

# Research on Operation Model of Financial Cooperative for SMEs

Dong Bing

School of Management, Wuhan University of Technology, Wuhan, P.R.China, 430070

(E-mail:whlgdx1313@126.com)

**Abstract:** China's small and medium enterprises (SMEs) are facing difficulties in financing, and financial cooperatives is an effective financing channels for many small and medium enterprises. This paper studied the concept and characteristics of cooperative finance. Subsequently, based on the theory of financial cooperation, this paper discussed the preparation stage, initial phase, operation phase and distribution phase of financial cooperatives.

**Key words:** Financial cooperative; Small and medium-sized enterprises; Operation model

## 1 Introduction

The small and medium-sized enterprises(SMEs) are honored as the most active cell in the economy development and have played a very important role in economy development, market prosperity and employment expanding. However, due to the shortcomings of SMEs and imperfect financial system in China, it is difficult for them to make use of internal and external financing. Lacking of funding has become the main bottleneck for the development of SMEs.

Financial cooperatives described in this paper are to specifically solve the real financing problems for SME. The financial cooperative is established mainly aimed at improving its members' production and living conditions by using the collective strength of cooperatives, and maintain their own share of interest. A regional financial cooperatives can make full use of local information, easily understand the operating conditions, future projects as well as credit standards of SMEs, thus they can overcome the high barriers of financial service industry caused by asymmetric and incomplete information. Therefore, the financial cooperative is an effective financing channels for many SME, particularly for small and medium-sized enterprises with poor credit. As financial cooperatives are established on the basis of credit unions and financial companies, therefore, in theory, the establishment of financial cooperatives is a new starting point of financial intermediaries, as well as the intersection of corporate finance and finance Intermediaries. This has a very important theoretical value for exploring effective financial management, improving capital effectiveness and accelerating the development of SME.

## 2 Literature Review

### 2.1 Concept of cooperative finance

The idea of cooperative finance is produced and developed on the basis of cooperative economy, mainly evolves from the idea of Schultz's urban cooperative finance and Ray's rural cooperative. Harvey offered the explanation of cooperation finance, most people voluntarily gather together their savings, excludes the profit-making purposes of banks and money lenders, and the surplus is evenly distributed between the borrower and depositor<sup>[1]</sup>. Borgen argued that grass-roots cooperative financial organization could be interpreted as a combination of equal status. He didn't considered cooperatives as combination of property but money. All members, regardless of rich or poor, are equal in status. The aim of combination is to receive funding in the group which they cannot collect individually. They only loans to its members, make use of money carefully for production or other necessary things<sup>[2]</sup>. Light as well difined the co-finance. He argued that cooperative financial organization is automatically organized by small producers and workers. There is no limit on the number of members. The total assets are owned by all of the members, and democracy is considered as the basis of its business. They absorb the savings of members, while lending to members with the most favorable conditions, which makes the members share the benefits mutually. The surplus turns into a public accumulation or distribution of the depositors, borrowers and Shareholders<sup>[3]</sup>.

### 2.2 Characteristics of cooperative finance

#### (1) Cooperative

Cooperative is the most fundamental feature of cooperative finance, which makes cooperative finance relatively self-contained, and be different from commercial finance and political finance<sup>[4]</sup>. People who advocate cooperation organized their own cooperative financial institutions in line with the principles of cooperation, in order to gather funds as a whole continually, and obtain

loans through cooperative organizations which can meet the financial needs of members. Therefore, cooperation is the foundation of financial needs of the members.

(2) Slight joint by the media capital

The joint is frail, as it is very difficult for commodity's producers and workers to meet the funding needs for production and life through commercial finance. The production scale is small, and the risk of resistance is low, therefore, even they can get part of money, its conditions are quite demanding<sup>[5]</sup>.

(3) Not simple for the purpose of profit

The objective of cooperative finance is to realize mutual assistance between members, provide members a variety of convenient financial services, not to profit from them<sup>[6]</sup>. In the credit cooperatives, members store the balance in the credit cooperatives, and borrow money from the credit cooperatives when they need fund<sup>[7]</sup>. They obtain mutual benefit by time difference of money surplus between members. Of course, cooperative financial organizations also pursuit operating costs and appropriate profit, while they don't consider chasing high profit as the only target.

### 3 Operation Model of Financial Cooperatives

The operating model of financial cooperatives can be divided into four stages, namely, the preparation phase, initial phase, operational phase and distribution phase.

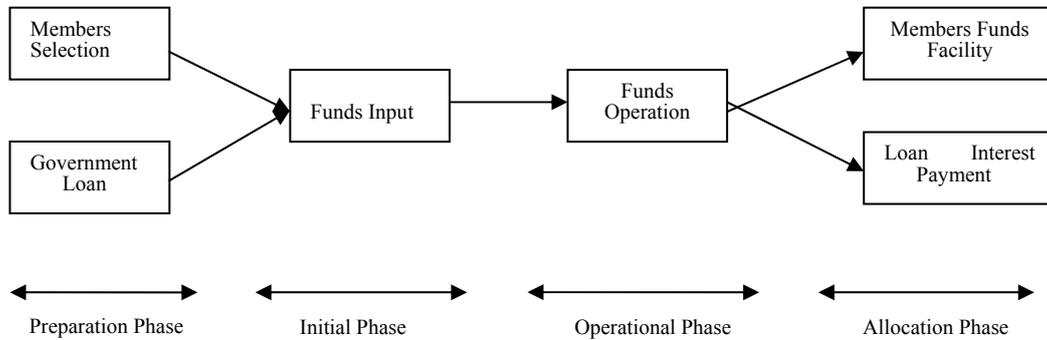


Figure 1 The Figure of Financial Cooperatives Operating Model

#### 3.1 Preparation phase

##### 3.1.1 Members selection

As financial cooperative is the emerging financial intermediaries for SME, and the research is still in its pilot phase, therefore, there is a certain standard for choosing members in order to reduce operational risk of financial institutions.

As financial cooperative is regional, the choice of members is accordingly regional. Selecting members from a certain region can take full advantage of local information, easily understand the operational conditions, prospects of the project, and credit worthiness of SME in the region. It also can effectively overcome the operating barrier of higher transaction costs leading by asymmetric information and incomplete information, which can reduce the operational risks of financial cooperative.

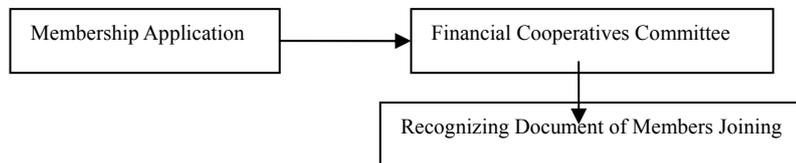


Figure 2 The Figure of Members Entrance Flow

##### 3.1.2 Government loan

Government loan mainly refers to the government's political support funds, which will be one of the important funding sources of financial cooperatives.

Cooperative financial mechanism can only effectively run in certain social environments. Effective operation of financial cooperatives also needs some governmental support. Financial cooperatives are

after all regional financial institutions which are organized by private voluntary.

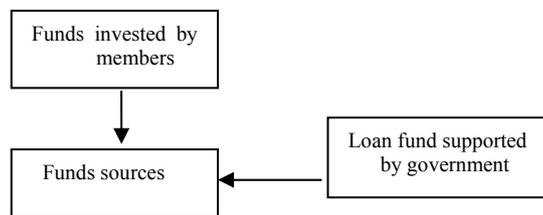
Government borrowing means the supporting fund for financial cooperative is allocated by the government. Financial cooperatives absorb these political borrowing funds and pay the corresponding loan interest.

The supporting fund of government loan can play a significant role in achieving financial intermediation for the members. Political loan fund can be divided into different types according to different types of SME, for example, development fund of SME can be paid by the developing SME, scientific and technological achievements fund and seed fund of scientific and technological innovation can be issued by high-tech SME. In addition, government should supervise the operation state of the loan fund as a creditor.

**3.2 The initial phase**

The initial stage of operation of financial cooperatives refers to the input stage of capital. Through members selection and government loan, the establishment of financial cooperatives have sources of funding. One of the investment funds is for members joining, another is supporting loan fund of the government.

Members can pay for the joining funds in the forms of cash and cash equivalents, as well as physical, intangible assets, real estate, capital contributions and other property rights, but not investment in labor. Members make contribution by physical, intangible assets, real estate and other property rights. The input stage of the funds provides a funding base for the establishment of financial cooperatives, which is also the starting point of the effective functioning of cooperatives.

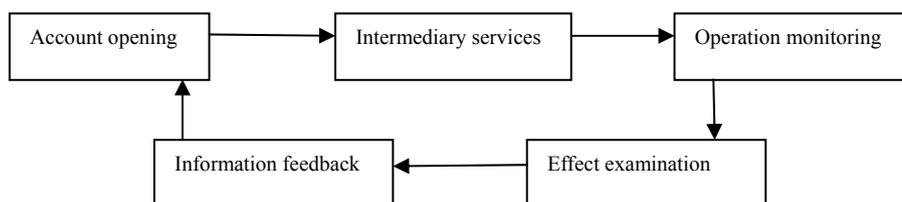


**Figure 3 Funds Sources of Financial Cooperatives**

**3.3 The operational phase**

The operational phase of financial cooperatives is after the phase of fund preparation and investment. This stage is crucial for the operation of financial cooperatives, which is an important stage for members to achieve financial intermediation.

After recognizing members joining, the members have to sign an agreement to undertake the rules of complying co-operation. In the operational phase, members are responsible for the entire process of funding which includes purchase, production sales and profit distribution. The entire process is accounted in the cooperative financial system. All members open deposit and loan accounts in the financial cooperatives. Meanwhile, financial cooperatives run the implementation of the escrow funds, operational monitoring, assessment and feedback effects of fund operation.



**Figure 4 Funds Operation Flow of Financial Cooperatives**

The unified operation and account of members' capital mainly includes three lines of business which are liabilities business, asset business and intermediate business. Liabilities business mainly refers to the absorption of members' deposit, which will become an important funds source of financial cooperatives. There are two kinds of asset business, one is giving loans to members in the cooperative, the other is discounting for the members and further broadening the scope of agency facilities. Intermediate business refers that financial co-operative provides financial intermediation services for their members and charge procedures fee.

### 3.4 The allocation phase

The fund sources of financial cooperatives' operation mainly includes investment funds for members joining, loan funds from government support and idle funds deposits of the members. Since organization's mutual funds help is the fundamental function of financial cooperatives. In the distribution stage of cooperatives, funds should be embodied and the allocation of funds should be optimized.

#### 3.3.1 Community financing facility

Since members are responsible for the entire process of funding which includes purchase, production sales and profit distribution, and the entire process is accounted in the cooperative financial system, in and after the process of capital running, strengths and weaknesses complement each other can be achieved for members.

Part of the seasonal bank deposits and other idle funds can be loaned to members who have financial shortfall by deposit and loan accounts in order to achieve the rational allocation of funds between members and financial facility for members who have financial shortfall.

#### 3.3.2 Loan interest payments

The interest payment of loan here only refers to those paid to government by financial cooperatives in the distribution phase, rather than absorbing interest of members' deposit. Absorption of members' deposit and capital interest payment of short-term deposits should be intermediation service fee for financial cooperatives, which is owned by the cooperatives.

In the preparatory phase of preparing financial cooperatives, government's supporting loan funds become one of the important sources of funding. As a financial cooperative's creditors, government should receive some money paid.

## 4 Conclusion

Based on the ideas of financial co-operation, combined with the basic knowledge of financial intermediation, this paper constructed a special financing institution for the SME financing services. Through analysis and elaboration of the preparation stage, initial stage, operational phase and distribution phase of financial cooperation, this paper explored the new operational model of financial cooperation in theory. Limited by the author's knowledge, the theoretical studies of financial cooperatives have yet to be perfected.

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