GOVERNANCE IN FINANCIAL COOPERATIVES AND PROPOSALS FOR THE BRAZILIAN SYSTEM

Ventura, Elvira Cruvinel Ferreira
Av. Presidente Vargas, 730, 19º
- Centro20071-900 –
Rio de Janeiro - RJ - BRAZIL
EBAPE/FGV/RJ e Banco Central do Brasil
elvira.ventura@bcb.gov.br
Soares, Marden Marques
Banco Central do Brasil
Setor Bancário Sul (SBS) Quadra 3 Bloco B
70074-900 - Brasília - DF - BRAZIL
marden.soares@bcb.gov.br
Fontes Filho, Joaquim Rubens
Fundação Getulio Vargas - EBAPE
Praia de Botafogo, 190 sl. 502
– Rio de Janeiro (RJ) – 22.230-080. BRAZIL
ebrubens@fgv.br

ABSTRACT

On dealing with relations among owners and managers, proposing solutions to conflicts of interest, minimizing the costs of collective decisions and monitoring implementation of strategic decisions and goals, corporate governance practices have shown themselves to be quite useful to public and private entities and, particularly, to cooperatives. As the organization charged with regulating and supervising the financial system - which includes financial cooperatives - and in light of the specificities, growth and potentiality of this segment in the national framework, the Central Bank of Brazil carried out a survey aimed at generating proposals capable of fostering good governance practices in financial cooperatives in Brazil. The objective of the article is to present the results of this survey, with due consideration of theoretical references on governance and their adaptation to the peculiarities of cooperative organizations.

Key-words: governance, financial cooperatives, Central Bank, participation, boards, supervision, control.

1. INTRODUCTION

Problems of governance begin at the moment of separation between company ownership and management and are generated by questions involving alignment of the interests of the different parties, motivation, information asymmetry and propensity to risk. The primary function of corporate governance practices is to ensure that executives pursue not their own interests but rather the objectives set out by the proprietors or by those responsible for strategic decisions. To avoid such problems - termed agency problems in literature - those responsible for elaboration and implementation of strategic questions are charged with monitoring the behavior of those responsible for execution.

In the framework of private companies, "good practices" of corporate governance have been pursued, demanded and viewed as a tool through which investors are able to assure themselves that their interests are receiving suitable treatment, principally in the form of returns on investments. Dissemination of studies demonstrating that such good practices generate value for stockholders has driven elaboration and publication of codes and guidelines of a didactic nature.

Since organizational models vary according to the distribution of capital control, surveys of governance have demonstrated how solutions are found to wide-ranging questions rooted in the interaction among groups that influence a specific organization - owners, managers and councils - and have explained how power is shared and decisions are taken, with due consideration to aspects of accounting control, transparency, representativeness, rights and equity.

All types of organizations, including pension funds, state-owned enterprises and cooperatives, can benefit from progress in the field of governance. International organizations have assumed a position of leadership in disseminating information on governance practices to these entities, based on the supposition that such organizations also have owners or sources of financing and managerial groups - whether they are or are not proprietors. The major reason underlying concerns with governance in organizations focuses on adjusting the interests involved, aligning differences in expectations of ownership groups and orienting and monitoring managers.

However, dissemination of good governance practices is not restricted to the specific or exclusive interests of the organizations involved, as witnessed by guideline proposals put forward by such organizations as the World Bank, Organization of Economic Cooperation and Development and the Securities and Exchange Commission in Brazil and, in the international cooperative context, by the German Confederation of Cooperatives - DGRV. It was in this sense that

Carvalho (2002) analyzed how questions of corporate governance become problems of public interest. Good governance practices contribute to reducing the problems generated by asymmetry of information and rights among owners and managers which, in the case of open capital corporations, implies higher control premiums and lesser attractiveness to minority stockholders, generating funding shortages and reducing stock market liquidity (Carvalho, 2002). Akerlof (1970) demonstrated that certain deformities in private relations can become collective problems, disqualifying the market as a whole. A well developed system of governance results in more transparent relations, reduces a diversity of risks and improves the security of all of the system's organizations.

The Central Bank of Brazil, the organization charged with regulation and supervision of financial institutions and, therefore, of financial cooperatives in Brazil, has elaborated and developed a strategic project denominated Cooperative Governance. The underlying objective of this project is to present a model of governance that respects the singularities of each type of organization subject to Central Bank authority.

Giving due consideration to theoretical references on governance and their adaptation to the peculiarities of these cooperative organizations, the objective of this article is to present the results of this study. The article presents an overview of financial cooperatives in Brazil, with the aim of contextualizing the reader and presenting the research methodology followed in the Cooperative Governance Project. The third part highlights aspects of governance in these organizations and, following that, presents descriptive results of the surveys carried out, together with recommendations for construction of good governance practices within the system.

2. FINANCIAL COOPERATIVES IN BRAZIL

Since financial cooperatives are considered member institutions of the National Financial System, the National Monetary Council (CMN) is charged with regulating their activities in Brazil, while the Central Bank of Brazil has the task of overseeing their operations. Financial cooperatives are created to receive deposits, supply credit and provide a variety of services to their members.

The structure of Brazilian financial cooperatives is composed of three levels. Singular cooperatives (first level) provide services directly to their members; central cooperatives and cooperative federations (second level) provide services to associated singular cooperatives, fostering integration of activities and reciprocal

utilization of services; and confederations of cooperatives (third level) orient and coordinate the activities of central cooperatives and federations of cooperatives. In December 2007, this structure was composed of 1,427 singular cooperatives, 37 central cooperatives, four confederations and two cooperative banks.

Based on the objective or nature of the activities carried out or the type of bond they have with the membership, financial cooperatives can be classified according to modality: cooperatives composed of public or private sector employees, professionals, rural financial cooperatives, cooperatives of micro-entrepreneurs, business people and those allowed to admit members freely.

Financial cooperatives can also be grouped according to their link to the cooperative system to which they belong and with which they share internal bylaws, systems, procedures, technologies, products, services and trademarks, all with the objective of improving the effectiveness of their relations with members and enhancing organizational and systemic controls. The existent systems are: Sicoob, Sicredi, Unicred, Ancosol, Centralcred, Cecred, Cecrers, Federalcred and Ceeoopes, encompassing 79% of Brazilian financial cooperatives in December 2007. Cooperatives not linked to systems are classified as independent and account for 21% of the total.

Starting in 2000, a combination of technical and institutional factors had the impact of reducing the pace of growth in the number of financial cooperatives. Among these, one should stress the activities of new agents in the microcredit sector, launching of financial products and innovations and a constant process of updating regulatory requirements. The financial cooperative system has responded to these transformations by seeking scale and efficiency-based gains, consolidating their role as alternative financial organizations in the increasingly more competitive environment of the financial services market.

Reflecting these measures, the number of members served by financial cooperatives has increased in recent years, moving from 1.4 million in 2001, to 2.8 million in 2006, closing 2007 at a level of 3.5 million.

3. THE COOPERATIVE GOVERNANCE PROJECT

"Cooperative Governance: guidelines and mechanisms for strengthening governance in financial cooperatives in Brazil" is a strategic Central Bank of Brazil project, idealized to contribute to sustained growth in the financial cooperative segment.

Various areas of the Central Bank participated in the project, with the support and participation of organizations linked to the cooperative movement in Brazil, financial cooperatives themselves and their members.

One of the major reasons underlying the project was the fact that, in recent years, the Brazilian financial cooperative segment has expanded sharply while undergoing changes in its profile. Consequently, the project is designed to contribute to construction of a solid and adequate governance environment that takes due account of the specificities of financial cooperatives in the financial system and in the context of the Brazilian socio-economic reality.

The project sought to identify governance questions specific to the cooperative movement, while analyzing as to how adoption of good practices could resolve these issues and not simply transfer practices from other organizational contexts and countries. Studies and surveys were carried out for the purpose of diagnosing governance in the financial cooperative segment in Brazil, in order to develop guidelines for good governance practices, the major outcome of the project.

Consequently, a bibliographic and documentary survey was made in the period extending from August to November 2006 in order to create a solid reference foundation based on systematized information regarding the following: 1) principal governance models and codes in the world and in Brazil; 2) governance models adopted by financial cooperatives in the country; and 3) governance models in cooperatives of other countries.

The second stage of the survey extended from November 2006 to March 2007 and included detailed interviews with representatives of 34 singular cooperatives and 11 central cooperatives from all parts of the country. The objective of this effort was to generate a knowledge base on governance practices, together with the documentary foundations. The selection process focused on the various types of cooperatives and different systems (including independent cooperatives), in such a way as to respect the proportionality of these organizations in the different regions of the country. The selection also sought to include cooperatives of varying sizes, since their governance environments may vary from one to another.

These interviews were semi-structured and followed a routine that had been tested and discussed beforehand with both directors and persons well informed regarding the cooperative movement, as well as members of the research/project team.

Based on this first diagnosis, designed to recognize the major governance-related questions and problems of financial cooperatives, including their strong points and vulnerabilities, a questionnaire was drawn up with approximately 100 questions,

broken down into the following sections: 1) Representativeness and Participation; 2) Direction; and 3) Management and Oversight. The questionnaire was applied through the Internet in September and October 2007 and was targeted to all singular financial cooperatives. Answers were received from 1199 singular cooperatives, corresponding to a return of 86% of the total number existent in the country at that time. In this context, the major objectives of the questionnaire were two: in the first place, provoke a discussion of the subject among cooperatives, aimed at leading their directors to evaluate and rethink governance mechanisms; secondly, obtain a diagnosis of the perceptions of these directors (council members and executives) and of current governance practices within cooperatives.

Furthermore, considering that the interested parties in any cooperative are the members, a survey was carried out among the members of 30 singular cooperatives in November-December 2007. Telephone interviews were made with 14 members of each cooperative, for a total of 420 persons. The questionnaire contained approximately 30 questions. Two of these questions were open-ended and had the objective of analyzing the perceptions of members regarding the administration and directors of their cooperatives. The survey covered practically all areas of the country, including 14 states and 30 municipalities, of which six represented state capitals and 24 were located in the interior. This survey was fundamental to understanding the viewpoints of cooperatives directors.

This research effort made it possible to generate the foundations required for defining guidelines for good governance practices in financial cooperatives in Brazil.

4. GOVERNANCE IN FINANCIAL COOPERATIVES: SINGULARITIES TO BE CONSIDERED IN THE BRAZILIAN CASE

The central problems dealt with in corporate governance are similar to those faced by most organizations - in which there is no single proprietor responsible for executive management. In large-scale organizations, there are managers who are not owners or a diversity of owners with varied degrees of influence and different interests. Cooperatives also have specific governance-related questions that must be adequately dealt with. The definition of good governance practices in cooperatives must involve mechanisms capable of strengthening their structures and processes in a systematically articulated manner, in order to improve overall security, efficiency and risk reduction conditions.

Characterized as societies of persons and not of capital, the fundamental principles of cooperative management are voluntary and free union among individuals in a framework of democratic management, economic participation of the members with autonomy and independence. Consequently, contrary to what occurs in large-scale private companies, cooperatives are managed by their members and not by the "owners of the business". Thus, each member is entitled to one vote, independently of the value of that member's capital. Moreover, the profit motive does not exist and goals are long-term, since the overriding objective is to meet the needs of the proprietors of the cooperative.

Management by the members eliminates agency problems, a concept that refers specifically to the relations between owners and managers. Nonetheless, the partners may not have the same objectives and interests. Such a situation may create segmentation between those who run business operations and the other members. When decision-making authority is delegated by the members to an elected group of directors, the classic problems of governance may arise.

One example would be the separation between strategic decisions and execution. According to the legal framework currently in effect, cooperatives do not have an obligatory separation between their administrative councils and Executive Boards. Consequently, council members who do not occupy executive positions find it difficult to accompany the proposals and decisions made by others, given that executives have easier access to information and greater knowledge of the practices and operations of the cooperative. A fundamental question of governance, therefore, is reduction of the imbalances in decision-making authority that tend to result from asymmetric information.

Aside from these factors, financial cooperatives have an additional characteristic that is fundamental to any analysis of governance practices, which is the simple fact that, aside from being associations, they are also financial institutions (Brazil, 1964). This, obviously, has a series of implications.

The financial sector is characterized by a high level of exposure to systemic risk or, in other words, the risk that the collapse of one member institution may contaminate the entire system. However, differently from banks, financial cooperatives are not listed on stock markets and, therefore, are not subject to investor scrutiny, a fact that further increases the need for good governance. Their participation in the National Financial System (SFN), therefore, raises governance to a position that transcends the specific interests of members, perhaps even to a public policy level (FONTES FILHO *et al*, 2006). According to Pagnussat (2004), the external public imposes restrictions on governance in cooperatives, since the members are clients and directors. Though this may be a positive factor in

protecting their interests, it may also transfer risks to third parties, such as the government and suppliers. Thus, in financial cooperatives, the owners are also the clients (borrowers of credit, products and services) and suppliers (depositors) of resources to the organization.

Though concentration of ownership does not exist, there is another problem of behavior consequent upon the low level of participation that is equally damaging to governance and that indirectly generates power asymmetry - the so-called "free rider" effect. This behavior is directly related to the feeling of belonging and proprietorship of members and arises when people feel that their individual contributions represent very little in the overall framework of the cooperative or do not result in individual benefits.

Since, in most cases, groups of members have ties to elected directors, this type of organization is characterized by a climate of confidence among members and managers, something clearly desirable in an association-type culture. However, to exemplify the importance of consolidating good governance practices, this same confidence can result in perceptions of lesser need for monitoring and oversight on the part of the members, thus weakening one of the major instruments for controlling the organization. At the same time, it can lead to a concentration of power and influence in the hands of specific directors, reducing the capacity of other members of the Council of Administration and Executive Board to act.

Following this line of thought, it is evident that participation demands information, knowledge and decision-making capacity. In governance practices, the principle of transparency defines management's interest in guaranteeing that the owners - in this case, the members - be fully aware of all information and results so as to be able to form their own opinions. This leads to the necessity of including recommendations for creating efficient channels of information and receiving criticisms and suggestions.

With the growth that has taken place in recent years in the segment of financial cooperatives and, principally, with introduction into Brazilian regulations of the possibility of free admission of members, the interests of members of a single cooperative will tend to become more varied in the future. In this sense, majority-based decisions may give rise to a series of future problems, such as lack of motivation on the part of specific member groups, declining interest and conflicts among the different groups.

Among other purposes, the definition of a set of corporate governance guidelines has the aim of sharing practices already utilized by those organizations, in such a way as to disseminate and strengthen their utilization, while indicating paths to be

followed in order to improve aspects of strategic importance to good governance. Improvement in the governance practices of a cooperative represents not only individual benefits, but benefits for the entire financial cooperative segment, since such practices will enhance security, reduce oversight and control costs, improve image and strengthen the cooperative spirit of participation, collective action and belonging. With this in mind, we will now present the rationale underlying the major guidelines indicated by the Central Bank as the path to be followed by cooperatives in the pursuit of good governance.

5. GUIDELINES FOR GOOD GOVERNANCE PRACTICES IN FINANCIAL COOPERATIVES IN BRAZIL

The Guidelines for good practices consist of a list of recommendations covering the major issues identified in the governance of these organizations. This item will discuss the most important questions dealt with in this document.

a) The importance of participation and representation of members

Cooperatives are characterized as nonprofit organizations. However, the fact that the net funds remaining at the end of the fiscal year are distributed proportionately to the operations carried out by the members generates internal pressures for efficiency and the pursuit of maximum economic results. Contrary to nonprofit association-type organizations such as clubs, religious associations or even nongovernmental organizations, positive results are targeted individually to the members.

Cooperatives operating in Brazil are also self-managed with members participating directly in their administration and are able to contract employees. However, differently from production or labor cooperatives, the area of activity of the members is not the same as the end-activity of the financial cooperative, thus generating a negative impact on motivation to participate.

In questions of governance, distribution of remaining net funds and the self-management structure reflect highly significant differences. As Fama and Jensen (1983) affirm in proposing the classic references for analyzing agency problems, nonprofit organizations do not have transferable residual claims that could be incorporated by the members. In the case of cooperatives, in contrast, the members are able to directly and individually appropriate the positive results of operations.

This change demands a new outlook for analyzing the governance problems of these entities. More useful than analyzing a separation between owners and managers would be to view the directors of financial cooperatives at the center of a network of relations among the major stakeholders of the organization, considering that an adequate model of corporate governance must lead to a situation of equilibrium among such varied interests.

It is also important to recall that, in a cooperative, the members face very few financial risks, according to the rules covering limited responsibility, as set down in Law 5,764. These rules are typically used in the creation of financial cooperatives and determine that cooperative organizations will have limited responsibility, when the responsibility of the member for the commitments of the society is limited to the value of that member's subscribed capital. Therefore, since responsibility is basically limited to the value of subscribed capital, the incentive to make an extra effort to monitor management is obviously lessened.

From the strictly economic point of view, the motivation of the member to monitor the acts of management must be proportional to the risk incurred. In general, the participant is tempted to evaluate the benefits and costs of his individual involvement according to economic reasoning. If the benefits or risks associated with the decision to participate or not are small, the incentive to transfer this responsibility to others will increase, generating room for free riders. In the specific case of cooperatives connected to corporate entities, such as companies, large-scale production cooperatives or public-sector organizations, the member will view himself as incurring even less risk, since the organization will have strong motivation to monitor management and take measures to avoid problems. In this case also there is additional motivation to nonparticipation and a posture of free riders.

Adopting the suppositions of the agency theory, the cooperative must create additional incentives that may or may not be financial in nature, or even a sense of urgency in order to motivate participation. According to Birchall and Simmons (2004), furthermore, though organizations involved in credit operations may be owned and controlled by their members, in practical terms they tend to transfer governance to an elected council and management to a group of executives, as the number of members increases.

Since they are viewed as societies of persons, cooperatives must have internal mechanisms of participation, mutual trust and a spirit of volunteerism in their activities. Consequently, the existence of an adequate low cost highly

representative model of participation is essential to the success of financial cooperatives and to the strengthening of cooperative ideals.

Assemblies: Participation in the process of convoking and holding assemblies and decision-making are elements of fundamental importance to legitimizing the processes of internal control triggered by cooperative governance mechanisms. In this sense, cooperatives must make every effort to ensure effective participation of the members in the assembly process, together with representation for the various legitimate interest groups that exist within the membership. Participation of members in financial cooperative assemblies in Brazil is very low, as demonstrated by the results of surveys: 31% of the responses received from cooperatives indicated that less than 5% of the members registered presence at their most recent assemblies; while 23% indicated participation between 5% and 10% of members. Therefore, most cooperatives have an attendance level of less than 10% in their most important meetings.

Most of the answers received from directors/cooperatives (73%) state that the reasons underlying the low level of participation in assemblies are specific to the members themselves, including issues or reasons of an individual nature. Here, "confidence of the member in cooperative management", indicated in 31% of the responses, was the major reason cited, followed by "lack of knowledge on the part of the member as regards the importance of participating in the assembly" (27%), and difficulties experienced by the member in getting to the site of the assembly (15%). Only 16% of the reasons indicated bear any relation to the activities of the cooperatives themselves: the absence of festivities and raffles (12%); holding of assemblies by persons delegated for this task (2%); and the lack of mobilization or invitations sent to the members (2%). Another 11% cited "other" reasons for low participation.

From the point of view of the members, justification for low levels of participation are related mainly to personal factors (38.9% of the responses), including: 12.9% stated that going to the assembly "makes no difference"; 12.4% affirmed that "too much time is lost"; 10% responded that they have "difficulty getting to the assembly"; and only 3% indicated that the reason is "confidence in the management of the cooperative", while "other" reasons was the most common alternative cited, with 51% of the answers. Analysis of the "other" motives shows that 55.9% are related to such personal factors as lack of time (35.9%), lack of interest (12.2%) and incompatible schedules, dates or distances (7.7%). Only 9.2% of the responses of the members indicated the activities of the cooperative as an explanation for the low level of participation. Of this total, 8.8% stated that the cooperative had failed to announce holding of the assembly.

Therefore, the responses tend to converge to the personal motives of the members in explaining the low level of participation in assemblies. It is interesting to compare these results with aspects such as "confidence of the member in the administration of the cooperative", indicated by 31% of the answers given by directors/cooperatives as the reason underlying low participation of members in assemblies. From the point of view of governance, though confidence is obviously a positive aspect, it can have the opposite impact of weakening internal control and monitoring systems, since participants will perceive less usefulness in their role as overseers or strategic directors.

With regard to measures adopted by cooperatives to stimulate participation on the part of members, the most commonly cited is implementation of education programs, with 26.88% of the responses calling for education programs dealing with the cooperative movement and 5.46% stating a demand for programs of financial education. Aside from the need for cooperatives to implement such programs, these measures presuppose interest on the part of members in putting them into practice or, in other words, there must be an individual willingness or incentive for the member to take the decision to participate in such courses/training. Holding of this type of program aids members in aligning their thinking with the cooperative philosophy, thus encouraging increased participation. Parallel to these motives, 21.65% of the responses pointed to the question of transportation of the members to the assemblies and 14.79% called for festivities and raffles as measures to be taken by the cooperatives in order to stimulate members. On the other hand, 14.14% of the cooperatives responded that there were no specific measures that would encourage the participation of members and 17.08% pointed to other measures required to encourage participation.

Instruments for members to express their opinions: In its efforts to encourage participation, the cooperative can utilize various types of instruments that allow the members to express their positions. According to the response given by cooperative directors, among the measures most commonly utilized by members to express their opinions on the cooperative are informal (undocumented) conversations with directors (35.23%) or with managers and employees (35.03%), pre-assemblies (7.96%), the suggestion box (6.42%), the Internet (5.70%) and opinion polls (5.41%). As these numbers demonstrate, informal conversations represent 70.26% of the responses and demonstrate the importance of the role played by directors and employees in forming relationships with the members. In contrast, such a response may also signal a low level of confidence or effectiveness in the formal systems of communication with the cooperative.

When asked about the ways in which they can express their opinion, present complaints or channel suggestions to the cooperative, 54.4% of the responding

members stated that they utilize conversations with managers and employees and 21.6% chose conversations with directors, representing an overall total of 76% of the responses. This total is quite close to that obtained in the survey among cooperatives. However, there is a difference in the proportion of conversations with directors and conversations with managers and employees. In the survey with cooperatives, these responses were approximately equal, but weighted more toward conversations with managers and employees in the survey carried out among members. Of the other responses put forward by the members, 7% utilize the suggestion box, 3.9% use the Internet, 3% focus on pre-assemblies and 0.3% on opinion polls. In this question, the responses given by the members converge with those given by cooperatives in relation to the use of the suggestion box and the Internet, but diverge in the cases of pre-assemblies and opinion polls.

Communication/information channels: Aside from the mechanisms used to gather opinions and suggestions, cooperatives must also have channels capable of providing members with access to information. In this regard, cooperatives responded that the means most frequently utilized to provide access to information are: bulletin boards (29.87%), Internet (18.77%), informative bulletins or journals (18.08%), external media (17.73%) and pre-assemblies (6.56%). When members were asked how they were able to gain specific knowledge regarding the questions dealt with in assemblies, they responded that they received correspondence sent to their homes (34.1%) and used informative bulletins published by the cooperative (14.9%). However, 12.3% affirmed that they were unaware of these issues. The cooperative bulletin board is cited by 6.8% of the answers and pre-assemblies by only 0.8%.

Mechanisms for ensuring representation to the different groups of members: Since cooperatives exist to serve the interests of all their members in detriment to private interests, mechanisms designed to ensure that the different groups will be represented are essential, since these groups may have distinct and sometimes conflicting objectives, particularly in the case of cooperatives allowed to freely admit members. In this framework, the cooperatives were asked if they were concerned with the question of representation of the different segments of members when forming the bodies required by legislation or when taking decisions of importance to the organization. The response "there is no concern with the representation of the different segments" was chosen by 35.6% of the cooperatives, followed by "yes, each segment is represented in the Council of Administration/Board of Directors and/or Fiscal Council" (23.8%). It is important to note that many cooperatives did not respond to this question (16.66%), despite the fact that they were given the option of responding "yes, in another manner", which received 16.79% of the answers. The answers highlight the need for instituting channels of communication between the different groups of members

and the directors, since many of the cooperatives were shown to have little or no concern with the question of representation.

b) The importance of separating strategic and executive functions in administration

With respect to administrative entities, Brazilian cooperative legislation requires that the institution opt to be administered by a Board of Directors or Council of Administration, both of which would be elected by the General Assembly, with due attention to the need for renewing specific percentages of the members of these bodies. The legislation also states that renewal of membership is not obligatory when the cooperative chooses to be administered by a Board of Directors.

Most of the financial cooperatives that responded to the survey (71.8%) had Councils of Administration for management purposes and not Boards of Directors, which are the two forms allowed by legislation. Of these cooperatives, 83.0% had an Executive Board within the Council of Administration, accounting for almost 60% of the total number of cooperatives included in the sampling. In other words, most financial cooperatives in Brazil have a configuration in which strategic functions and executive functions are superimposed one on the other. In 70.14% of the cooperatives covered by the survey, daily administrative affairs are mainly the responsibility of an "elected director, with executive functions", while a contracted executive is charged with administration in just 29.52% of these organizations.

The classic problem of governance - the superimposition of functions - is particularly evident when the president of the Executive Board and the president of the Council of Administration are the same person. This situation is found in 94.4% of those cooperatives that have Councils of Administration - and reveals that there is no concern with separating strategic from executive functions. Added to the fact that the president-director is, in most cases, indicated during the electoral process, with that person's name being included on the list of candidates, this situation contributes significantly to reducing the importance of the Council of Administration, by strengthening the position of the president-director.

At the same time in which they are members and vote on decisions taken by the Council of Administration, members of the Executive Board play a fundamental role in defining the strategies of the cooperative and in forming lists of candidates to legally required positions. Thus, most of those interviewed, including both Council of Administration and Executive Board members, stated that the Council of Administration plays the role of confirming Executive Board decisions rather than

adopting a proactive stance of proposing and supervising measures to be taken by the Executive Board. Therefore, the degree of independence of the Council of Administration in relation to the directors is compromised as a result of the concentration of power and information in the Board of Directors. Since the Executive Board often dedicates its efforts only partially to the activities of the cooperative - to the extent in which it is connected to the group of external control that created the cooperative (rural producers, business people, professionals or employees) - the Board tends to delegate a substantial share of its authority to the manager or superintendent, a fact that also compromises the Board's autonomy in the decision-making process of the cooperative.

In most of the cooperatives interviewed, the Council of Administration is composed of seven to nine members and, in all of them, the Executive Board is chosen among the members of the Council of Administration. The number of executive positions within the Council of Administration varies from two to four, with three being the most common number found.

With respect to the percentage of time required of the members of the Council of Administration or directors that do not have executive functions, the activity of "defining or analyzing strategy" occupies the largest amount of time (23%). Paradoxically, verification of numbers and operations (control function) occupies entirely too much time (21%), reflecting a superimposition of functions with those of the Fiscal Council or possibly a deviation from the role of the Council of Administration. The role of meeting the needs of members also occupies a significant share of the time of those members who do not have the executive functions. Though 18% of the time of the members of the Council of Administration is spent monitoring the activities of the executive directors, 22.19% responded that these directors do not provide information on their activities in a formal manner to the Council of Administration/non-executive directors. Furthermore, several factors are cited as evidence that, even when this information is provided, it is often given in a very limited way. The wide-ranging authority of the President-Director compared to the other executives and to the Council itself, asymmetry of information regarding the activities of the cooperative and frequent reelection of directors tend to create an environment that effectively limits the information required for oversight activities. Obviously, this does not mean there is no accountability, but only that its effectiveness can be considered quite limited. In many cooperatives, those holding positions in the Council of Administration are not paid for their efforts (40.95%). Though this can be understood as a voluntary contribution to the cooperative, the demands of dedication and time and the responsibility inherent to the position recommend that payment be made.

The data gathered by this survey indicate that there is a reasonable level of turnover among cooperative directors - 44.17% of all directors who responded to the survey are now in their first term in office. However, a glance at the other extreme shows that 6.09% have been returned to office at least five consecutive times. It should be stressed, however, that this does not indicate whether turnover does or does not exist. In 505 cooperatives, there are directors who have been elected for five or more consecutive terms, representing 42% of the sample. Only 18.02% of the cooperatives impose a formal limit on the number of times a member can be reelected. From the viewpoint of good governance practices, it is recommended that the number of reelections be limited in the bylaws of the cooperative.

Thus, it is recommended that there be a clear separation between strategic and executive functions in the administration of cooperatives.

c) The importance of different actors in the role of oversight and control

Potential differences between directors and owners and possible opportunistic behaviors can be limited through the use of internal and external control instruments (LAMB, s/d). Among the agents able to act as oversight and internal control instruments in financial cooperatives, the following deserve mention:

- Members: through active and well-informed exercise of their rights and responsibilities.
- Fiscal Council: through effective and independent inspection activities.
- Internal Auditors: by exercising their profession with quality and independence, adopting appropriate legal standards and notifying materially relevant results in objective and understandable reports to executive management, Council of Administration and Fiscal Council.
- Employees: by understanding the control processes approved by the executive management and Council of Administration, adoption of ethical institutional values. Institutional channels of communication and confidentiality must be provided to them so that they can communicate their concerns with regard to illegal or anti-ethical practices.

Though the Council of Administration and executive management have the major responsibility for operation of control and oversight instruments, they are subject to failure if the opportunistic interests of Council members are aligned with those of managers in such a way as to obtain benefits in detriment to the interests of other members. In this context, there is a need for establishing external controls, arrangements or dynamics found outside the framework of the organization, with

the aim of limiting opportunistic behavior on the part of directors (Council of Administration and executive management).

Differently from banks, since they do not have securities on the secondary market, financial cooperatives are not subject to investor analysis or market-imposed disciplinary measures. Nonetheless, integration of individual cooperatives into networks can be a powerful external oversight and control instrument and a guarantee of governance quality (Paradis, 2001). In this sense, the following agents act as inspection and control instruments in financial cooperatives.

- Financial system regulatory and inspection entities: by issuing rules and overseeing the activities of the segment, the Central Bank encourages creation of desirable standards of behavior. Since its mission is that of systemic security, it also coordinates the various external monitoring mechanisms aimed at enhancing effectiveness.
- External Auditors: professionals subject to the rules and oversight of the Securities and Exchange Commission, held judicially accountable for their position statements and reports in both the civil and criminal spheres. This tends to make the work of external auditing an effective instrument for overseeing and controlling accounting records.
- Credit Guarantee Funds: should a cooperative go bankrupt, these funds guarantee a specified amount to depositors; they can and must oversee the activities of these institutions, following the example of what occurs in the USA, where the *Federal Deposit Insurance Corporation* (FDIC) also has the function of banking supervision.
- Other agents that have interests in the cooperative: for example, private and governmental suppliers of resources.

With regard to inspection and control instruments, it is important to stress that information asymmetry is one of the major causes of opportunistic behavior. Therefore, the efficiency and efficacy of any oversight and control instrument, whether internal or external, are strongly dependent on the quantity and quality of the information made available to those responsible for this function. Consequently, these instruments must be guided by the principle of transparency in the relations among the agents/actors and in the dissemination of information.

Those charged with monitoring, control and oversight of financial cooperatives - members, internal and external auditing staffs, Fiscal Council members and other institutions included in the cooperative system - can act in such a way as to achieve greater security and strengthen the financial cooperative system in Brazil.

Members: as proprietors, members are the interested party in the business dealings of the cooperative. Therefore, the administration has the duty of creating instruments that will ensure participation and, in this way, avoid the so-called "free rider" effect. According to data revealed by the survey, 65% of the cooperatives stated that less than 15% of the members registered their presence at the most recent ordinary general assemblies of their cooperatives, thus revealing a very low level of participation. The major reasons cited by directors/cooperatives for this level of participation are: "confidence of the members in the administration of the cooperative" (32.2%) and "lack of knowledge on the part of members regarding the importance of the assembly" (27%).

Parallel to this, when members were questioned with regard to the low level of participation, the reasons given were related to personal factors (38.9% of the responses): 12.9% affirmed that going to the assembly "made no difference"; 12.4% said that "it took too much time"; 10% cited "travel difficulties"; and only 3% indicated that the reason was "confidence in the administration of the cooperative" - though 85.5% affirmed that they have total trust in their directors. More than half of the members (51%) stated that they had "other" reasons. Analysis of these "other" reasons shows that 55.9% are related to personal factors, such as lack of time a (35.9%), lack of interest (12.2%) and incompatible schedules, dates or distances (7.7%). In the framework of members' perception of the activities performed by the cooperative, one of the reasons indicated for the low level of participation was that holding of the assembly had not been publicized, with 8.8%.

These responses reveal the fragility of internal control and monitoring systems, as well as the existence of the so-called "free rider effect". By not participating, the member becomes less aware of his role and interprets his participation as increasingly less productive, thus generating a cycle that weakens internal control by the members. Lack of awareness of their rights and duties is another factor that tends to weaken the control function of the members: 50.6% of the members interviewed had never read the bylaws; 23.9% were not aware of their rights and duties and 41.3% had only partial knowledge of them.

This lack of control by members is an increasingly greater cause for concern among financial cooperatives. Since the users of the services are also the owners of the business, they assume risks and responsibilities that go well beyond those of a simple user of financial services. In light of the results of the surveys and the responsibilities that Brazilian legislation attributes to members, administration of cooperatives must guarantee the existence of institutional channels through which the members can effectively exercise their right/duty to oversee and control the business of the cooperative, since the legal responsibility of the members of cooperatives can be either limited or unlimited. The administration must create the

means by which members will be aware of their rights and legal duties, particularly as regards losses and/or damages.

Audits: one of the major contributions of audits is to reduce the information asymmetry that tends to favor opportunistic behavior on the part of those responsible for executive management. Managers tend to have better knowledge of the business of the cooperative than those responsible for oversight and control and, therefore, are in a position to omit information in their own benefit. The audit can reduce this asymmetry by verifying the veracity of the data provided in managerial and economic-financial reports sent to the Fiscal Council and Council of Administration. Auditing also mitigates operational risk, known also as process risk - risks of human failings, equipment or process defects and the risk of fraud and/or omission. Particularly in the case of small cooperatives that do not have computerized controls, risk management depends greatly on audits that are capable of independently reporting irregularities and relevant facts to the Council of Administration and the Fiscal Council.

According to the responses provided by the cooperatives, 74.48% did not have an internal auditing structure. This is partly explained by transfer of this service to central cooperatives. In those that have their own internal auditing structures, they are not normally subordinated exclusively to the Council of Administration - only 17.18% of the responses received from cooperatives indicated that the Council of Administration was charged with defining auditing guidelines and operations. If the Council of Administration is not responsible for this task, the auditing process could easily be jeopardized and lose the required degree of independence.

For internal auditing to be a significant oversight and control instrument, it must be independent and, in order to achieve this, rules and procedures must be set down that will guarantee the quality of its work. In this light, it is recommended that: (i) internal auditing be directly subordinated to the Council of Administration; (ii) the same Council should be charged with the task of contracting internal auditors; (iii) internal auditing reports should be sent to the Council of Administration, Fiscal Council and those charged with executive management; and (iv) the rules governing the cooperative should contain provisions that guarantee independence to internal auditing activities.

In the case of external auditing, since there is always the risk of contracting this function for the sole purpose of complying with a legal demand without guaranteeing the required level of independence, it is recommended that approval of the Council of Administration be required and that cooperatives adopt rules containing provisions that ensure the necessary degree of independence. As evidence that this may not be occurring, only 37.11% of the cooperatives included

in the sample stated that they have formal mechanisms designed to avoid the possibility of ties between the external auditing companies contracted and members or relatives of members of the legally required entities that exist within cooperatives. At the same time, this may also reveal a low level of concern with adoption of rules that guarantee the independence of such audits.

Fiscal Council: the Fiscal Council is a legally required entity that is independent of the administration and is composed of three effective members and three substitute members, all of whom are elected annually from among the membership by the General Assembly (BRASIL, 1971). The Council operates permanently and its primary responsibility is to oversee management and analyze financial statements, reporting its findings to the members during assemblies. Thus, the Fiscal Council is one of the most important inspection and control instruments, since it is subordinated exclusively to the General Assembly.

Despite its relevance, the Fiscal Council is mistakenly viewed by many as an entity that must restrict itself exclusively to questions of an accounting nature, based on analysis of quarterly balance sheets and financial statements for the fiscal year, after which it should issue reports regarding the latter. The responsibilities and the importance of the Fiscal Council are practically unknown to almost all of the parties involved, starting with the members themselves: only 20.2% responded that they were fully aware of the responsibilities of the Council; another 13% stated that they had partial knowledge, while the majority, 54.3%, confirmed their total lack of knowledge regarding these responsibilities. Despite this, 77% of the members responded that they considered the Fiscal Council to be effective and concerned with the solidity of the cooperative.

As regards the independence of the Fiscal Council, 62.6% of members considered it totally independent of the administration. In contrast to this position, the directors/cooperatives stated that the major reason for someone to become a candidate to the Fiscal Council was the indication/invitation by one of the directors or Council members (58.47%). This fact points to a situation of limited independence of Fiscal Council members in relation to cooperative directors, which further reinforces the perception obtained during the interviews that the Fiscal Council is often viewed as a steppingstone to the post of director, obviously deviating from its true functions and undermining control and oversight structures. In order to perform their oversight responsibilities, Fiscal Council members must have autonomous access to information pertinent to their office, coupled with the capability and duty to denounce errors, frauds or crimes found to exist to the proper administrative entities, while suggesting measures to be taken. Should the administration fail to take the required measures or hamper or impede access, the

Fiscal Council must have the authority to convoke a General assembly to denounce such facts.

Considering the importance of the Fiscal Council as an inspection and control instrument, as well as the scope of its work, several recommendations are required. For example, the Fiscal Council must be able to demand that the administration provide the human, material and financial resources needed to fulfill its responsibilities. At the same time, at the petition of any member, it must have the authority to request that the administration provide clarifications or information pertinent to its oversight function, together with elaboration of special financial or accounting statements, and to petition clarifications or information and investigation of specific facts from external and internal auditors. Furthermore, the Fiscal Council should have authority to convoke members of the Council of Administration, executive management or staff or invite members of the cooperative to provide clarifications.

With regard to the technical training of Fiscal Council members, 31.28% of the responses received from directors/cooperatives informed that there were no prerequisites regarding the technical background of members. The understanding expressed in this question is that, differently from the administration, which, in the case of cooperatives, is an entity with a high degree of political representation, the predominant factor in the Fiscal Council should be the technical capacity of its members. The answers received indicated that there is a great deal of space for improvement in this regard.

Considering that the Fiscal Council has specific responsibility for oversight and that the reason for its existence is to provide security to members, the cooperative must adopt institutional channels through which the members can monitor and question the work of the Council.

Systemic organization: in financial cooperatives, the network structure is an important external control instrument, since these organizations are not subject to the control exerted by capital market investors. To offset this lack of control, cooperatives require more supervision and regulation than other financial institutions. If they are connected to a cooperative system or a central cooperative that has self-regulation mechanisms or its own oversight system, this will evidently aid in completing the control and oversight structure, contributing to the good governance of these institutions.

By fulfilling their responsibilities in the area of governance, confederations or organized systems must lead the effort to reconcile the individual governance strategies of their affiliated cooperatives and singular cooperatives. Of the 1199

cooperatives that responded to the questionnaire, only 223 have no ties with another system. However, it is important to remember that the activities of confederations or organized systems in no way exempts the central or singular cooperatives from responsibility for the individual effectiveness of good governance practices.

With respect to relations among institutions within a cooperative system, it is recommended that organized systems define and publicize policies governing the relations among their affiliated organizations, in order to mitigate conflicts of interest among the central cooperatives and among these institutions and their respective singular cooperatives.

In order to ensure the independence of central cooperatives and confederations, particularly as regards supervision, executive positions in the singular cooperatives, central cooperatives and confederations must not be occupied by the same person. In 36% of the cooperatives interviewed, at least one of the members of the legally defined entities held a similar position in central cooperatives or confederations. Accumulation of positions, primarily including those of an executive nature, can generate conflict situations, since one of the responsibilities of the central cooperative is to oversee singular cooperatives. At the same time, holding positions at different levels will also reduce the dedication of members of singular cooperatives when they assume functions in the central cooperative and/or confederation.

It is also recommended that central cooperatives produce and publicize the classification/indicators of their affiliated cooperatives - such as administrative costs compared to revenues, levels of risk exposure and delinquency rates, among other items of interest to members. These indicators may also serve as a source of reference for the various parties concerned - members, employees, community, supervisory and control entities, financial institutions supplying resources.

6. FINAL CONSIDERATIONS

The financial cooperative system is recognized as a mechanism for facilitating the access of its members to financial savings and credit instruments, reducing operational costs and stimulating local allocation of the resources obtained, thus contributing to improving the quality of life of the population in the municipalities in which they operate. Aside from this, by fostering the principles of the cooperative movement, the system helps to reinforce such values as ethics, the spirit of participation, solidarity and accountability, all of which contribute to the

quality of the institutional business environment. These factors demonstrate that, given the direct benefits received by participants and others located in the same region, expansion of the system is highly desirable.

However, the growth of this system demands strengthening in terms of specialization and management capacity, in such a way as to make the business operations carried out by the cooperative just as attractive or even more attractive than those carried out by other financial system institutions. As competitive pressures with the financial market tend to become more accentuated, personal relations with members/clients, proximity to directors and adequate customization of products and services to the needs of members represent competitive advantages for the cooperatives that must be preserved in order to mitigate risks and strengthen the system.

Consequently, given its responsibility for financial system regulation and supervision, the Central Bank of Brazil developed this study as the foundation upon which it elaborated proposals for good governance practices in financial cooperatives in Brazil. Duly respecting the specificities and potentialities of this system in the national framework and acting in a permanent dialogue with cooperatives and their respective professional representative entities, the underlying philosophy of this study is not to coerce but rather to induce these organizations to improve their governance standards, in the understanding that only in this way will it be possible to achieve the sustained growth of this system.

BIBLIOGRAPHY

AKERLOF, George A. The Market for "Lemons": Quality Uncertainty and the Market Mechanism (1970). *Quarterly Journal of Economics*, Vol. 84, No. 3, pp. 488-500

BIRCHALL, Johnston; Simmons, Richard (2004). What Motivates Members to Participate in Co-operative and Mutual Businesses? *Annals of Public & Cooperative Economics*, v. 75, n.3, p. 465-495.

BRASIL. *Lei n. 4595*, de 31 de dezembro de 1964. Dispõe sobre a Política e as Instituições monetárias, bancárias e creditícias. Cria o Conselho Monetário Nacional e dá outras providências. <http://www.senado.gov.br>.

BRASIL. *Lei n. 5764*, de 16 de dezembro de 1971. Define a política nacional de cooperativismo, institui o regime jurídico das sociedades cooperativas e dá outras providências. <http://www.senado.gov.br>.

CARVALHO, Antonio Gledson. Governança corporativa no Brasil em perspectiva (2002). *Revista de Administração*, São Paulo, v. 37, n.3.

FAMA, Eugene F.; JENSEN, Michael C. (1985). Organizational forms and investment decisions. *Journal of Financial Economics*, v. 14, p.101-119.

FONTES FILHO, J. R.; VENTURA, E. C. F.; OLIVEIRA, M. J. (2006). *Avaliando as possibilidades de modelos participativos de governança: o ambiente das cooperativas de crédito*. X Colóquio Internacional de Poder Local. Anais... Salvador.

LAMB, Roberto (s/d). *Governance corporative: arena e contexto*. Universidade Federal do Rio Grande do Sul, mimeo.

PAGNUSSATT, Alcenor (2004). Guia do cooperativismo de crédito: organização, governança e políticas corporativas. Porto Alegre: Editora Sagra Luzzatto.

PARADIS, Ghislain (2001). *Governance in Savings and Credit Cooperatives*. Notes for a presentation – Fourth Seminar on New Development Finance – September 7. <http://www.did.qc.ca/documents/GPA_Frankfurt_SEP01.pdf>.