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SYNOPSIS OF [ESSP WORKING PAPER 100](#)

Synopsis: How should rural financial cooperatives be best organized? Evidence from Ethiopia

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What is the optimal size and composition of rural financial cooperatives (RFCs)? With this broad question in mind, we characterize alternative formations of RFCs and the implications of each in improving the access of rural households to financial services, including savings, credit, and insurance services. We find that some features of RFCs have varying implications for delivering various financial services. The size of RFCs is found to have a nonlinear relationship with the various financial services RFCs provide. We also show that compositional heterogeneity among members, including diversity in wealth, is associated with higher access to credit services, while this has limited effects on the savings behavior of members. Similarly, social cohesion among members is strongly associated with higher access to financial services. These empirical descriptions suggest that the optimal size and composition of RFCs may vary across the different domains of financial services that they are designed to facilitate. This evidence provides suggestive insights on how to ensure financial inclusion among smallholders, a priority among agricultural sector policy makers in developing countries, including Ethiopia. The results also provide some insights for the design of rural microfinance operations as they seek to satisfy members' demand for various financial services.

INTRODUCTION

Rural Financial Cooperatives (RFCs) are member-owned institutions that provide financial services to rural households. They are considered suitable instruments to promote self-financing among customers that conventional banks traditionally spurn. As members are simultaneously the owners and the users of the RFCs, the cooperatives capitalize on having better access to information about members' financial viability, as members have strong incentives to monitor one another. RFCs are particularly appealing in Ethiopia where rural financial services are lacking – only 22 percent of the population has access to formal financial services.

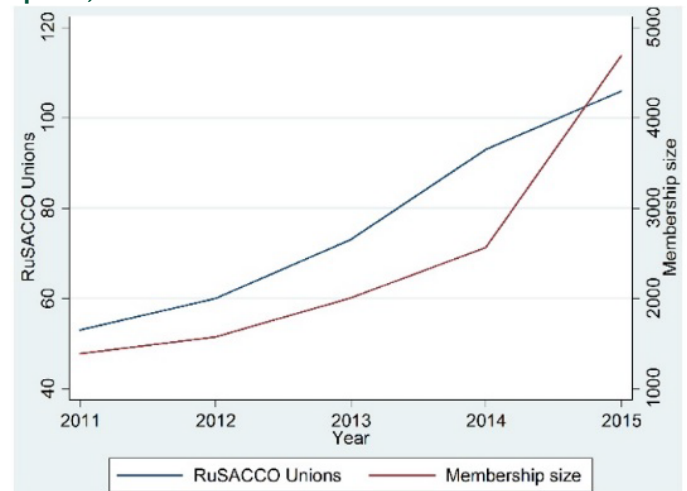
The potential of these institutions to ensure financial inclusion of poor rural households is unexplored, and there is limited evidence on what affects their efficiency. In this paper, we empirically characterize alternative formations of RFCs and their implications on households' access to financial services. We focus on three important attributes of these organizations: size, composition, and social cohesion among members.

RECENT DEVELOPMENTS IN RURAL FINANCIAL COOPERATIVES

Since the economic reforms in Ethiopia in the 1990s, with strong government support through agricultural policies, RFCs have become common in most rural areas of Ethiopia. Their key purpose is to mobilize savings from local economies and provide credit services to their members. However, some recently have started providing credit-life insurance services in some areas.

RFCs in Ethiopia are much smaller than banks and micro-finance institutions, and they deal with a member clientele that most banks would not be willing to serve. They generally cover a small geographic area, usually a kebele (sub-district). The average size of primary saving and credit cooperatives in the country is small, although growing both in numbers and membership base (Figure 1). There are now about 14,000 RFCs in more than 100 cooperative unions serving more than 2.5 million rural households in Ethiopia. While RFCs account for a sizable amount of savings

Rural Financial Cooperatives in Ethiopia and average membership size, 2011 to 2015



Source: Federal Cooperative Agency (FCA) of Ethiopia

held by non-bank financial institutions, their share of total credit provision in Ethiopia is estimated at only one percent.

ATTRIBUTES OF RURAL FINANCIAL COOPERATIVES AND THEIR COMPARATIVE PERFORMANCE

RFCs possess features that can be intrinsically associated with their performance in serving their members – size and coverage, social cohesion among members, and their compositional and organizational structure.

i) **Size and coverage.** Large membership and geographic coverage make rural cooperatives financially strong by increasing their capital base and options for risk diversifications and greater resilience. These attributes enhance the ability of RFCs to raise loanable funds and provides them with more opportunities to grow. In contrast, a small membership size implies that the RFC is operating in an environment where members have considerable knowledge of each other. These local relationships permit cheap and effective screening, monitoring, and enforcement mechanisms for the RFC.

There appears to be a trade-off between effective peer monitoring and financial strength.

ii) **Composition.** Repayment performance on loans made to homogenous, self-selected groups of individuals in the same village tend to be more successful than in more heterogeneous groups. However, compositional heterogeneity among members, in terms of wealth, risk, and need for financial services, is a positive feature of some successful RFCs. Heterogeneity enables RFCs to broaden their capital base and diversify their risk.

iii) **Social cohesion and acquaintances among members.** Social connections can be vital instruments for reducing transaction costs and information asymmetries, serving as substitutes for collateral, which in turn facilitates peer monitoring and enforcement among members. Social connections have positive effects on saving contributions, loan repayment, and loan enforcement.

DATA DESCRIPTIVES

To more closely examine the relationship between attributes of RFCs and their performance, we conducted a two-round survey of 38 RFCs and RFC member households in the four major regional states in the highlands of Ethiopia, collecting detailed information about the operation, structure, and organizational profile of the RFCs in 2014 and then again in 2015. The RFCs surveyed had an average of 337 members, and 74 percent of members knew each other before becoming members of their cooperative.

RESULTS - SAVINGS, CREDIT, AND INSURANCE

As we see in our results, delivering different financial services – savings, credit, and insurance services – through RFCs have different implications based on the services provided.

1. **Savings.** Three elements are examined as to whether they explain households' savings (investment) behavior in their RFC: (a) the size, composition, and structure of the RFC; (b) the household's association and sphere of influence in the RFC; and (c) the household's human and physical resources. We find a significant and nonlinear association between RFC size and household monthly savings, suggesting that increased membership beyond a certain level may create managerial, monitoring, and enforcement problems and, hence, negatively affect an RFC's ability to mobilize local savings. Stronger social connections among members and the level of affiliation of a household with their cooperatives are associated with higher savings behavior. A household's wealth level significantly predicts investments in these institutions as well, i.e., richer households tend to save more.

2. **Credit.** Households joining RFCs dominated by members from the same village (kebele) have a lesser likelihood of obtaining credit from their cooperatives. Diversity in wealth among members is strongly associated with higher household access to credit services. This supports the idea of heterogeneous formation of social networks and rural cooperatives for creating market opportunities among members, a finding that stands in contrast to those of other studies.

Our results suggest that compositional heterogeneity among RFC members has varying implications across types of groups and the products (credit or savings) that these groups provide. Social cohesion among members and a longer membership record is associated with higher access to credit. However, household characteristics and resources have no significant implications on demand for or access to credit services from their cooperatives. RFC size significantly predicts households' access to credit from the cooperative. However, beyond a certain size threshold, this could impact monitoring of these credit services.

3. **Credit-life Insurance.** RFCs are well-positioned to provide micro-insurance to rural households, offering protection against specific risks in return for payment of regular premiums. Given their close links to and experience with rural households, RFCs can overcome information asymmetry and moral hazard problems in the provision of insurance coverage. Notably, institutional trust appears to be crucial in explaining households' demand for credit-life insurance. In addition, the composition of cooperatives is significant in explaining this demand.

Given that the credit-life insurance is loan-linked, entry policies of RFCs may explain households' access to credit and associated credit life insurance. However, household demographic characteristics and observable resources do not appear significant in explaining households' demand for insurance.

CONCLUDING REMARKS

We find that some features of RFCs have varying and sometimes conflicting implications for successfully delivering financial services. The optimal size of RFCs may differ depending on the product offered. On the other hand, compositional heterogeneity among members, including diversity in wealth levels, is associated with higher access to credit—probably through the broker function of RFCs in bringing together potential borrowers and with potential lenders – while this has no implication on households' savings behavior. Heterogeneous group formation can create economic opportunities among members. Similarly, strong social cohesion among members is associated with better access to financial services, particularly savings and credit access.

Overall, these results suggest that the optimal size and composition of RFCs may vary across the domains of financial services they provide. The results also suggest that in areas with limited access to financial services, the supply-side attributes of the market (and, hence, the qualities and attributes of RFCs) appear to be more crucial in explaining take-up and the price of these products than do demand-side attributes. While savings decisions are significantly explained by households' human and physical resources, these attributes are insignificant factors in explaining demand for credit and insurance. Moreover, without the necessary institutional capacity and risk bearing abilities, expanding the product range of these cooperatives may have varying and conflicting implications. The evidence from this research may help in scaling up the application of best practices in Ethiopian RFCs.

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