of cooperatives. They have been unable to cope with the rapid pace of change in the financial sector. New products and services, application of technology and adoption of advanced management practices have improved the efficiency and driven the margins down in the financial sector. While other players have adjusted to these changes, cooperatives have lagged behind. This pulled them into a vicious cycle of falling business, poor governance and weak human resources.

23. The declining share of cooperatives in rural credit is worrisome especially since they are oftentimes the only source of support for small and marginal farmers. The health of the long term cooperative credit structure is also a cause for concern as it affects capital formation and hence productivity in agriculture.

Yet their outreach is their strength and they need to leverage on this

24. Do all the infirmities I have outlined above mean that cooperative institutions do not have any positives and are not relevant today? The answer is clearly no. Their vast network, with over 100,000 live outlets of the Short Term Cooperative Credit Structure (STCCS), is a major strength. I believe there is no other institution that has this depth of penetration for purveying credit and mobilisation of resources. How then do we leverage on this strength of cooperatives, especially for furthering financial inclusion in the country?

25. The three tier STCCS consists of more than a hundred thousand primary agricultural credit societies, (PACS), nearly four hundred District Central Cooperative Banks (DCCBs) with 13,000 branches and 31 State Cooperative Banks with nearly one thousand branches.

26. More significant – besides the numbers – is the location of these outlets. The number of PACS located in hilly terrains, deserts and other areas with poor access far exceed the number of rural branches of commercial banks and RRBs. Located as they are in the rural areas, the STCCS units have better knowledge of their existing and potential clients. The large cooperative structure with deep penetration and endowment of local knowledge is an ideal platform for furthering financial inclusion. Arguably, cooperatives have been in the business of financial inclusion long before the phrase became fashionable.

27. Notwithstanding the above advantages, PACS were not formally recognized as Business Correspondents and were not formally integrated into the Financial Inclusion Programme (FIP) at par with commercial banks and Regional Rural Banks. The DCCBs were not allocated any villages despite the fact that a large chunk of rural population held their bank accounts in DCCB and SCB branches. One reason is that these banks are not sufficiently technology-enabled to participate in the *technology driven* Financial Inclusion Programme. To redress this handicap, as part of its mandate of institutional development, NABARD has embarked on an ambitious effort to bring the cooperative banks on a common technology platform in a phased manner. They should then be ready to be integrated into the FIP provided there is also an improvement in their financial health.

Reviving the cooperative structure – what needs to be done?

28. If the inherent advantages of cooperatives as member-owned and operated entities is to be realized and they are to play a meaningful and sustained role in financial inclusion, many of the above constraints and handicaps will need to be urgently addressed. Let me briefly outline the agenda in this regard.

Improve professionalism in governance / management

29. Governance in Cooperative Banks lacks professionalism. There is need to professionalize both the governance structure and the functioning of these institutions. First, governance has to be segregated from management. The Board must restrict its role to governance and allow the CEO and the senior management to manage the day to day operations of these entities. The Board can exercise oversight over the management through established channels like reviews in Board Meetings and by seeking progress reports and information. There is also a need for stringently applying the “fit and proper” criteria to personnel considered for managerial positions in these institutions.

Address poor financial status

30. The deteriorating financial position of unlicensed cooperative banks is an issue of concern. Of the 402 cooperative rural cooperative banks in the country as on March 31, 2009, 313 were unlicenced. In accordance with the recommendations of the Committee of India’s Financial Sector Assessment (CFSA), the Reserve Bank decided that no unlicenced cooperative bank will be allowed to function in the country after March 31, 2012. After this, RBI and NABARD worked closely with the cooperative banks and licensed 272 of them, in some cases by relaxing the licencing norms.

31. As on April 1, 2012, there still remained 41 cooperative banks which could not meet even the relaxed licencing norms. In order to maintain the integrity of the cooperative system and to protect public interest, the Reserve Bank imposed Directions on these 41 banks prohibiting them from accepting fresh deposits. I must mention here that the Directions do not imply any ban on the normal operations of the banks with the existing account holders. While prohibiting these banks from accepting fresh deposits, the Reserve Bank has been guided by the need to protect the interests of depositors and by larger public interest.

32. Also, a large number of Cooperative Societies at the bottom level i.e. 18553 PACS (around 20 per cent of total) could not be covered under the revival package recommended by the Vaidyanathan Committee- I (VC I)[3] because of poor recovery performance. States have to come out with a road map for reviving these PACS. The remaining eligible PACS covered under VC-I have to work towards achieving full recapitalisation by bringing in their own share towards recapitalisation.

33. The position of Urban Cooperative banks is relatively better as the process of consolidation and resolution over the last few years has weeded out many of the financially weak banks in a non-disruptive manner. As on date, only one UCB remains to be licenced.

Adopt technology for a level playing field

34. Technology has become a major factor in determining the essence of modern banking efficiency. Cooperative banks are still far behind commercial banks and RRBs in upgradation of technology. Cooperative banks must realise that banking in today’s world cannot be independent of technology, not so much because of competition from commercial

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[3] A Committee set up in 2004 to make recommendations for strengthening the rural cooperative credit institutions in the country.

banks alone, but because that is what the modern customer – rural or urban – demands. Cooperatives must, therefore, come up to speed in regard to technology.

Improve share capital and deposit safety

35. As I mentioned earlier, the critical issue for the future of cooperatives is to ensure that members have a substantial financial stake in the cooperative. A number of initiatives including increasing the face value of the membership fee or shares would be necessary to make this happen.

36. Members today are hesitant to keep deposits even with their own PACS because of concerns about the safety of their deposits. Deposits in PACS are not covered by DICGC, and the deposit insurance schemes of states have remained only on paper. There is an urgent need to rebuild customer faith and trust in cooperative institutions so that small depositors do not vote with their feet and take business away from cooperatives.

Increase member participation

37. With the ever increasing number of small and marginal farmers and hence increasing informal tenancy, developing aggregation models for financing, agronomic practices, input supply, use of equipments, marketing and processing are immediately required. While the Joint Liability Groups of farmers can serve as an intermediary step, the long term solution is more intense engagement with members.

38. For increasing member participation in the affairs of the PACS, it is essential to increase the number of points of contact between the members and the PACS. The most effective contact can come only be through fruitful business between the two, and hence, the product range offered by the PACS needs to expand significantly.

39. We need to work towards converting PACS into multi functional entities so that all members automatically think of their PACS whenever they think about products and services. Examples of PACS engaged in procurement, providing warehousing facilities, stocking and providing other inputs including seeds and saplings, leasing out farm equipments, becoming e-enabled common service centres providing land records and information on weather, market prices, and extension advisories, and so on are now available in some states. PACS also need to provide other financial products, especially insurance, and enhance their fee based income.

Questions for the way forward

40. Having set out the agenda for repair and reform, let me now raise a few questions which, I hope, will engage the attention of this Conference over the next two days.

Question 1: Are cooperatives doing enough for financial inclusion?

41. The basic philosophy and essence of cooperative credit structure is to ensure financial inclusion. Financial exclusion, as we all know, is not confined only to the remote parts of this country; it exists in urban centres as well. The significance of urban financial inclusion also lies in the fact that financial inclusion of the urban poor, and particularly of migrant labourers, provides a forward linkage to rural financial inclusion through the remittance corridor. This question is directed particularly to cooperatives working in urban set up. Are they doing enough for financial inclusion? Have they cared to open large enough number of accounts of slum dwellers and migrant labourers?

Question 2: Can cooperatives improve the supply chain to ease inflationary pressure?

42. In developing economies where the supply chain management is generally weak, the layering of middlemen oftentimes creates an artificial inflationary pressure. Can a more

proactive approach in developing sustainable agri-value chain through cooperatives help in sustainably easing inflationary pressure?

Question 3: How to strengthen the democratic character of a cooperative?

43. Democracy and open membership are among the cardinal principles of cooperation. However, a recent study conducted on urban cooperative banks by the College of Agricultural Banking presents a disappointing picture of the democratic set up in these institutions. The low attendance of members in general body meetings and their poor participation in the election process raise questions about the democratic quotient. Are governing bodies and associations working towards encouraging greater involvement of members in cooperative governance? Should there be a separate institution similar to the Election Commission to improve the democratic ethic of cooperatives?

44. A relevant issue is that there are several instances of cooperative institutions becoming leader centric. They do well under some good leaders, but crumble when those leaders leave. What is the "*mantra*" for institutionalizing leadership at the grass root level?

Question 4: Should cooperative banks diversify beyond basic banking?

45. There is an ongoing debate on whether cooperative banks should restrict themselves to offering plain vanilla products, or whether they should also, like commercial banks, diversify into offering exotic and complex products. In deciding on this, we should be guided by the experience of the crisis. The main criticism against banks post-crisis has been that they have mostly turned into becoming "casinos". Isn't there value then in cooperatives restricting themselves to being "utility" banks?

Question 5: Should these be social audit of cooperatives?

46. While "cooperative" is a social phenomenon, "banking" is a commercial and business proposition. Keeping in view these two conflicting dimensions of cooperative banking, there is an argument in favour of evaluating cooperatives on non-financial parameters alongside the financial parameters. Can there be a system of social audit which world assess the performance in terms of social, environmental and community goals of the organisation? If yes, what should be the appropriate institutional mechanism for this social audit function?

Conclusion

47. Let me now conclude by summarizing what I have said. I argued that notwithstanding stereotype views to the contrary, the cooperative ethic remains relevant even today. Indeed, we have become even more aware of the value of a member driven, grass root institution like the cooperative after witnessing the devastation caused by the greed and excess of the financial sector that resulted in the global financial crisis of 2008/09. Thereafter, I traced the Indian experience of cooperatives and conjectured whether the main weakness of the cooperative structure in India is the fact that it grew on the basis of support from a top down state policy rather than as a broad based bottom-up movement.

48. I then reflected on the several infirmities of the Indian cooperative sector, but argued that despite these infirmities, cooperatives have played a vital role in furthering financial inclusion. I then moved on to listing the main issues concerning the cooperative sector that we must address in order to revitalize it. Finally, I raised five questions relating to the cooperative sector on the way forward that must engage the attention of this Conference.

49. As I come to a close, I realize that I have been more cynical than I actually want to be. Perhaps I should correct that. The cooperative ethic is unexceptionable. It has been and can be a powerful instrumentality for enfranchising the poor and the less privileged. Indeed, there are numerous instances from around the world, and from India too, of successful

cooperatives. Yet for a variety of reasons, both financial and governance related, the credibility of cooperatives has got eroded, especially since cooperatives have come under the spell of several infirmities, some of them chronic. Yet, it is possible to cure these infirmities and revive the cooperative structure into health and vibrancy. Indeed this is not a matter of choice, but an imperative if we are to achieve our collective aspiration for inclusive growth. I hope this Conference will help us find a way forward in this regard.

My best wishes for the success of this Conference.