Supervision of Savings and Credit Cooperative Societies (SACCOs)

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WHY ARE SACCOs IMPORTANT?

SACCOs matter because they offer a model of financial intermediation and outreach that can mobilize local savings and offer loans with low information costs, low enforcement costs, low operating costs, and most importantly wide a wide outreach to the low income individuals in both urban and rural areas. They also contribute to building social capital and providing opportunities for effective collective action. By mobilizing local savings through mutual trust, local knowledge, inexpensive human resources, and social networks within communities, cooperatives use the assets of the poor that otherwise remain unutilized. The non-profit orientation of SACCOs are important because they aim at providing affordable financial services such as savings accounts and or loans and it is service and not profit that drives them.

However, problems relating to member incentives, poor business strategy and management skills, weak governance, limited access to basic infrastructure, high illiteracy, high morbidity and mortality, limited market opportunities, seasonality of production and climatic factors, lack of livelihood diversification, absence of linkages to other financial institutions, and the limited availability of advice and supervision have posed major challenges to their development. These challenges are constant threats to their reliability, financial sustainability and growth and can therefore undermine their potential impact.

REGULATION AND SUPERVISION OF SACCOs

External supervision is especially important for member-owned financial institutions such as the SACCOs because of the dual nature of member incentives affecting institutional governance of such institutions. In a stockholder-owned financial institution such as a commercial bank, there is usually a single incentive, i.e. returns to investment in the form of dividends and share price appreciation. Such institutions are governed by a single set of values and are often controlled by concentrated ownership stakes making governance a straightforward issue of accountability and profitability.

In member owned financial institutions, on the other hand, returns on shares have never been a motivating factor while the primary incentives can vary depending upon the value of financial services perceived by members, i.e. whether the member is a net-debtor or a net borrower. A net-debtor would try to promote cheaper interest rates on loans, more flexible repayments and less emphasis on loan collection. The net savers, on the other hand, would wish to see conservative and prudent lending practices, high returns on savings and easy loan terms. This duality of incentives is the principal cause of governance problems in member-owned financial institutions.

Moreover, members are often poorly informed and lack the incentives for effective monitoring and participation. External supervision is essential to detect and prevent unsound practices and fraud. SACCOs can grow at a fast rate and may manage substantial volumes of public deposits. Bank supervision departments can use their internal regulatory synergies to adapt their supervision experience to the needs of smaller member-owned financial institutions at relatively low costs. Prudential regulation within the existing superintendencies such as the central banks, subject to a good understanding of the internal incentives, operational structures, and member-owned governance systems usually offer the best institutional arrangement for undertaking supervision for SACCOs.

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1. See Jeffrey Poyo, “Regulation and Supervision of Credit Unions”, Safe Money, Edited by G. Westley and B. Branch, IDB, 2000 for a more detailed discussion of these issues.
RISK CHARACTERISTICS OF SACCOs

It is important to understand the principal risk characteristics of SACCOs are similar to those of commercial banks although with different degrees. The principal risk areas are:

- **Fraud and malfeasance** - This is likely to be a more recurring risk during the formative stages of SACCOs since the board and managers are still not used to rigorous external supervision. Fraud arises from many sources but especially from manual accounting manipulation of entries such as ghost savings withdrawals or not crediting customers who back their loans and pocketing the money.

- **Interest rates** - This risk arises when SACCOs engage in mobilizing highly interest sensitive short-term deposits by raising their rates on savings accounts. They may also raise rates because of competition with banks. Meanwhile, the loans are issued out on fixed rates. As the spread between the two rates narrows, so does profitability.

- **Credit risk** - This is the risk arising from loan delinquency arising from the borrower’s unwillingness or inability to pay. The risk is particularly serious if the loan security is insufficient or adequate to cover the outstanding amounts.

- **Borrowing risks** - SACCOs are sometimes used to channel targeted credit programs. External debt may encourage the domination of net borrowers with adverse consequences for governance. Commercial borrowing should also be limited to amounts that are within the repayment capacity of the cooperative banks and would not distort their costs and income.

- **Capital adequacy** - SACCOs must ensure an adequate solvency ratio of capital to risk-weighted assets. This should be higher than the level for commercial banks because of lower diversification and more problematic governance structure.

- **Liquidity** - Risk of a temporary cash flow problem because assets can only be liquidated at a large discount. SACCOs often face liquidity problems because they don’t have access to a lender of last resort facility such as the Reserve Bank as do commercial bank. Even central financing facilities may have insufficient funds to meet systemic liquidity needs of the members. Risks arising from liquidity shortage have been a major cause of failure of many financial cooperatives.

- **Insider loans** - The risk arises when board of directors take advantage of their insider connections and privileged information and issue loans to themselves or their friends and relatives. Insider loans are a common phenomenon especially in small communities where social ties can override professionalism in management.

- **Portfolio Diversification** - The limited geographic spread of loan portfolios can present a significant operating risk. Prudential norms must address not only concentration of loans extended to individuals but also to sectors and areas. The definition of common bond within the SACCOs may need to be revisited to enable them to diversify their risks over a larger geographic area.

A number of financial ratios such as CAMEL or a modified version known as PEARLS developed by WOCCU are available to help SACCOs and their supervising agencies to better monitor key risk areas.  

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