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The Role of Credit Cooperatives in Rural Russia

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Abstract

In this paper we discuss the potential role of credit cooperatives for the development of a more viable rural financial market in rural Russia. After Russia’s financial crisis many commercial banks have closed their rural branches. While the newly emerged large scale agro-holdings are able to get credit from commercial banks, small and medium sized farms and other enterprises in rural Russia are faced with a shortage of credit. We discuss why Russia’s rural financial market is faced by many market failures and point out the specific advantages credit cooperatives may have in overcoming these problems. Further, the paper describes how the institutional basis for the establishment of rural credit cooperatives has developed in Russia over the last decade and highlights some important shortcomings. The paper concludes with some policy options for furthering the establishment of rural credit cooperatives.

Keywords: Micro-finance, credit cooperatives, Russia

JEL classification: G21, Q14
The role of credit cooperatives in rural Russia

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1 Introduction

Rural credit can be a powerful tool to foster agricultural and rural development when it is made available to a) efficient and productive farmers and b) for efficiency enhancing investments. However, reaching these farmers and identifying the best investment opportunities in rural economies, is not easy. In Russia, the task of building an efficient rural financial sector has been particularly difficult because of various distortions inherited from the former socialist system. Additionally, the transition of Russia’s agricultural sector has been particularly slow and therefore it is still typified by various structural features which make the development of a market-oriented rural financial sector difficult. Hence, many Russian farms suffer from a lack of access to credit which constrains their potential to grow, to increase efficiency and to contribute to a vibrant rural economy.

Microfinance institutions, such as savings and credit cooperatives, have demonstrated considerable success throughout the industrialised and developing world in increasing small and medium enterprises’ access to credit in rural areas. In Russia, a number of different microfinance institutions have emerged since the mid 1990s that address the credit needs of farms and other small and medium sized businesses in rural areas. In this paper, we argue that the rural credit cooperative is one such institution that has particular advantages for overcoming some of the difficulties encountered in Russia’s rural financial system. In fact, the Russian government is currently drafting legislation that will provide a new legal basis for the operation of rural credit cooperatives. We ask to what extent this proposed legislation provides an adequate and improved institutional framework for the establishment of efficient rural credit cooperatives.

The paper is structured as follows. In part 2 we briefly summarize why the design of an efficient rural credit system in general, and in Russia in particular, is a difficult task. Next, in part 3, we outline the specific advantages rural credit cooperatives have in delivering services to farmers and other rural businesses. The status of the rural credit cooperative sector in Russia and the new legislation under discussion is described in part 4, along with the challenges faced by the sector. The paper concludes with some policy options for the further development of rural credit cooperatives in part 5.

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2 Russia’s rural financial sector

2.1 Characteristics of rural finance

Developing an efficient rural financial sector in Russia is particularly difficult because of a) inherent difficulties in the development of financial institutions in rural areas, and b) transition specific factors that aggravate these problems.

The imperfections of agricultural credit markets include:

- **Asymmetric information** - Generally, any lending bank is confronted with the problem of insufficient information about the borrower’s economic situation, and his willingness and potential to pay back the loan. In the agricultural sector the identification of those borrowers who are most likely to repay can be particularly difficult because of structural deficiencies that are typical for agriculture in many countries: in most countries there is a relatively high number of farms, many of which are small and often characterized by low productivity. Therefore, financial intermediation in rural economies is generally confronted with relatively high transaction costs.

- Lending to farmers can be associated with substantial covariate risks. Farmers of one region normally face similar natural risks (e.g. drought and other climatic conditions) and tend to have an extreme seasonal pattern of revenues.

- Furthermore, the assets offered by farms as collateral are often too specific to constitute a safe form of loan security for commercial banks. For instance, in the case of loan default commercial banks could encounter substantial difficulties in realising the projected market value of agricultural land, agricultural machines and livestock given as loan security. Russia’s new land code, which became effective in summer 2002, is an important step forward in enabling land to be potentially used as collateral to secure loans (Serova 2002). However, the low value of land continues to limit the role of land as collateral. Considering the high collateral requirements of banks in Russia (normally between 150-160% of the value of the loan) providing sufficient securities for a loan remains problematic.

The transition specific factors inhibiting the development of efficient rural financial markets in Russia are:
Incomplete restructuring of agricultural farms resulting in low farm productivity, which has been a serious problem in Russia since 1992. Restructuring of the former collective farms was more passive than active (Sedik et al. 2000). Active restructuring would have been associated with more market oriented financial management of farm operations. Prior to the financial crisis in 1998 about 80% of large scale agricultural enterprises were unproductive (Tillack and Schulze, 2000). After the financial crisis the share of unprofitable large-scale farms declined to below 50% and today is still high. A notable exception are the new agro-holdings which, due to their size and commercial orientation have had higher levels of productivity and therefore have had better access to commercial credit, at least during the past three years.

The tendency of Russian borrowers in general, and farm borrowers in particular, to view debt repayment as optional (cf. Tompson, 2000). Under central planning, loans were allocated to state and collective farms according to credit plans and little importance was placed on loan repayment (Ianbykh, 1999). The repayment of loans was very poor leading to regular debt rescheduling and write offs. The prevailing soft budget constraints meant that lack of loan repayment was sanctioned and heavily indebted farms continued to have loans allocated to them. Introducing the custom of timely and full loan repayment is thus difficult.

Finally, it needs to be acknowledged that agricultural credit is neither independent from the general financial system nor from macro-economic developments. Because of efforts to stabilize the macro-economy nominal interest rates during the transition period have been continuously higher than in western economies. Even after the financial crisis, when inflationary pressure was reduced significantly, nominal interest rates remain high. Currently (in mid-2003), interest rates for farm credits in Russia are said to be at about 21%. Such comparatively high nominal interest rates may act as a psychological barrier to credit demand, with efficient farmers taking on less credit than they would do under more stable economic conditions. Although the high interest rates did not seem to limit the demand for farm credit at the time of writing, as shown by the large unsatisfied legitimate demand for credit, they may do so in the future.

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1 This is often referred to as a problem of asymmetric information and does not only apply to agricultural credit transactions.

2 Anecdotal evidence from rural credit cooperatives in a backward region 300km north of Moscow indicates that the level of legitimate but, due to lack of refinancing, unsatisfied demand for farm credit was substantial (RCCDF, 2003a).
The above factors all actively contribute to inhibiting the development of efficient rural financial markets in Russia. The result is a lack of access to credit for many rural enterprises, including efficient and productive farms. This in turn has led to demands for government intervention in Russia’s rural credit markets.

2.2 The role of the government in rural financial markets
Against this background, the role of the government should be to reduce market distortions in Russia’s rural credit markets. Indeed, during the past decade the federal government and regional governments have implemented a number of different policies directed at rural credit markets. These have tended to focus almost exclusively on large-scale agricultural enterprises and prominent measures include subsidized short-term credit programmes, the provision of loan guarantees for banks specializing in rural credit operations, and, most recently, an interest rate subsidy programme for capital investments in agriculture. Government intervention in addressing the credit needs of small and medium enterprises has been most notable for its absence.

Any evaluation of government intervention in rural credit markets has to ask several questions (see also Swinnen and Gow 1999):

- To what extent do they reduce the market distortions mentioned in the previous section?
- Do the respective policies address the causes or only the symptoms of the problem?
- Are the policies designed to have a short or a long-term impact?
- Are subsidies or incentives granted which may affect the decision of unprofitable farms to stay in operation?
- Are the specific policies consistent with the long-run objective to develop a viable, efficient and self-independent rural financial system?

An evaluation of Russia’s now discontinued subsidized credit program along these lines highlights some of the problems inherent to direct government intervention in rural credit markets. From 1992 to 2000, one of the major agricultural policy instruments used in Russia was subsidized farm credit. Such credits were available for large-scale agricultural enterprises only (Ianbykh, 1999). Often, the major factor for the allocation of available funds was to keep the former collective farms operational and to maintain their social functions in the rural economies.

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3 The problem does not seem to be one of too high farm indebtedness. Relative farm indebtedness of Russian large-scale enterprises (as measured in an equivalent value of grain per ha) was 13 times smaller than average indebtedness in Germany (von Cramon-Taubadel and Zorya, 2003).
In contrast, economic efficiency considerations played at most a secondary role. Furthermore, the subsidized agricultural credits were channelled to a large share of the large-scale farms with insufficient attention paid to the efficiency and/or productivity of the individual farms. In addition, such credits were frequently granted not for investment purposes, but to finance short run obligations such as the purchase of inputs. Hence, credit subsidies addressed short run and non-economic concerns such as social issues rather than long-term objectives. And they failed to realise the goal of developing a viable and efficient rural financial sector. In contrast, subsidized credit for longer-term investment plans would have the potential at least to foster productivity of the respective farms.

The consequences for this failure have been most severe for small and medium rural enterprises as these were excluded from most government-supported credit policies, including the subsidised credit policy described above. Small and medium sized rural enterprises have generally had to rely on commercial bank credits, personal loans or their own savings for any investments. The closure of many rural banks’ branches (e.g. of the former state-owned Agroprom Bank) coupled with the reluctance of commercial banks to lend to small enterprises, aggravated the lack of access to credit for the rural small and medium enterprise sector. In addition, access in terms of distance deteriorated in the aftermath of the 1998 financial crisis. For example, in Volgograd oblast every raion centre had an Sberbank and an Agropombank branch in 1998. Since then many of these local branches have been closed and average distance to a bank branch in the rural areas of the oblast have increased to 100km. Such large distances considerably constrain access to banking services.

This limited access to credit of small and medium rural enterprises is increasingly being recognised as a problem by policy-makers in Russia and the international donor community. The success of microfinance initiatives, such as the municipal rural development support fund set up in Lodeynoye Pole with the assistance of Rosagrofond, has highlighted both rural people’s need for credit and their ability to meet loan repayments (see Ianbykh, 2001). Thus, even some commercial banks are beginning to show interest in reconsidering their attitude to medium-sized rural enterprises. Rosselkhozbank, for example, is currently embarking on an experiment to extend loans to rural households (Avis, 2001). Nevertheless, given the planned scope of the experiment (1000 credits) and the problems of collateral provision it seems likely that commercial bank credits to small and medium-sized rural enterprises will continue to be the exception rather than the rule. Alternative forms of rural financial intermediation are thus required to ensure a competitive and market-driven rural financial sector.
3. The role of credit cooperatives in improving access to credit in rural areas

3.1 Basic principles guiding savings and credit cooperatives

Since the mid 19th century, cooperatives have been an important form of enterprise. Today, more than 80 thousand enterprises in the European Union are run as cooperatives. There are a number of different forms of cooperatives, including production, consumption and marketing cooperatives. Savings and credit cooperatives (hereafter credit cooperatives) have proven to be successful in improving rural people’s access to credit throughout the industrialised and developing world. They can be defined as mutual self-help organisations that serve the financial needs of their members. Thus, credit cooperatives are comprised of individuals who voluntarily join a social group or association to form a cooperative society. At the same time, the cooperative presents a business unit that intends to make profits and which has to be registered to participate in economic life. Hence, credit cooperatives have a dual nature. On the one hand, they are profit orientated but on the other, they are self-help organisations. Today, credit cooperatives are generally classified as financial institutions and thus come under the jurisdiction of the Banking Law.

More specifically, savings and credit cooperatives, like the cooperative movement in general, are guided by three major principles (cf. Pabst, 2001):

1. self-help,
2. self-governance, and
3. personal responsibility.

_**Self-help** describes the fact that a group of people join forces in order to reach their economic objectives. To this end they are prepared to raise the necessary financial means or mandatory venture capital for starting the cooperative’s operations. _**Self-governance** implies that by and large it is the members who are jointly responsible for the management of their cooperative⁴. Furthermore, internal democracy is secured by the application of the principle ‘one member – one vote’, which is a very different decision rule to that used by stock companies for example, where the capital share of individual owners determines their share of votes. The principle of _**personal responsibility** implies that the members themselves are responsible and liable for

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⁴ However, in the course of economic development it becomes more and more common for credit cooperatives to hire non-members for management positions, in order to benefit from the highly specialized know-how of well-trained bankers.
maintaining and developing the cooperative enterprise with respect to business partners in order to establish confidence in the economic life of the cooperative enterprise.

Closely related to these three principles is the principle of *regionalism*. This describes the fact that each individual cooperative has a decentralised organisational structure that leads to a more or less strict territorial localisation of a cooperative’s activities. This last principle is particularly pertinent to the success of savings and credit cooperatives. The precise geographical definition of the area of operation of an open savings and credit cooperative allows it to use informal but valuable information in the assessment of loan applicants and their collateral (Pabst, 2001).

The guiding principles mentioned above all help to reduce the problem of asymmetric information between the lender and the borrower. Consequently, rural credit cooperatives normally develop close relationships with their rural constituency. Such a close relationship fosters the creation of trust between lender and borrower, which facilitates the screening of loan applicants with respect to their solvency and collateral. Moreover, rural credit cooperatives normally have better information for the evaluation of the effective market value of agricultural assets, which improves their ability to deal with the problem of “collateral specificity” (see part 2.1).

These guiding principles of rural credit cooperatives thus effectively help to improve the rate of timely interest rate payments and loan repayment, and reduce the risk of credit default. This is especially the case for natural persons and micro and small enterprises that frequently cannot provide real security and completely reliable economic-financial information. Hence, rural credit cooperatives have a distinct advantage over banks in serving the credit needs of these types of borrowers.

### 3.2 Increasing access to credit in rural areas

Savings and credit cooperatives tend to focus their activities on natural persons and micro, small and medium enterprises in rural localities. These groups are often disadvantaged when applying for bank loans as the size of the loan may simply be too small to warrant the high screening costs incurred by the bank - they may have problems in establishing their creditworthiness - or the distance to the nearest bank may simply be too large to warrant the effort required. Credit
cooperatives increase access to credit for these groups through reducing two types of barriers to access:

1. geographical barriers, i.e. distance to a financial intermediary, and
2. transaction costs involved in a loan application.

The regional principle strictly limits the territory of operation of an individual credit cooperative, thereby ensuring that a credit cooperative is located in the same areas as its members. Thus, the regional principle results in the establishment of financial intermediaries in the very rural areas that they serve, substantially reducing travelling time and costs for loan applicants.

The reduction in transaction costs is also largely a product of the regional principle. Although credit risk appraisals conducted by credit cooperatives should not differ from the procedures employed by banks, in practice they do because credit cooperatives consider such things as the personal integrity of the loan applicant, something that commercial banks often cannot do (Wolz, 2001). Commercial banks tend to focus on the creditworthiness of the loan applicant and consider such factors as credit history and value of collateral. However, screening loan applicants in rural communities is costly, especially when the loan applicant does not have a credit history. The high risks involved in lending to someone without a credit history lead to high collateral requirements and an interest rate premium. Relative costs for screening also increase with a declining size of the loan. By substituting personal knowledge for credit history credit cooperatives may considerably reduce their screening costs.

If credit cooperatives are successful in using the above advantages to reduce their transaction costs they can offer lower interest rates to their customers. The decision to grant a credit is then taken on the basis of the prospective rate of return of the investment. Additionally, peer pressure by fellow members increases the likelihood that the borrower actually will repay the loan. In case of non-payment all members will be liable and will have to bear the losses (Armbruster, 1997). This mutual self-reliance is one decisive advantage credit cooperatives have over other forms of organizations involved in rural finance intermediation.

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5 In this paper access is defined as the opportunity to use a financial intermediary and is considered to be a function of both distance and economic factors. For a recent application of this definition of access in rural Russia’s public good markets see Lohlein (2003).
3.3 Prerequisites for the establishment of viable rural credit cooperatives

The experience of other transition economies and a number of developing countries has shown that it is not always easy to set up sound and viable credit cooperatives (see Wolz, 2001). In the transition economies a general distrust of the population in financial institutions, the negative association of the term cooperative with the socialist past, and the view that debt repayment is optional are legacies of the socialist period that impede the development of sustainable credit cooperatives.

One of the most important factors required to establish sound credit cooperatives is the ability of cooperatives to accumulate own funds. Generally, credit cooperatives have two means to achieve this. Firstly, own capital should be accumulated in the form of share capital and the savings of members. Secondly, credit cooperatives can obtain additional capital through refinancing via the national or international banking system. In this context the existence of organisations at the secondary and even tertiary level in the credit cooperative structure, that spread risk and channel funds between regions, becomes necessary. Such an organizational structure is also the best focal point for channelling outside funds into the system without giving members the impression that these funds are ‘easy money’ that does not have to be repaid (Wolz, 2001).

Another measure that contributes to the sustainability of credit cooperatives is a diversified membership structure. As mentioned above, substantial covariate risk is associated with lending within a homogenous group such as farmers (Ellis, 1996). For instance, if farmer “A” is not able to meet his repayment obligations on loans because poor weather conditions destroyed his yield, farmer “B” from the same region is likely to have the same difficulties. The credit cooperative, of which both farmers are members, consequently could suffer from a substantial capital shortfall due to the inability of a large number of borrowers to repay their loans on time. This covariate risk is reduced when the membership structure is more heterogeneous. Furthermore, heterogeneity of membership has the added advantage of reducing the effects of seasonality on lending, thus preventing investment capital from lying idle during particular seasons.

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6 There are a number of different legacies of the socialist period. Wiesmann and Wehrheim (2003) show how such legacies can be assessed quantitatively and discuss how they are likely to affect agricultural development in the transition countries.

7 Sound credit cooperative systems throughout the world generally have a multi-tier structure. The individual credit cooperatives that operate at the local level constitute the primary tier. To support these local cooperatives secondary organisations are founded at the regional level. These coordinate the activities of the individual cooperatives, share information and experience and provide external refinancing. In large countries such as Russia, secondary organisations together establish a tertiary organisation at the national level to support the secondary organisations.
Finally, it should be noted that rural credit cooperatives do not present a panacea to the problems associated with rural financial markets. However, as part of a diversified rural financial system they do increase access to credit for the rural population, especially for small and medium sized enterprises. Without economically healthy members credit cooperatives cannot grow and prosper. The requirement of rural credit cooperatives to be profitable means that they must deliver services at comparatively low costs, profitable interest rates must be charged and that only economically viable investments projects can be financed. Thus, they need members that have the capacity to save, and borrowers with sufficient productive opportunities to be able to afford to repay a loan in full. To this end, credit cooperatives must retain the right to refuse a loan application made by one of its members and membership must remain voluntary. That is, even though the guiding principles of credit cooperatives differ from those of commercial banks, their credit operations should be governed by the same economic principles as those of normal commercial banks.

4 Credit cooperatives in Russia, 1992-2002

4.1 Credit cooperatives – a traditional feature of Tsarist Russia
Credit cooperatives have a long history in Russia. The concept of credit cooperatives was introduced from Germany in the middle of the 19th century and quickly took hold in Russia. In 1883 some 981 credit cooperatives operated in Russia, by 1914 this figure had increased to 13,000 credit cooperatives with a total membership of 8 million (Foundation for the Support of Mutual Financial Organizations, 2003). Indeed, the development of the credit cooperative sector had been such that a secondary level organisation was deemed necessary, leading to the establishment of the Moskovskii Narodni Bank in 1911 (Pakhomov, 2003). Thus, by the time of the revolution Russia did not only have the largest credit cooperative sector in absolute terms, in the world, but it also had a multi-tier system.

4.2 Status of the rural credit cooperative sector today
In the transition process, rural credit cooperatives began to emerge again in Russia in the mid 1990s. Their development has been much slower than that of the credit unions, which are found almost exclusively in urban areas. Nevertheless, by mid 2003 there were more than 280 rural credit cooperatives operating in 66 regions in Russia. Of these, 205 are members of the Union of Rural Credit Cooperatives and the Rural Credit Cooperation Development Fund (RCCDF). The
Fund is arguably the most important organisation advancing the work of credit cooperatives in Russia today. It was founded in 1997 as a non-governmental non-commercial organisation to develop the financial sector in rural area, and effectively constitutes the third tier in the cooperative system in Russia. Its main tasks include the collection of financial resources and technical equipment for the support of rural credit cooperatives. The Fund also collects statistics from its members and much of the information presented below pertains only to those credit cooperatives that are members of the RCCDF.

Currently, only few of the rural savings and credit cooperatives are in fact savings and credit cooperatives, the vast majority only carry out credit transactions. For most credit cooperatives equity is thus limited to the capital share of the members. The size of the capital share varies considerably from region to region and cooperative to cooperative. In most instances the minimum size of the capital share is linked to the employment status of the member. For example, the minimum capital share in the case of pensioners is at least RUB 500, while a legal person (small company) may have to contribute at least RUB 12,000 (RCCDF, 2003a). Initially, on the first establishment of a rural credit cooperative, capital shares tend to be fairly small, as the members have to learn to trust each other. The longer a credit cooperative has been in existence the larger the minimum capital share becomes.

The few ‘savings’ and credit cooperatives that do exist, do not actually handle the saving activities of their members, as legally they are not allowed to do this. Instead, members tend to either lend money to the savings and credit cooperative itself, or members acquire additional shares in the cooperative. The latter can increase the likelihood of receiving a credit and/or influence the size of a credit. The fact that only few credit cooperatives acquire additional funds through these means can be attributed to their early stage of development. The first development stage of a credit cooperative is the actual foundation of a cooperative, which in Russia includes the gathering-in of compulsory capital shares, sometimes a one-off capital injection by the oblast authorities or a donor, and then entering into credit transactions. The second stage, at the earliest one-year after the successful foundation of the cooperative, involves refinancing of the credit cooperative, by the RCCDF for example. Only when cooperatives have passed through this stage into the third stage, does the development of ‘liabilities transactions’, such as lending by members to the cooperative, gain in importance. At the moment, many credit cooperatives in Russia are reaching the third development phase; hence there is a growing interest in development of the liabilities side of business.
The rural credit cooperative sector in Russia is still fairly small (see Box 1). Nonetheless, it has been very effective at increasing rural people’s access to credit. In Volgograd region alone, loans extended by rural credit cooperatives in 2002 totalled RUB 240 million, compared to RUB 20 million extended by commercial banks. Although Volgograd region is not typical of all Russian regions, it was one of the first regions to establish rural credit cooperatives and their development has received unprecedented political support by regional authorities. Developments there indicate that rural credit cooperatives are more effective than banks at serving the credit needs of the rural population. This is despite the fact that credit cooperatives follow standard banking procedures in loan disbursement; i.e. borrowers must provide securities of 150% of the value of the loan and they are charged a profitable interest rate of 28%.

Credit cooperatives’ success in improving access to credit stems from their ability to reduce geographical barriers and transaction costs (see section 3.2). In Russia, rural credit cooperatives serve only their members and the cooperatives have indeed proven that they reduce transaction costs in at least three ways:

1. substantially lowering the transport and opportunity costs involved in loan application by being located in rural areas (reducing geographical barriers),

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8 By comparison, in Perm more than RUB 20 million were disbursed in 2002 and in Yaroslav just over RUB 10 million (Medvedeva, 2003).

9 In other countries this restriction has become less stringent over time and today many rural credit cooperatives in western Europe offer a similar range of financial services to those offered by banks.
2. substituting credit history with informal personal knowledge of the loan applicant, thereby giving people with no credit history the opportunity to receive a loan,

3. taking a more flexible approach to the question of items considered suitable as collateral. In particular, farming equipment is accepted as loan security by rural credit cooperatives, as members can easily place a value on this. Commercial banks tend to be more circumspect and prefer other forms of securities such as cars.

Moreover, the interest rate charged by rural credit cooperatives compares favourably to interest rates charged by other financial institutions for loans of similar sizes. The most appropriate comparison is perhaps the KMB bank, as it specialises in extending loans to small and medium enterprises. Here, the interest rate for a 12-month loan of up to RUB 300,000 is 27-32%, and therefore may be slightly higher than the 28% charged by cooperatives for the same loan (KMB, 2003; RCCDF, 2003a). It must be stressed, however that for larger loans, commercial banks’ interest rates tend to be lower and normally are highly competitive. Indeed, for large loans, commercial banks tend to be the more efficient credit provider. Even when the rural credit cooperative sector is more firmly established in Russia the RCCDF envisages that commercial banks will continue to provide very large loans while the credit cooperatives will serve the slightly smaller credit needs of the rural population. Thus, credit cooperatives are complimentary to other banking activities in rural areas. Rather than being in competition with commercial banks, they may actually benefit them by familiarising the population with banking procedures.

4.3 Challenges to the development of the rural credit cooperative sector, 1992 - 2002

One of the reasons why the development and expansion of rural credit cooperatives has been relatively slow in Russia is the uncertain and restrictive legal basis for their operation. In Russia, only licensed banks and state and municipal development funds have a clear legal right to disburse credits and accept savings (Safavian et al, 2000). According to Russian legislation a bank is defined as a:

1. commercial organisation,

2. that regularly disburses credits, and

3. offers a service to the public.

However, according to the Russian Civil Code, a non-commercial organization may undertake profitable activities, as long as these are limited to serving the aims for which the organization
was founded (Safavian et al, 2000). Rural credit cooperatives in Russia have the status of non-commercial organizations that extend credits only to their members. This provides the legal foundation of their activities. The issue of savings is not covered in the Russian Civil Code; it is only addressed by the banking law, which relegates all savings activities to banks. Hence credit cooperatives are not allowed to become saving societies for their members.

This rather vague and narrow legislative basis for rural credit cooperative operations needs to be strengthened to allow the further development of rural credit cooperatives. To this end, a law on ‘Credit Cooperation’ has been proposed and, at the time of writing, it had passed its first Duma reading. This law would provide the framework of operation for all forms of credit cooperation, thereby providing the rural credit cooperative system with a better legal foundation for their further development (Medvedeva, 2003). The proposed law gives both natural and legal persons the right to be members of a credit cooperative and states that all members of a credit cooperative must be registered and given membership papers. This will contribute to the financial stability of the rural credit cooperatives. This financial stability will be further strengthened through the creation of reserve funds, which are also envisaged by the proposed law. The law on ‘Credit Cooperation’ includes the provision to form a multi-tier rural credit cooperative system and envisages supervision of rural credit cooperatives by a federal state body. The proposed law thus addresses many of the weaknesses currently inhibiting the further development of rural credit cooperatives. A major weakness is the fact that it does not grant credit cooperatives the right to enter the liabilities side of financial intermediation.

The legislative basis of rural credit cooperatives has also been strengthened by the law on ‘Rural Cooperatives’, which had just been signed into law by President Putin at the time of writing. This law, in parts, specifically addresses rural credit cooperatives and compliments the proposed law on ‘Credit Cooperation’. The law on ‘Rural Cooperatives’ gives rural credit cooperatives the right to extend loans to their members and levy interest rates on these loans. However, this law too does not address the issue of savings. Thus, even though this law has strengthened the legislative basis for the operation of rural credit cooperatives, rural credit cooperatives will continue to have strict limits of operations.

The inability to mobilize the savings of the rural population inhibits the organic growth of rural credit cooperatives. At present, the only way to increase the equity of individual rural credit cooperatives is through members lending to the credit cooperative itself or the purchase of additional members’ shares, but this does not cover the total capital needs of the credit cooperatives. Even the most successful and richest cooperatives, those located in Volgograd
oblast, currently only fund 40% of credits from their own capital (RCCDF, 2003b). The remainder comes from external refinancing. This external refinancing is not a substitute for a rural credit cooperative’s equity, but a complement to it: the two are highly positively correlated (see RCCDF, 2003b). External refinancing of rural credit cooperatives is thus highly important to the continued growth of the sector.

At present, the RCCDF is the major source of refinancing for rural credit cooperatives. The refinancing capital of the RCCDF in turn stems from external sources: the Russian-American Lending Programme (RAP) provided the seed capital for refinancing (USD 5.9 million). This capital is in turn lent on to individual rural credit cooperatives that have been accredited into the scheme. In 2002, some 46 individual credit cooperatives had benefited from the RAP (RCCDF, 2003a). The refinancing resources provided under the RAP, are however, proving to be insufficient for the refinancing needs of rural credit cooperatives. Despite the strict accreditation criteria of the RAP programme at least twice as many rural credit cooperatives were eligible for refinancing than actually benefited from the programme in 2002 (RCCDF, 2003a). In the entire RCCDF system, the legitimate demand for refinancing in 2002 was RUB 300 million, but owing to a lack of resources actual refinancing was only RUB 207 million, leaving an unsatisfied refinancing demand of RUB 93 million (RCCDF, 2003b). Additional sources of refinancing are thus needed, this could include refinancing from other international donors. In some regions, regional commercial banks are beginning to enter this market, covering some of the refinancing needs of the rural credit cooperatives. Ideally, the RCCDF would be expanded and institutionalised to become the third tier of a multi-tier rural credit cooperative system. Under such conditions the RCCDF or a similar national organisation would be able to raise refinancing capital from commercial and national banks as well as from international donors, thereby covering the refinancing needs of its members - the individual credit cooperatives.
5 Policy options for the development of sound and sustainable credit cooperatives

5.1 Limits to government intervention
Credit cooperatives are a tried and tested means of increasing access to credit in rural areas throughout the world. In particular, they improve the access of small-scale enterprises and individuals to credit, complementing the activities of standard commercial banks. In this paper, we have argued that credit cooperatives exhibit several features that allow them to overcome some of the inherent weaknesses of Russia’s rural credit markets. Moreover, by improving small enterprises access to credit, credit cooperatives actively foster private entrepreneurship in rural areas, which in turn contributes to a more vibrant and diversified rural economy.

The creation of such a vibrant rural economy is of prime interest for the state, as this reduces the costs of structural and social support programs otherwise needed for rural areas. Hence, the state should have an interest in establishing a sustainable credit cooperative system, but this task is neither simple nor one-dimensional. The state has a role to play, albeit a limited one. Experience from western countries has shown that direct state intervention in rural credit markets, e.g. through credit subsidies, are at best “second best policies”. Such interventions often fail to deliver the desired results and at the same time are expensive. Instead, “first best policies” would be those that help to reduce the market distortions typical for rural economies. State action is necessary, but should be limited to establishing and enforcing the “rules of the game”. The state itself should not seek to be a player in the game.

5.2 Appropriate policy options
In order to establish a sound rural credit cooperative sector in Russia that is part of an efficient rural financial system, state action in the following areas would be helpful:

a) reduce the manifold distortions in Russia’s rural markets, and
b) improve the institutional and legal framework of rural credit cooperatives.

More specifically, to enhance the possibilities for rural credit cooperatives and financial intermediaries to fully serve the needs of the rural economy, the following market distortions need to be addressed:

- The ability to mortgage land and use it as collateral.
The difficulties creditors face in realising collateral on loan default.

Transparency in rural financial intermediation

Increasing competitiveness in upstream and downstream industries

Creating a more stable macroeconomic and policy environment.

At the same time, specific action is required to improve the legal environment for the operations of rural credit cooperatives. The law on ‘Rural Cooperatives’ and the proposed law on ‘Credit Cooperation’ do much to strengthen the legislative basis of the operation of rural credit cooperatives and some of the following are indeed covered by them. To reiterate, short and long-term measures necessary to further the development of rural credit cooperatives include:

- Creation of an institutional framework for a multi-tier rural credit cooperative system. This should improve refinancing opportunities for rural credit cooperatives and spread risk.

- Introduction of a compulsory internal and external control system over credit cooperatives, which would further strengthen the financial integrity of the rural credit cooperatives.

- Establishment of an external supervisory body for rural credit cooperatives.

- Granting rural credit cooperatives the right to enter the liabilities sides of financial intermediation and therefore become savings and credit cooperatives.

- Inclusion of rural credit cooperatives in the banking law.
References


RCCDF (2003a) personal communication with Ludmilla Koslova and Nina Medvedeva of the Rural Credit Cooperative Development Fund, 10.06.2003.


