



CO-OPERATIVE BANKS DEVELOPMENT AGENCY

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Briefing note: The Common Bond

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Supervision Unit

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Background

This discussion paper looks broadly at what defines co-operative banking, the historical significance of the common bond in formation of financial co-operatives and some trends in “opening up” common bonds. The guidance note concludes with the approach the CBDA supervisor will adopt when reviewing an applicant’s common bond during the CFI s registration process.

Co-operative Financial Institutions

The term co-operative financial institutions (CFIs) is used to define institutions that bear different names but have essentially identical characteristics, primary member-ownership and subscription to co-operative values and principles. The most common English expressions used for CFIs are financial co-operative (FC), savings and credit co-operative (SACCO) and credit union (CU). There are also many non-English expressions such as the French *caisse* with its variations—*agricole, populaire, mutuelle*—of which *populaire* is probably the most common. The Spanish translation of *caja, cooperativa financier, cooperativa de ahorro y crédito, CAC, COPAC, union de crédito* or in Portuguese *caixa* are names of common use in these counties or their previous colonies.

Under CFI we also include a number of institutions known as co-operative banks (CB). The expression co-operative bank is often used to represent a CFI that holds a banking licence, but also a number of other very disparate structures, such as: the apex of a CFI network that holds a banking licence (Germany, Colombia); a joint stock banking subsidiary of an apex of a CFI network (Brazil, Finland); a joint-stock bank subsidiary of an apex of a non-financial co-operative network (U.K., Switzerland); or an entire network of CFIs, usually with a relatively high level of integration that holds a banking licence (Netherlands’*Rabobank*). On the other hand, the expression *caisse, caja, caixa* is also often used to represent what in English is known as a “savings and loans association” (S&L) of mutual ownership, which are strictly speaking not co-operatives¹.

Co-operative banking is retail and commercial banking organized on a co-operative basis. Co-operative banking institutions take deposits and lend money in most parts of the world. Co-operative banking, as discussed here, includes retail banking carried out by credit unions, mutual savings banks, building societies and co-operatives, as well as commercial banking services provided by mutual organizations (such as co-operative federations) to co-operative businesses.

Despite the definitional variations, the mission of all CFIs is to promote the economic interests and the social and economic benefits of their members, within a not for profit framework. Their activities are founded on such crucial ideas as mutuality, locality, ethics, solidarity and social cohesion.

CFI Genesis in South Africa

In South Africa, literature reviews reveal an early mention in the 1940s of Credit Unions in the Kwa-Zulu Natal and Eastern Cape. However these disappear from the landscape and only

¹ Carlos E. Cuevas, Klaus P. Fischer Co-operative Financial Institutions, *Issues in Governance, Regulation, and Supervision*, The World bank, Washington, D.C. 2006

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begin to re-emerge again as Credit Unions in the early 1980s within the Western Cape, expanding nationally until 1992. The movement then, under the leadership of the Cape Credit Union League, and after consultation with the African Confederation of Co-Operative Savings and Credit Associations (ACCOSCA) agreed to align South African Credit Unions name to the continentally preferred SACCOs.

Shortly there-after, in 1994, SACCOL become a member of ACCOSCA. It was also in 1994, that the SARB recognised SACCOs and Stokvels as “common bond institutions”, and allowed them to operate through an exemption notice with specific conditions, one being they are members of approved self-regulatory organization. the FSA and FINASOL whom begun to pilot Financial Services Co-operatives (FSC) would in due course too be granted exemption notices as by the SARB.

During the financial sector summit negotiations at the Nedlac beginning 2002, the constituencies agreed to “Co-operative Banking” legislation with the final version of the Co-ops Banks Act defining a co-operative bank meaning “a co-operative registered as a co-operative bank in terms of this act whose members-

- a) are of similar occupation or profession or who are employed by a common employer or who are employed within the same business district; or
- (b) have common membership in an association or organisation, including a business, religious, social, co-operative, labour or educational group; or
- (c) reside within the same defined community or geographical area

As a result, the South African landscape now consist of common bond institutions that incorporate Savings Groups, Stokvels, Savings and Credit Co-operatives, Financial Services Co-operatives (FSCs), Credit Unions and Co-operative Banks.

The Common Bond

The **bond of association** or **common bond** is the social connection among the members of CFIs. Common bonds substitute for collateral in the early stages of financial system development. The common bond is also sometimes referred to as the chain of trust amongst members. In modern financial co-operative systems, common bonds remain a key building block, especially for the strategic networks that underpin many of Europe’s co-operative banks.

How the common bonds work

Hermann Schulze-Delitzsch, an early co-operative organizer, explained the concept of the ‘bond of association’ at credit union meetings in this way:

... your own selves and character must create your credit, and your *collective liability will require you to choose your associates carefully*, and to insist that they maintain regular, sober and industrious habits, making them worthy of credit.

In his book *People’s Banks* (1910), Henry W. Wolff summarized the character of this ‘common bond’ based on his observations of credit unions all over Europe as:

1. many individuals bringing small amounts of share capital into a common pool, which collectively amounts to significant base of collateral,
2. borrowers, lenders and guarantors *live near one another (e.g., in the same village), making it convenient* for the lender and guarantors to monitor the performance of the borrower, and manage any problems that may come up,

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3. an *'inter-connection of liability among members'* is created by the bond, which may either involve direct and unlimited 'financial liability', or 'direct responsibility for good management' (which once publicly established increases the sense of security of claim-holders), and
4. all operations of the credit union must be conducted along 'business like lines' based on a strong sense of *collective responsibility*.

Diverse types of bonds

There are several distinct types of bonds, corresponding to distinctive types of financial co-operatives. For example:

- The Raiffeisen banks in Germany relied on **parish-based bonds**, as parishes were very small and people were in constant communication with each other through the central nexus of the local church. Similarly, the *Caisses populaires* of Quebec were originally "organized along the boundaries of Roman Catholic parishes".
- The bonds on the multi-ethnic Canadian Prairies were **community-based**, linking members through their common residency in small towns and villages.
- Common bonds in early United States credit unions were generally **employee-based**, and concentrated in the manufacturing and transportation industries, and among teachers and postal workers.
- The bonds of many credit unions in Kenya are based on **out-growers** -- farmers who deliver tea, sugar and other cash-crops under contract to a company that handles marketing and sales.
- In the UK, guidance note 8 of 2003 issued by the Financial Services Authority (FSA) following a review of the common bond provided the following guidance i.e. the common bond must be:
 - (a) following a particular occupation;
 - (b) residing in a particular locality;
 - (c) being employed in a particular locality;
 - (d) being employed by a particular employer;
 - (e) being a member of a bona fide organisation or being otherwise associated with other members of the society for a purpose other than that of forming a society to be registered as a credit union;
 - (f) residing in or being employed in a particular locality

As the general principles mentioned above state, the common bond is not restricted to any specific type of bond, but this aspect of CFI activities has been a feature of virtually all CFIs since their earliest recorded examples. It is also worth mentioning that it is clear from the preceding discussion that the common bond is usually multiple, associational, occupational or residential. The requirement to belong to a common bond is seen as a corner stone in the success of these usually high-risk financial co-operatives, as the social pressure that is created by the members knowing each other, lessens the risk of default, especially in its start up phase.

Open vs. closed common bonds

The debate on open vs. closed common bond often questions whether indirect members or non-qualifying members may join a CFI.

It is accepted that a CFI may opt to have the following types of member;

- (1) directly qualifying member – who fulfils the "appropriate membership qualification";

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- (2) Indirectly qualifying member (“family member”) - who lives in the same household as, and is a relative of, a directly qualifying member;
- (3) non-qualifying member – who joined the credit union as a directly or indirectly qualifying member, but has ceased to be so.
- (4) A client of a CFI. This is common in co-operative banks regulated as commercial banks.

It is difficult to differentiate membership based on the closed vs. open common bond debate using the above membership types. Depending on your particular position, you might argue that anything besides direct membership constitutes an open bond. However, it does seem standard practice around the world, that closed common bonds currently include family members and ex-members. The allowance of a percentage of non-members (clients) to transact with a co-operative bank is far more controversial.

Some cooperative banks are criticized for diluting their cooperative principles. Principles 2-4 of the "Statement on the Co-operative Identity" can be interpreted to require that members must control both the governance systems and capital of their cooperatives. A cooperative bank that raises capital on public stock markets creates a second class of shareholders who compete with the members for control. In some circumstances, the members may lose control. This effectively means that the bank ceases to be a cooperative. Accepting deposits from non-members may also lead to a dilution of member control. Most co-operative banks without common bond limitation are typically regulated under the country's Banking laws and must meet all commercial bank capital and registration and regulatory requirements. In return these banks have no limitations on the activities in which they may engage in.

According to research done² on the historical development of CFIs in seven countries reviewed, (Germany, USA, Canada, India, Ireland, Brazil and Kenya) it is based primarily on the common bond, be it a common employer, association or geographical location.

The key issue is whether ‘open common bonds’ or ‘closed common bonds’ are instrumental in the development of the sector. The ‘closed common bond theorem’ is supported by an analysis based on a theoretical model of CFI formation and consolidation using an extensive United States CFIs dataset and a nonlinear approach³In this particular study, the authors concluded that the larger the pool from which a CFI can draw membership, the less effective it is in attracting members.

However, using the same dataset, albeit a few years later, Goddard et al (2002) noted that less restrictive interpretation of the common bond in US CFIs created opportunities for growth and mergers, with the number of CFIs declining from 15,000 in 1987 to 10,858 in 1999. Remarkably however, membership, as an indicator of outreach, increased from 53 million to 76.6 million and asset size from US\$571 million to US\$1.9 billion over the same period. This was also confirmed by a separate study by Robbins (2005) who noted that less restrictive common bonds in the US resulted in improved financial conditions of CFIs as well as increased competition between banks and CFIs.

The growth in the CFI sector in Kenya has also been largely attributed to early restrictions limiting common bonds to a secure crop or employment⁴.

² by McIntosh Kuhlengisa for his Master Thesis

³ by Emmond & Schmid (1999).

⁴ (World Bank, 2007)

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How the CBDA will regulate common bonds

The common bond exemption notice states “a common bond” exists between-

(a)

- (i). members of a co-operative that chooses to identify itself by use of the name Financial co-operative, Financial services Co-operative, Credit Union or Savings and Credit Co-operative which members-
 - a. consist of persons who are employed by common employer(s) or who are employed within the same business district; or
 - b. have common membership in an association or organisation, including religious, social, co-operative, labour or educational groups
 - c. Reside within the same defined community, rural or urban district, and which group receives funds from members against the issue of stock or by means of the subscriptions of members
- (ii). Members of a secondary financial co-operative consisting of primary financial co-operatives registered in term of paragraph 3.(l) iv below.

Examples seen as acceptable to the supervisor with regards to a (i) (a) include:

- I. All employees of the “example” company Pty. Ltd and “example 2” company Pty Ltd. Adding additional common employer(s) should be read in conduction with note XX below.
- II. All employees working in the “example” business district, “town centre” or an (singular) industrial area of a town or city.

Examples seen as acceptable to the supervisor with regards to a (i) b includes:

- I. All member of the “example” trade union, “example” parish, employees and students of the “example” FET or university, members of the “example” co-operative or staff and volunteers of the “example” society.

The supervisors interpretation of (i) c requires that applicants include the specific (defined) district community, which could be either rural or urban. In particular the supervisor will not focus on the geographical boundaries as much as what brings makes that a defined community.

Examples seen as acceptable to the supervisor with regards to a (i) c include

- I. All residents who live and work in the “example” village.
- II. All the residents of the “example suburb/township”

Metropolises and cities are not considered communities nor districts as they are amalgamations of districts and communities.

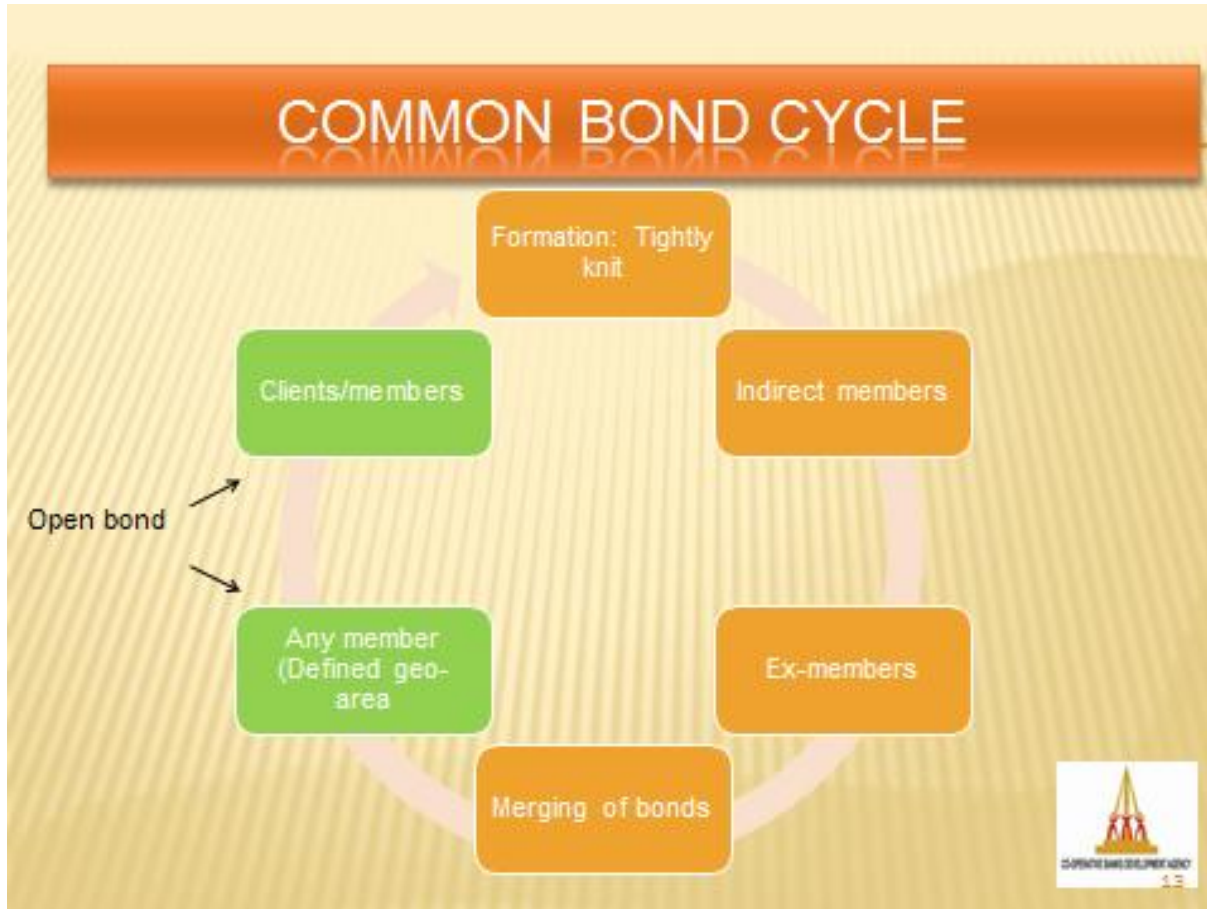
Well managed CFIs will be allowed to extending their fields of membership conditionally based on additional possible capital requirements. As CFIs grow and saturate their membership of their common bond, they will be allowed to look at way in which to “open” their bonds of association. Typically this would initially be to allow family members to join, and thereafter to allow expanding the geographic area the CFI is servicing, or alternatively to allow additional employer groups to join/merge with an existing CFI.

The regulatory effect of an open bond is that such CFI's will require higher capital and prudential requirements. This is as a result of increased risk as the CFI's reliance on the mutuality

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relationship predominant in 'closed bond' CFIs is replaced by a need for skills in credit risk appraisal. In other words, common bond restrictions are assumed to reduce the cost of gathering credit information, thereby minimizing exposure of individual CFIs to bad debt losses

In considering whether to allow an applicant an open common bonds or not, the CBDA supervisor will look at the attendant increase in risk, and the necessary features that need to be put in place to mitigate such risk, such as increased capital and higher prudential requirements.



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Additional Resources on the Common bond

Credit Unions and the Common Bond, William R. Emmons and Frank A. Schmid,
FEDERAL RESERVE BANK OF ST. LOUIS, September/October 1999

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Manchester M60 0AS, May 2007/5.

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Common_Bonds.pdf](http://library.uniteddiversity.coop/Money_and_Economics/Cooperatives/Credit_Unions/Common_Bonds.pdf)

Financial Services Authority, UK, Registration forms, Common bond specimen wording,
http://www.fsa.gov.uk/smallfirms/your_firm_type/credit/pdf/common_bond.pdf

Google search: [Credit Unions and the Common Bond](#)