What is Good Governance for Member-Owned Institutions (MOIs) in Remote Rural Areas?

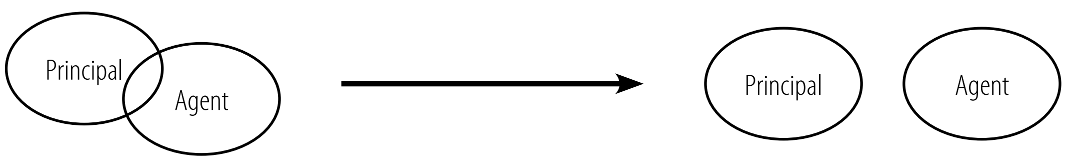
Nanci Lee

Introduction

"Reaching the Hard to Reach," an in-depth examination of MOIs carried out under the direction of the Coady International Institute, has highlighted good governance as one of the critical requirements these institutions must meet in order to be able to provide effective financial services to large numbers of people in remote areas. This focus note summarizes the findings of the "Reaching the Hard to Reach" study pertaining to internal governance of MOIs.

The main challenge with member governance is the principal-agent dilemma (depicted in Figure 1). As long as members are directly acting on their own behalf and in protection of their capital, satisfactory accountability can be ensured. The challenge is for a member (principal), particularly a member living in a remote area, to supervise someone else, someone who is acting on his or her behalf to perform management functions (i. e., to be an agent). MOI members may not have the capacity, literacy, power, and resources to hold their representative decision-makers accountable. Good governance occurs when MOIs have been able to adequately address this dilemma and the risks that accompany it. Where there is no adequate oversight, there is a risk that some members will dominate the governance process or access to services, or even commit fraud. An MOI with strong governance is able to establish a fair "playing field" for members through the right mix of ownership incentives, member decision-making, and other control mechanisms.

Figure 1: The principal-agent dilemma



The larger and more sophisticated the MOI, the greater the separation

Ranging from informal village groups to nationwide cooperative networks, MOIs feature a wide spectrum of governance models (see Table 1). At one end of this spectrum are small autonomous "cash-out" groups that typically have no capital except members' savings, and periodically disburse all their funds. In these MOIs, all members participate in all decision-making. Autonomous or networked groups that accumulate funds on an ongoing basis represent the next level of sophistication. Aside from re-investing part of their earnings back into the common pool, these groups often leverage their funds with local banks and handle various savings payments, which requires more complex internal control mechanisms. Yet, these MOIs are still small enough for peer monitoring to be effective.

Table 1: Governance models of various MOIs examined in the "Reaching the Hard to Reach" study

	Time-bound "cash-out" groups	Groups accumulating funds	Small representative MOIs	Medium-sized representative MOIs	Large representative MOIs
Key features affecting governance	• Informal norms • Unwritten rules	• Informal norms • Written (largely external) and unwritten rules	• Informal norms • Internal written and unwritten rules	• Size and sophistication • Internal written rules • Internal and external controls	• Size and sophistication • Internal written rules • Internal and external controls
Case examples	• Village savings and loan associations (VSLA), Niger	• Self-helf groups (SHG), India • Networked VSLAs, Niger	• Village credit institutions (LPDs), Indonesia • Community growth mutual funds (MC2s), Cameroon • Networked SHGs, India	• Mixtlan savings and credit cooperative, Mexico • MC2 network, Cameroon • SHG federations (three-tier), India	• Jardín Azuayo savings and loan cooperative, Ecuador
Control mechanisms	• Cashing out and member witness at each meeting • Memory of bylaws and balances • Oral recitation of rules • Simplicity	• Lock box • Member witness • Member passbook • Frequency of meetings • Leadership • Simplified bookkeeping	• Elders and leaders in community • Meetings with members • Customary rules and norms • Internal control policies	• Management information system and internal control • Members are represented • Management may be outsourced • Internal and external audit • Regulation	• Management information system and internal control • Members are represented • Management may be outsourced • Internal and external audit • Regulation
Potential blindspots	• Transparency	• Domination of more powerful members • Over-sophisticated mechanisms	• Domination of more powerful members • Over-sophisticated mechanisms	• Member ability to hold system accountable • Technical elite	• Member ability to hold system accountable • Technical elite

Still more sophisticated are networked structures that consolidate a number of primary groups. Aside from supporting and supervising their base tier, they typically provide more complex financial services than primary groups can handle. These structures are governed by elected representatives and rely largely (or exclusively) on paid staff. Amongst representative MOIs, medium-sized and especially small institutions face a particular governance challenge. Though too big for peer monitoring to work, they are still too small to afford or attract some of the controls that replace it (such as professional auditors, more skilled staff, and government supervision). At the same time, their local roots may provide them with some community oversight.

Finally, there are large representative MOIs that rely completely on professional management. The costs of skilled staff can be covered due to their economies of scale and they may attract direct or delegated supervision from the government. These MOIs do not benefit from peer monitoring or community oversight. In fact, they may look more like banks than like community-owned institutions.

The two extremes—small "cash-out" groups and large representative MOIs—appear to have the strongest forms of governance and accountability. The other types of MOIs have control challenges as they operate in the murky area between simple, informal norms and complex institutional rules. Table 2 presents key lessons from various cases.

Table 2: Key lessons on governance suggested by the MOIs studied

Country	Institution type	Key features and lessons
Niger	Village savings and loan associations (VSLA)	At the level of individual VSLAs, the simplicity of "witness-style" governance by all members and annual disbursal of the groups' funds enable effective control. However, due to the lack of strong collective ownership, governance, and internal capacity, the VSLA network creates more challenges than benefits.
India (Andhra Pradesh)	Self-help groups (SHG) federated into mutually aided cooperative societies (MACS)	Individual SHGs have effective governance mechanisms. The federation has clearly articulated functions and capacity building plan, yet poses a governance challenge by overlapping with governance structures of individual and networked SHGs and supporting NGOs, which leads to disempowerment of primary groups.
India (West Bengal)	SHGs linked to primary agricultural cooperative societies (PACS)	The growing influence of external capital through bank linkages dilutes the group members' sense of ownership and trust, leading to their progressive disengagement from governance.
Indonesia	Village credit institutions (Lembaga perkreditan desas, or LPD)	The governance of LPDs is intimately tied to the customary traditions, which ensures management discipline, as well as high member accountability to the MOI. At the same time, this restricts the ability of rank-and-file members to hold the leadership (made up of the village elite) accountable.
Cameroon	Community growth mutual funds (Mutuelles communautaires de croissance, or MC2)	Flexibility in the MC2 network, where each MC2 is allowed to determine locally things like daily reporting and collateral requirements, contributes to effective governance, as does reliance on traditional structures such as *tontines* (informal savings and loan groups affiliated with local agricultural and women's associations).
Mexico	Federated savings and credit cooperative (SACCO) with an urban and rural presence	Mexico's policy and regulatory regime have encouraged consolidation of MOIs. Mergers tend to weaken the self-governance capacity of smaller remote SACCOs. On the other hand, the federation's scale has provided important efficiencies.
Ecuador	Large predominantly rural cooperative	By combining the advantages of self-managed local offices with the strengths of centralized direction of policy and access to a large and growing range of services, this MOI demonstrates that economies of scale and increased sophistication may enhance both the product range and remote outreach.

Highlights from the Case Studies

To get a substantive understanding of what good governance means across various types of MOIs, the study examined seven institutional cases from the perspective of base-tier groups and their members. Four questions were used to direct this work:

- What matters in good governance design for MOIs in remote areas?
- What is the role of member participation in good member governance?
- What other control and accountability mechanisms may be necessary?
- What factors affect members' perception of ownership?

The highlights of the study are presented below.

Members' Trust and Sense of Ownership Are Strongly Linked to Savings and Returns

Members are more likely to safeguard their own money than external capital such as donated or government funds. A high proportion of external capital and subsidy (relative to members' own capital) poses a threat to governance, creating conditions when non-members, particularly borrowers, may dominate. Members' sense of ownership is also directly proportional to how confident they feel about having ready access to their capital, the safety of their funds, and reasonable returns or profits for their families or their community.

All the case studies demonstrated that ownership for ownership's sake is not enough. When primary group members felt there was no clear link between their savings and returns they were receiving from their second-tier associations, they would not hesitate to go to other financial institutions looking for a better deal.

Linking member-owned groups to financial institutions has strong potential to expand rural outreach. The trade-off, however, is that external credit and subsidy associated with linkage programs can also lessen members' sense of ownership and MOI performance. A high level of subsidy gives members an impression that they need not pay back. For example, some members of SHGs linked to cooperatives in India claimed that the cooperatives could manage without their money. They described the cooperative as having many clients outside of the SHGs (even though their deposits comprised 75% of its capital). They also viewed the cooperative loans as government money: "We did not know it was our own money."

High mobilization of savings (relative to other sources of funds) and growth of savings are clear signs of trust by members. For example, Jardín Azuayo in Ecuador, one of the strongest MOIs among those examined in terms of governance, witnessed a 54% growth in total voluntary deposits and a 77% growth in term deposits from 2005 to 2006. The Balinese LPDs, which represented one of the weakest cases in terms of governance, saw a decrease of voluntary deposits by 95% during the same period. Members of the decentralized SHGs in India and VSLAs in Niger preferred to save at the group level, feeling that it was safer than to rely on higher-level associations.

The cases examined also point to the importance of balancing contributions of member capital so that certain members or member groups do not dominate decision-making because of the relative size of their contributions. For example, the MC2s in Cameroon had difficulties with certain members dominating loan access, which is hardly surprising given that members of the village elite typically contribute over 55% of the share equity in these MOIs.

Different Types of MOIs Present Different Governance Approaches and Challenges

Small autonomous groups prove capable of maintaining strong governance by using simple processes that enable members to "bear witness." In these time-bound groups, members are both principals and agents, responsible for the management as well as the governance of the MOI. Members maintain control through direct witnessing of transactions and cash-out to control balances. Every meeting is essentially an audit. The viability of these groups demonstrates that governance in small MOIs may be better served by relying on simple oral systems that are transparent rather than by making traditional systems more complex.

In groups and associations that are networked or linked to other financial institutions, governance becomes more challenging. As decisions move toward representation in higher-level MOIs or management, member oversight becomes more difficult and members' sense of ownership more diffuse. Two-tier MOIs have two overlapping governance systems, one at the level of primary groups and another at the second-tier level. Particularly when the second-tier MOI collects savings from the primary groups, the financial intermediation role warrants strong member oversight. Largely self-regulated or weakly supervised systems, such as federated SHGs in India, do not prove adequate.

Linkages and networks can affect governance differently. For example, some linkages in India allow groups to maintain a certain degree of governance at the base tier, keeping group-level transactions relatively simple. By contrast, the leaders of networked SHGs are required to handle complex liquidity arrangements and financial management. Increasingly, SHGs in India are expected to provide more and clearer reporting through the National Bank for Agricultural and Rural Development. The ever-growing complexity threatens the ability of base-tier groups to keep their own records or to supervise others in keeping them.

The risk of "over-sophisticating" the system to a point when it no longer suits the capacity of members is by no means unique to India. In Niger, for example, there is some movement within the VSLA network to simplify bookkeeping and transactions in order to improve member awareness of financial affairs, reduce complexity, and increase transparency. There is a debate going on among those who promote VSLAs about whether to do away with the ledger and to replace it with passbook record-keeping only. Apparently, getting rid of the ledger would make things more convenient for VSLA members. However, it may also reduce their ability to make linkages in the future. This debate reveals the tension between keeping VSLAs simple, time-bound, and member-controlled and allowing or encouraging networking and linkages.

In Niger, Cameroon, and India, it is envisioned that member-owned financial networks will eventually become self-sufficient. In practice, however, higher-level MOIs often become dependent on subsidy, enjoying an almost monopolistic position of on-lending to their associations. Some sub-district-level cooperatives in India have graduated to self-sufficiency and are linked to commercial banks, but these MOIs are situated in urban areas where banks can monitor them. In rural areas, MOI networks, even when they are the only option, compete for the internal capital of their group members. Perhaps the main case to be made for networks lies in the social gains that they can provide, such as in the regions where Dalit[1] women's groups are federated. By establishing their own organization, Dalit women have not only gained access to financial services that were previously unavailable to them, but also created concrete opportunities for themselves to take on leadership roles within that organization.

Community-based models grafted onto local governance structures present a specific blend of gains and challenges. Grafting their governance and management onto local customary institutions may help these MOIs achieve broad outreach and sustainability. However, community-based MOIs are particularly affected by local power structures. For example, in both the Indonesia and Cameroon cases, where financial institutions (LPDs and MC2s, respectively) make strong use of the local governance systems, they are dominated by local male leaders. These power structures are reinforced by socio-cultural structures that may be exacerbated by policies, as in Bali, where loans are secured by land, which most women do not own.

Community-based MOIs rely heavily on traditional forms of social control. In both Indonesia and Cameroon, the governance of the MOI is intimately tied to the customary traditions of the local council, village elites, and elders. In Cameroon, the boards of elders play an important role in the MC2s, helping ensure member repayment in part by employing social sanctions (which include with-

[1] The term Dalit, which means "crushed," has been adopted across South Asia by caste-affected people formerly known as "untouchables" to refer to themselves.

drawal of land rights). In Indonesia, the customary council is the actual owner of the LPD. The local customary law, or *awig-awig*, determines the code of conduct in financial and cultural matters. The names of borrowers who are late in repayment are posted at the village council. Failure to comply with the code can result in banishment from the community or loss of the right to be buried within its boundaries. Harsh as these rules may seem, they are accepted and respected by community members and, in fact, represent effective mechanisms against credit risk—as demonstrated by LPDs' strong repayment records.

While customary governance and norms prove very effective for credit risk, Balinese LPDs do not have any mechanisms to effectively monitor the customary council and hold it accountable. The MC2s in Cameroon present an example of how this can be done. Village and urban elites play a significant role in these institutions, from initial mobilization and capitalization through to everyday governance, management, and control. Elites currently own over 55% of the MC2s' share equity. Undoubtedly they have tapped an important source of funds for rural areas. On the other hand, they also feel ownership with their stakes, and there were incidents of elite dominance and mismanagement in the MC2s. In these cases, mismanagement could be halted by the chief elders who have the right to remove a member of the MC2 executive board if necessary. So, one elite group held another accountable. It is hardly surprising that some MC2 members said that they trusted their traditional leaders more than professional management.

This example hints that corporate governance can, at best, be used to complement elite domination in community-based MOIs, but is highly unlikely to replace traditional structures (at least in the short term). In remote areas, particularly at the village level where cultural identities are strong, these structures are the default. Local governance solutions must be based on a clear understanding of how conventional norms and institutional rules function, without overestimating what corporate governance can do.

Large representative MOIs are able to effectively combine internal controls with external regulation and supervision. In large sophisticated networks or cooperatives, such as Mixtlan in Mexico, Jardín Azuayo in Ecuador, and the MC2 network in Cameroon, where elected representatives of the members oversee paid managers, peer monitoring is no longer effective or possible at all.

Where members can no longer witness, there must be opportunities for them to act as watchdogs. The general meeting is the most common forum for member accountability in large MOIs. However, it is a cumbersome governance tool, especially in rural areas. Remote-dwelling members often identified the time away from work and transport involved in attending meetings as costly. As the study found, decentralized governance structures provided effective alternatives to annual general meetings.

Jardín Azuayo is a case in point. While its average rural office size exceeds 3,000 members, it has a system of local assemblies that provide opportunities for members from remote areas to meet more frequently in smaller, more manageable forums. Before the local assemblies were initiated, meeting attendance could be as low as 10%. After they were set in operation, participation immediately rose by over 30%, eventually reaching 90% or more. Jardín Azuayo also encourages member turnout by providing service incentives. For example, the length of term for loans is tied to the number of months' savings. Those members that did not attend the last meeting are required to save for an extra month.

In addition to that, Jardín Azuayo has created local governance structures parallel to the management structure of the overall cooperative. Neighbourhood and parish councils meet regularly and feed into loan and audit committees at the local office level as well as provide representation for the general assembly. This solution relies on small control bodies that are more accessible geographically as well as linguistically, since they tend to discuss issues in plain non-technical language.

Large MOIs do not rely on member oversight only. They have information systems advanced enough to both detect problems internally and allow external controls to hold the internal operations in check.

For example, both Mixtlan and Jardín Azuayo use PEARLS[2] as well as internal and external audits. Further control mechanisms of these MOIs include self-regulation by the Federation and the National Banking Security Commission (Mixtlan) and external prudential supervision (Jardín Azuayo).

Tension between Member Oversight and the Need for Standardization

The type of control an MOI requires depends on the level of sophistication of its products and systems. Remote rural areas demand a certain amount of flexibility at the local level—for example, the freedom to accept traditional forms of collateral. However, larger MOIs with a more diverse product range, even networked associations, require a certain amount of standardization in order to permit adequate oversight and control. This is the core tension in finding the right mechanisms and structure for governance: flexibility vs. control.

The first trigger for internal control is accumulation of funds. When earnings are not cashed out, associations start to accumulate their internal funds and must handle varied payments and disbursements. This requires more sophisticated internal control mechanisms. Aggregation or standardization is another key trigger. While decentralization may be important for flexibility and tailoring to local needs, some level of standardization is essential for control of risks and for safety. Controls are as important for internal management as they are to be credit-worthy for a linkage, to be able to be regulated, or to be rated by an external agency.

Members' Sense of Ownership and Community Benefits

As noted earlier, ownership was not a value for members in its own right if financial services provided by their MOI were not competitive or flexible enough. At the same time, the case studies clearly indicated that perception of ownership was not limited to the right economic incentives. Members also felt a strong sense of ownership when the MOI was situated in the community and benefited the community socially.

Two of the countries considered in the study—Ecuador and Cameroon—had strong policies that encouraged reinvesting excess liquidity in the local rural community rather than siphoning it up to higher-level institutions or investing in urban areas. Similar conventional norms were reported in Indonesia, where LPD members determine together how to spend the 20% of the profits that are dedicated to village development.

Overall, commitment to the broad-based well-being of local communities is a common feature across various MOIs. For example, the MC2s provide their members (most of whom do not have a direct access to markets owing to their remote location) with fertilizers, chemicals, and seeds that are purchased at wholesale prices in the cities. MC2 members also noted that important community facilities, such as warehouses, would not be possible without these institutions. Jardín Azuayo operates an active education program that includes links and scholarships to a local university. In Niger, elders observed that the grain banks had improved food security in the areas where the VSLAs were operating.

Conclusions

- Members feel greater ownership when the capital belongs to them and when they perceive that their money comes back to them. They are more likely to save and increase their savings when the services provided by the MOI are competitive and flexible. Members' sense of ownership is also strongly linked to non-financial returns such as community or social investments.
- Both the most simple and the most complex MOIs are capable of designing and maintaining strong governance mechanisms. Small informal or semi-formal associations can use cashing-out, oral recitation of rules, and member witness as

[2] PEARLS is a financial database designed by the World Council of Credit Unions to help cooperatives monitor financial trends and improve their performance. Its name comes from "**P**rotection, **E**ffective financial structure, **A**sset quality, **R**ates of return and costs, **L**iquidity, and **S**igns of growth."

effective control mechanisms. The more sophisticated networks or cooperatives can effectively combine internal controls with external regulation and supervision including audits.

- Linkages may not present too many governance challenges provided that the gains they provide outweigh the costs in terms of lost liquidity, flexibility, and oversight. Networking, however, becomes more challenging if the second-tier institution plays a financial intermediation role. With two overlapping governance structures, the system can become too sophisticated for members to provide adequate oversight yet may not be standardized enough for external regulation.
- Those MOIs that rely deeply on local customary institutions face a special governance challenge. While grafting onto the local governance structure enables MOIs to make good use of social capital and local leadership, it also puts them under the threat of being dominated by local elites. Other mechanisms may be required to hold these systems in check.
- As MOIs begin to accumulate, their transactions become more complex and member oversight more challenging. As MOIs grow larger or network and become more sophisticated, creative mechanisms for keeping members engaged are required, such as decentralized forums and training. The key is to keep some form of decentralization while ensuring enough standardization for control. The success of the larger MOIs depends on whether they can implement information systems and internal control mechanisms that facilitate external supervision.
- The fundamental lesson for good governance of MOIs is that governance systems should be tailored to the type and size of particular institutions. In the case of small MOIs, it is best to keep the governance at such a level of simplicity that it can be managed by members themselves. Large MOIs may require sophisticated information systems allowing adequate external regulation and supervision to complement internal controls. Medium-sized MOIs, especially village-based and networked associations, face the risk of becoming too complicated for members to maintain adequate oversight themselves (due to overlapping governance structures) while at the same time failing to attain a level of standardization necessary for external regulation. Besides, these institutions are particularly prone to domination by local elites. Therefore, good governance of medium-sized MOIs demands harmonizing member oversight and external control in order to maintain an appropriate degree of flexibility as well as to take advantage of economies of scale that their size allows.

As a general rule, ***good governance of any MOI, no matter how small or large, requires a careful balancing of precarious tensions: perceived ownership and legal structure; member oversight and external regulation; local conventions and institutional rules; flexibility and control.***

This focus note is an abridged version of the thematic paper “Savings and spider plants: What is good governance for member-owned institutions in remote areas?” by Nanci Lee. The original paper and other documents produced within the framework of the “Reaching the Hard to Reach” study are available on the Coady Institute’s website at <http://coady.stfx.ca/moi/>.

This abridged version has been produced by the editorial team at the Coady Institute.

COADY INTERNATIONAL INSTITUTE

St. Francis Xavier University | PO Box 5000 | Antigonish, NS | Canada B2G 2W5 | www.coady.stfx.ca

with funding by FORD FOUNDATION

March 2011