The rise and fall of the credit cooperative system in India

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Introduction

For centuries, since taxes had to be paid in cash instead of kind, farmers in India depended on moneylenders, dispossessing large number of farmers and throwing many of the rural population into abject poverty. As Sir Daniel Hamilton put it in1884: "The power that stands in the way of India's economic development is the power of evil finance…. The land lies blighted by the shadow of the mahajan (usurer)." Government intervention accomplished little: "The dole system was resorted to by rendering active help in times of famine and loans were given from Government funds. This… proved to be only a palliative but no cure." (Huss 1924: 83)

As news spread of the emergence of a new system of rural finance in Europe, Sir Frederick Nicholson was sent to study the question of mutualist credit and the mysteries of a system based on self-help by the farmers themselves. He summed up the results of his inquiry in two words: "Find Raiffeisen." 1894 thus marked the dawn of the restructuring and reform of rural finance in India, just five years after the passing of the credit cooperative act in Germany. Ten years later, in 1904, the Co-operative Credit Societies Act was passed, laying the legal foundation for a new system of rural finance in India. Within twenty years some 50,000 credit cooperatives came into existence. "People's Banks are the greatest benefit that India has yet received," stated an Indian registrar. (Huss 1924: 82-83)

The credit cooperative system continued to grow in quantity and complexity, with almost 15,000 banking outlets, more than 100,000 primary credit cooperatives and a total number of 135m shareholders today. However, while cooperative finance essentially is part of a self-help movement, its establishment and expansion in India involved the government as an active participant and promoter from inception. This stood in sharp contrast to countries like Germany, the Netherlands and many others where the state was kept at bay, entering only in due course upon the request of the movement to provide a legal framework. Not so in India, where a law marked the starting point, and the establishment of a central bank, the Reserve Bank of India, in 1935 opened the flood gates of a generous government supply of financial and human resources. This led to a long drawn-out process of restructuring and reform in reverse, which eventually turned a self-help movement into a vast network of public institutions.

The final result has been disastrous. Large numbers of cooperative banks, and more than half the primary credit cooperatives, are loss-making. Many are technically bankrupt, but are kept open, thanks to lenient supervision and political pressure.

A great start

Credit cooperatives in India had a great start, taking off with a legal framework in 1904, the Co-operative Credit Societies Act. In no other country, not even in Germany where the movement had originated around 1850, did credit cooperatives expand that rapidly. Regulation and supervision provided a conducive framework: "Registrars refuse to register societies unless the applicants have been properly instructed in co-operative principles and unless there is sufficient and efficient supervision…. Nonfunctioning societies are dissolved by the Registrar.” (Huss 1924: 84-85; Strickland 1922: 45)

Self-financing and self-governance kept the movement growing, as Strickland (1922: 51) stated in *Co-operation in India*: “The credit movement of British India is not working with official money: about 50% of its capital consists of small shares contributed by the members and the surplus accumulated from the interest on their borrowings; another 10% consists of deposits by the members themselves, the remainder is commercial credit. The societies are not managed by Government or by officials, they are in the hands of their members, subject to an audit prescribed by law and carried out by non-officials under a decreasing official supervision.”

Continual growth…

By 1912 credit cooperatives numbered 8,000; they reached around 50,000 by the mid-1920s. Lending rates of interest were in the range of 9%-12% p.a., far below those of the informal sector. As in the early Raiffeisen credit associations (*Darlehnskassen-Vereine*), unlimited liability initially served as a substitute for collateral. Citing Prof. Jadunath Sarkar, that “the movement of co-operative credit is tending to create a revolution… in rural India. The people have developed an extraordinary capacity for united action”, Huss (1924: 83) simultaneously issued a prescient warning: “The fact that the British Government planted the idea of co-operative credit in the minds of the Indian people and guided the movement through the last twenty years is now considered by the Indians as a >pre-natal defect<.” A decade later, in 1934, the Reserve Bank of India Act included provisions for refinancing the cooperative credit system. After a good start, this marked the wrong turn. From there onwards the number of loans overdue grew rapidly.

The credit cooperative system (CCS) has continued to grow and forms an essential part of what today is one of the largest rural finance systems[1] in the world. The CCS comprises 51 state cooperative banks, 1,133 district cooperative banks with 13,743 branches, and about 107,000 primary credit cooperatives. Total outreach is around 135m shareholding members, plus an unreported number of so-called nominal members.

… but ruinous government intervention

The impressive growth has not been matched by performance. Rather, the >pre-natal defect< has turned into a contagious disease, resulting in frozen assets and heavy overdues as noted by the 1945 Cooperative Planning Committee. “State partnership” in terms of equity, governance and management, introduced in the mid-1950s in state cooperative laws,[2] worsened the disease. Encumbered by an ideology of central planning, the state assumed control over all institutions including cooperatives. Governance was alienated from the local communities and the members. Instead, state governments were given full authority in matters such as appointment of chief executives, suspension of elected boards of directors, fusion or fission of co-operative banks, amendment of bylaws, vetoing of bank decisions, issuing of directives, and supervision. State cooperative administrations are in charge of registration, licensing, statutory inspections and audit of the cooperative banks. The states participate also in the ownership of cooperative institutions at all levels.

[1] India’s formal rural financial sector is mostly state-controlled. In addition to over 120,000 cooperative units, there are 98 commercial banks with more than 47,000 rural and semi-urban branches; and 196 regional rural banks (RRB) with 14,372 branches. The semi-formal sector includes about 800 MFIs. At the aggregate level, there are roughly 94m rural borrowers and 300m rural savers, including those who save at post offices. The outstanding rural credit as of March 2005 from formal sources was estimated at $100bn, with the commercial banks accounting for 53.0%, the CCS for 38.5%, and RRBs for 8.5%. There are 60m rural loan accounts with the CCS, compared to nearly 20m in the commercial banks and 6m in the RRBs. Yet there is a significant supply and demand gap, the poorest households having little access to formal finance.

[2] In line with the cooperative act of 1919, which had made “cooperation” a provincial subject.

Bureaucracy, government intervention and loan channelling have replaced the original system of self-management and self-reliance. As stated by the Committee on Financial Inclusion, in the 1990s "an increasing realization of the disruptive effects of intrusive state patronage and politicisation of the cooperatives, especially financial cooperatives… resulted in poor governance and management and the consequent impairment of their financial health." The system became borrower-driven, and the concept of mutuality and self-reliance was lost. (Rangarajan 2008: 69)

Diagnosing the disease

The results have been disastrous: large numbers of cooperative banks, and more than 50% of primary credit cooperatives (PACS), are loss-making – probably many more if international accounting standards were applied. According to Nabard's annual report (2007: 87), cooperative credit institutions suffer from low resource base, high dependence on financing agencies, imbalances, poor business diversification and recoveries, huge accumulated losses, lack of professionalism and skilled staff, weak MIS, poor internal check and control systems, etc. As of 31 March 2006, large numbers of cooperative institutions incurred losses: 4 out of 31 reporting state cooperative banks (SCBs), 88 out of 366 district central cooperative banks (DCCBs), 53,626 out of 105,735 primary agricultural credit cooperative societies (PACS), 8 out of 19 reporting State Co-operative Agriculture and Rural Development Bank (SCARDBs) and 194 out of 696 reporting Primary Co-operative Agriculture and Rural Development Banks (PCARDBs). The total accumulated losses of the CCS, excluding PACS, amounted to Rs9,139 crore (US$2.05bn).

Three-fourths of CCS credit is for crop loans. After a century of cooperative development the farmers have not learned to finance their recurring seasonal financial needs from their savings. This portion of scarce financial resources is not available for investment loans, further widening the demand and supply gap.

The problem is most serious at the bottom tier, the PACS, with some 120m shareholders[3] and a large number of so-called nominal members. With reportedly half the PACS loss-making and most of the other half poorly performing, client deposits amounting to $4.3 billion are at risk. PACS are channeling agents, the largest part of their funds provided by Nabard, guaranteed by state governments and rolled over perpetually.[4] If Nabard refinance were recalled, the CCS would collapse. The CCS is supposed to be the binding element for the broader cooperative movement in India, which includes crop production, processing, marketing, input distribution, dairying, weaving, and textiles; its reach directly or indirectly extends to nearly half of the population. The sad state of the CCS is all the more tragic as it adversely affects the backward (*inputs*) and forward (*marketing*) linkages and their integration with the multipurpose service concept of the cooperative system, a major impediment to rural development.

Numerous problems in the cooperative credit system have been noted, including inadequate provisioning resulting in inflated reported profits or deflated losses, erosion in the value of assets, inadequate financial margins, ineffective fund management, poor risk management, lack of appropriate corporate governance, and weak internal checks and controls (ADB 2006: 94). All this can be brought down to one core problem: the lack of effective supervision, which in turn is due to fuzzy delineation of authority and to political control over the cooperative sector.

Nabard, carved out of RBI in 1982, supervises the cooperative banks, providing at the same time refinance and capacity-building. The DCCBs supervise the PACS; but no one

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[3] 42% are small or marginal farmers, 37% marginalized social groups. 51m members are borrowers.
[4] As of 31 March 2005, Nabard (2007:81) reports the following consolidated balance sheet data for the PACS: owned funds Rs92.0bn ($2.1bn); deposits Rs189.8bn ($4.3bn); borrowings Rs 402.5bn ($9.2bn). No data are given on loans outstanding and non-performing loans.

possesses the authority of enforcing compliance. Nabard reports serious deficiencies to the cooperative department of state governments, which act as concurrent supervisors, auditors, dominant shareholders, managers and regulators – an agenda of conflicting interests. SCBs and DCCBs are classified as banks under the Banking Regulation Act of 1949; but prudential norms cannot be enforced since the registrar of cooperatives is empowered to override or delay implementation of RBI recommendations. State governments are not inclined to close non-performing institutions or to insist on good corporate governance. To the contrary, credit cooperatives are loan channels for economic and political purposes; and the overall credit culture is undermined by interest subsidies and loan or interest waivers. Its long history has been a liability rather than an asset of the CCS, with no living memory, or institutional recollection, of a splendid past.

Towards cooperative reform

Some states have recently provided a different legal framework, starting with Andhra Pradesh which in 1995 passed a Mutually Aided Cooperative Societies (MACS) Act. These societies are autonomous and not subject to the authority of Nabard or a cooperative registrar. Some remarkable developments have ensued, as among SHG federations; but the problem of effective supervision has remained unresolved, as MACS and similar institutions have not, or not yet, established a financial authority of their own. They are also beyond the purview of the ongoing reform efforts.

Since the 1990s India has taken steps to liberalize its financial sector. These reforms have first been mainstreamed in the government-owned commercial banks and subsequently among the regional rural banks (RRBs), but not in the rural CCS. A comprehensive reform program to transform India's CCS is now under preparation (Vaidyanathan 2004).[5] Announced in January 2006, the reform package is "designed to transform the potentially viable CCBs into democratically governed, efficiently managed, financially sustainable, self-reliant entities that can provide a wider range of financial services to the rural poor" (World Bank 2007: 1-3). Legal reforms are to be geared at full independence and autonomy of cooperative institutions; regulatory reforms at effective enforcement of RBI's prudential regulations and corporate governance standards; operational reforms at uniform financial reporting and internal control systems, improved credit appraisal and risk management, and new staffing policies; and restructuring at cleaning the balance sheet.

Total cost of the short-term CCS at the all-India level has been estimated at Rs136bn (US$3bn): 92% for cleaning up accumulated losses and 8% for audit, human resource development, and technological support. The costs are to be shared by the central government (68%), state governments (28%) and the CCS (4%). The Central Government (GOI) will provide its share as grants, while the states will meet their share from their budget or through open market borrowing. In support of the revival package, ADB[6] has sanctioned a loan of US$1bn, the World Bank US$600m and KfW €140m to GOI. GTZ, in cooperation with DGRV, the German Cooperative and Raiffeisen Association, is among the agencies providing technical assistance.

Some critical observers from within the CCS question the likely outcome. They see restructuring at government's expense as a perverse incentive, just like interest and debt waivers, rewarding the defaulters and confirming expectations of continual government leniency.

[5] Some inspiration has reportedly come from isolated reforms in southern India including Bidar District.
[6] In line with ADB's strategic priority in India of inclusive social development. ADB's assistance is limited to five states, where total cost is estimated at $1.43bn.

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