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SmartLessons
real experiences, real development

An Old Innovation for a New Era: Lessons Learned from Financial Cooperatives in the LAC Region

Cooperative financial institutions (cooperative banks, credit unions, and building societies) have prospered in many markets around the world and have come to play a major role in financial inclusion. According to the latest data from the World Council of Credit Unions, there are currently 51,000 credit unions in 100 countries with a total of 196 million members. IFC's Financial Markets team has traditionally found it difficult to engage with cooperative financial institutions, due to challenges of democratic governance, low financial returns, and limited possibilities to acquire equity. However, in recent years there has been a concerted effort to develop partnerships with leading institutions in a number of markets. This SmartLesson highlights some of the experiences from IFC's engagement with cooperatives in the Latin American and Caribbean region.

Background

169 years ago, in 1844, a group of 28 tradesmen got together in Rochdale, Lancashire in Great Britain to discuss how the new machines of the Industrial Revolution were forcing skilled workers into unemployment and poverty. The Rochdale Society of Equitable Pioneers was formed, and the group met regularly for the following months while they struggled to save together a total of 1 British pound per person (US$1.55 at today's exchange rate) to serve as the capital for a store that would sell low-cost food items to the local community. This was the birth of the cooperative movement, which now involves millions of people around the world and continues to be based upon the seven principles proposed by the Rochdale tradesmen (see Box 1).

I was born just a few miles away from Rochdale, and have always been fascinated by the subject of cooperativism. This might be an old innovation, but it is still very relevant in today's economic era.

> **Box 1: The Seven Principles of Cooperatives**
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> 1. Open, voluntary membership.
> 2. Democratic governance.
> 3. Limited return on equity.
> 4. Surplus belongs to members.
> 5. Education of members and public in cooperative principles.
> 6. Cooperation between cooperatives.
> 7. Concern for community.

Business Model

Financial cooperatives can vary in business model quite dramatically from country to country. Although the cooperative movement principles may trace their heritage back to Rochdale, financial institutions are a blend of those original principles, together with practices from local cultures that predate the international cooperative movement. Some form of rotating savings and credit associations can be found in villages and communities on every continent (such as the *esusu* system in Nigeria, and *tontines* in Cambodia).

In general, cooperative financial institutions are quite different from the banks which IFC typically invests in. First of all they are nonprofit organizations and sometimes unregulated. The ownership structure of cooperatives is typically diverse, as they are owned by their clients with an extreme form of democratic ownership: each member of the organization has one vote, independent of the share of capital they own, and some form of regular contribution to capital is levied on all members. They tend to offer a broad range of products rather than focus on lending, as many microfinance institutions do. Profits are usually invested in growing the capital base of the institution, but over time they tend to be seen as an indicator that lending rates can be lowered and/or savings rates increased, squeezing margins.

Even though the governance structure can be a challenge, and the lack of focus on profit and growth a source of concern, there are many reasons why these institutions are interesting to IFC. Cooperative financial institutions are very close to their owners – the clients. They appreciate their financial needs and the potential of their cash flows. They also tend to play an important role in the communities they serve and understand the industries and value chains that make up the local economy. For this reason they are usually:

Box 2: IFC Investments in LAC Cooperatives

Sicredi is a network of Brazilian financial cooperatives present in more than 800 towns and cities, typically smaller communities in the interior of the country where banks have little presence. In 2012, the network grew 20%, closing the year with $15.7 billion of assets, equity of $2.3 billion, US$10 billion of deposits, and net income of $336 million. The total members of this cooperative system grew by 13% in 2012, to reach 2.3 million. The Sicredi cooperative system is the owner of a bank, Bansicredi, created in 1995, with equity of $239 million. It was the first cooperative bank in Brazil, and allows the network members to access government lines of finance and the national payments platform. In FY12, IFC invested $50 million subordinated debt in Bansicredi. In FY13, this investment was complemented with a further $10 million equity investment in the bank, with an income participation to capture the financial returns of the whole cooperative system, Sicredi.

Fedecredito is an integrated system, which includes the federation, 48 financial cooperatives (cajas de credito). and seven workers banks. In December 2012, the system had 671,000 shareholders, a total loan portfolio of $893 million, $518 million of deposits, and equity of $246 million. In FY12, IFC committed $30 million to the Federation, backed by a securitization of remittances from migrant workers, sending money from their US homes to their families in El Salvador.

Coopenae is the largest regulated financial cooperative in Costa Rica. It is the sixth largest private financial institution in terms of assets, and fifth largest in terms of equity, owned by its 73,000 members. Coopenae closed 2012 with $830 million of assets, $154 million of equity, and $14 million of net income. In FY12, IFC committed a $15 million A loan, and mobilized a further $15 million from FMO. In parallel, Advisory Services initiated a project with $367,324 to support COOPENAE in building expertise with financial services for Costa Rican small and medium enterprises (SMEs).

- Developing innovative financial products.
- Expanding outreach by penetrating underserved regions and rural communities.
- Promoting broader access to financial products, particularly for micro and small enterprises, which are typically neglected by most financial institutions.
- Forming partnerships with other cooperatives and financial entities, and playing an important role in the growth and development of financial sectors in many countries around the world.

IFC's Experience in the LAC Region

Investment and Advisory Services teams are working together on a number of transactions with cooperative institutions in the Latin America and Caribbean region. Over the last 3 years, IFC has invested in two wholesale banks that are owned by and fund their respective cooperative systems: Bansicredi in Brazil, and Fedecredito in El Salvador. IFC has also invested in and provides advisory services directly to a cooperative in Costa Rica – Coopenae (see Box 2). Investments in two more cooperatives in Costa Rica have recently been approved by IFC investment committees (for a total of US$15 million in debt), and cooperative institutions in Colombia and Paraguay are currently being appraised.

The experience of working on these transactions has provided the following interesting lessons:

Lesson 1: Financial cooperatives play an important role in financial sector development.

In many economies, significant proportions of the population are members of cooperatives. Cooperatives do not always provide all the financial services that individuals or companies need, and indeed may be prohibited from doing so, as in Costa Rica, where the regulator, SUGEF (Superintendencia General de Entidades Financieras) limits cooperatives to working only with individuals and nonprofit organizations according to the legislation (Law 7391). However, they often are the first choice for clients to go to because of pricing and/or their position in the community. An IFC engagement with the cooperative sector should always be considered as part of a comprehensive financial sector development strategy.

Lesson 2: Cooperatives promote outreach.

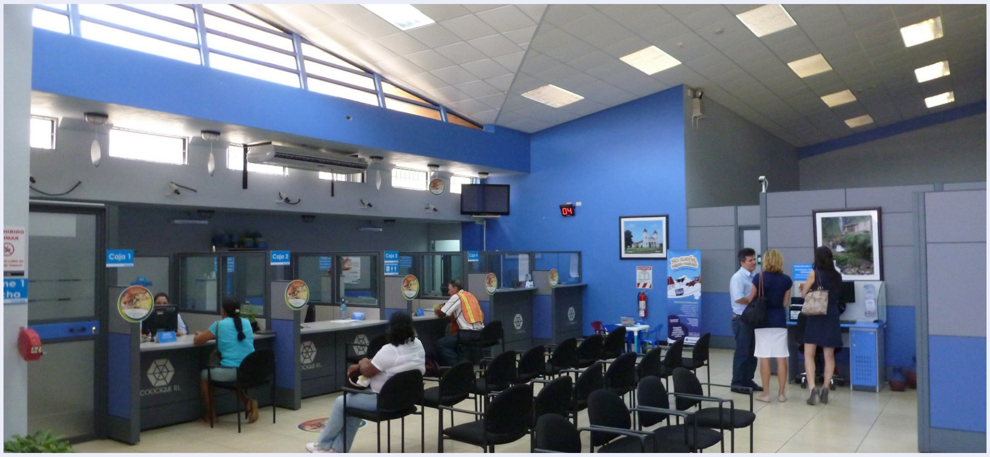
Cooperatives have proven to be extremely successful in reaching market segments that are traditionally underserved by the rest of the financial system; these include women, SMEs, and rural populations. For example, of the 800 Brazilian towns served by the Sicredi cooperative system, it is the only financial institution present in 100 of those towns. In countries with smaller institutions, working with a wholesale entity or aggregator is recommended (as in the case of Bansicredi in Brazil and Fedecredito in El Salvador). IFC can contribute to the expansion of access to financial services by supporting the growth of cooperatives and, by interacting systematically with a number of players, contribute meaningfully toward reaching IDG targets.

Lesson 3: Innovative products and services.

The position that cooperatives have in a particular community and the proximity to their clients mean that they are often innovators in product and service development. For example, cooperatives in Costa Rica intimately understand the production chain of a variety of agricultural products, and thus adjust loan tenors to harvests, and payment mechanisms to client cash flow variations. For example, milk purchasers pay bi-weekly loan installments for farmers. It is also common to see cooperatives encourage savings practices by promoting accounts for children of their members.

Lesson 4: Different strokes for different folks.

The business model for financial sector cooperatives appears to be standard, but actually it varies significantly across countries, and even within markets. It is essential to understand local legislation, as well as the origins and drivers of each institution. For example, ***closed*** cooperatives act like clubs, and seek to grow within a predefined client group (like IFC's own credit union, which is limited to employees). However, ***open*** cooperatives seek to capture new members and as a result have much more commercial, competitive practices, which makes them more interesting targets for IFC engagement. For example Coopenae began life as a cooperative for teachers but is now seeking to



attract members across all segments of Costa Rican society.

Lesson 5: More complex funding options are attractive.

Financial cooperatives tend to be liquid, as they can capture member deposits quite cheaply (especially where they participate in national deposit insurance schemes). This means that short-tenor debt financing is not often attractive to such institutions. However, they are likely to be capital constrained, as their governance structure and limited returns do not attract equity investors. Therefore, subordinated debt (particularly in the case of second-tier banks, such as Bansicredi), longer-term credit lines, structured products, and/or straight equity from IFC may be interesting products to propose.

Lesson 6: Examine issues of governance early in the process.

Given their common dispersed ownership base, financial cooperatives face governance risks deriving from the separation of ownership and control, which differ from those commonly found in developing countries caused by concentrated ownership structures. Governance should always be studied carefully, with the close involvement of IFC's specialists. Though the clients are the ultimate owners, it is often in their long-term interests to implement mechanisms that effectively guarantee stability and professional management. For this reason, many cooperative systems have evolved complex checks and balances, such as the appointment of several corporate bodies (regional and delegate meetings, electoral and oversight committees), restrictions on Board membership (it is common practice that only eligible cooperative members may be appointed as directors), incorporation of wholesale banks run by experienced bankers (as with Bansicredi), and limits on members' withdrawal of capital (as in Costa Rica, where regulation limits it to a maximum of 10% a year). Caution is recommended, particularly when a potential investee is not regulated.

Lesson 7: Interesting returns on investment.

Although financial cooperatives are essentially nonprofit entities, with a tendency to maintain slim margins to satisfy their owners – the clients, in practice their desire to grow and offer broader, product platforms provides an incentive to generate healthy returns.

Conclusion

IFC has engaged with a number of cooperative financial institutions in the LAC region and has found them to be professional, well-managed organizations, operating at the frontier of access to services in their respective markets. This renewed focus on cooperatives, together with innovative transactional structures, is making a significant contribution to international development goals in the region. There is an opportunity to build on this experience and evaluate the opportunity to support the development of cooperative sectors in many markets around the world. The author encourages colleagues who have worked on transactions with similar organizations to connect with him in order to leverage opportunities to share knowledge and continue to build on this experience.