WORLD BANK WORKING PAPER NO. 82

Cooperative Financial Institutions

Issues in Governance, Regulation, and Supervision

Carlos E. Cuevas
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THE WORLD BANK
Washington, D.C.

Manufactured in the United States of America
First Printing: June 2006

printed on recycled paper

1 2 3 4 5 09 08 07 06

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ISBN-10: 0-8213-6684-X ISBN-13: 978-0-8213-6684-4
eISBN: 0-8213-6685-8
ISSN: 1726-5878 DOI: 10.1596/978-0-8213-6684-4

Cover photo of Ghanaian women making payments by Ingrid Hesling, courtesy of Photoshare.

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Library of Congress Cataloging-in-Publication Data has been requested.

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Abstract

The paper addresses topics on which an agreement is necessary to arrive at consensus guidelines or "principles" of regulation and supervision of cooperative financial institutions (CFIs) in developing countries. Specifically we identify those aspects related to CFI industry structure, governance, legislation and regulation over which a well established base of knowledge exists; we point out the most important gaps in understanding and those over which a considerable degree of disagreement among stakeholders appears to exist and that require research to consolidate opinions. Three main topics covered are: (i) the fundamental structure of the sector in terms of its internal (micro) and inter-CFI (macro) organization, with focus on the agency conflicts inherent in the mutual structure, the extent to which they contribute to failure risk, and to whether and how these conflicts are controlled by existing governance mechanisms; (ii) the existing legal frameworks in an international context, their origins and the implications for the functioning of CFIs; and (iii) the regulatory frameworks under which CFIs operate and the different propositions by stakeholders about what should be an appropriate regulatory framework and an effective supervision mechanism.

The main propositions that emerge from the paper requiring verification are the following:

1. The CFI present advantages over investor-owned financial intermediaries in the provision of financial services through breaking the market failure that leads to credit rationing, thus contributing to a "functional financial system" in the sense of Merton and Bodie (2004).
2. (By extension of 1) a financial system that presents a diversified institutional structure, including institutional types, among other CFIs, will be more efficient in promoting economic growth and reduced poverty.
3. Expense preferences (EP) by managers—or equivalently the member-manager conflict—is the principal source of CFI failure. Control of expense preferences should be a central theme of prudential supervision of CFIs.
4. Inter-CFI alliances (federations, leagues, and so forth) are hybrid organizations that allow CFIs to exploit economies of scale and manage efficiently uncertainties in the procurement of intermediation inputs. Thus, the legal framework should facilitate the formation of such alliances and provide legal support to the inter-cooperative contracts that result.
5. Inter-CFI alliances that include private ordering mechanisms and separate strategic from operational decisionmaking between the base units and the apex contribute to the control of expense preference, thus enhancing the resiliency of the system to failures and crisis.
6. Mutual financial intermediaries require a specialized regulatory environment that supports the special nature of the contracts imbedded in the institutions.
7. Indirect supervision (auxiliary/delegated) is a powerful tool to: (i) adapt supervision to specific needs of the CFI; (ii) facilitate integration of the CFI to a

supervision environment with financial sector standards; and (iii) encourage integration.

8. Tiering (splitting) the CFI sector into two groups, one being a large/open CFIs under banking authority supervision and another a small/closed CFI, is (is not) a reasonable strategy to creating an appropriate regulation and supervision (R&S) environment for CFIs.

Preface

This paper is a product of ongoing work on Cooperative Financial Institutions at the Financial Sector Operations and Policy Department of the World Bank. The views expressed in the paper are those of the authors and not necessarily those of the World Bank or its affiliate institutions. The authors gratefully acknowledge valuable and elucidating comments on earlier drafts from Messrs/Mmes. Brian Branch (World Council of Credit Unions), Anne Gaboury (Développement international Desjardins), Renate Kloeppinger-Todd and Andre Ryba (both World Bank), and from participants at an IMF/MFD Seminar in November 2005. Remaining errors and opinions, however, are sole responsibility of the authors.

Abbreviations and Acronyms

AH	Appropriability hazard
ATM	Automatic teller machine
BCBS	Basel Committee of Bank Supervision
BCC	Banco de Crédito Cooperativo
BCC (Peru)	Banco Central Cooperativo (Peru)
BoD	Board of Directors
CFI	Cooperative financial institution
CGAP	Consultative Group to Assist the Poor
COFAC	Cooperativa Nacional de Ahorro y Crédito
CPM	Caja Popular Mexicana
CUSOs	Credit Union Service Organizations
DGRV	Deutschen Genossenschafts- und Raiffeisenverbands (German Confederation of Cooperatives)
DID	Développement International Desjardins
EEC	European Economic Community
EP	Expense preferences
FC	Financial cooperative
IAS	International Accounting Standards
IBDA	International Bond Dealers Association
ICA	International Cooperative Alliance
IDRC	International Development Research Centre
IFAD	International Fund for Agricultural Development
IFRIC	International Financial Reporting Interpretations Committee
ILO	International Labour Office
IRU	International Raiffeisen Union
ISDA	International Swap Dealers Association
NCUA	National Credit Union Administration
NGO	Non-Government Organizations
NIE	New Institutional Economics
PAMECAS	Programme d'appui aux mutuelles d'épargne et de crédit au Sénégal
PARMEC	Projet d'appui à la réglementation sur les mutuelles d'épargne et de crédit
R&S	Regulation and supervision
TCE	Transaction costs economics
UCONAL	Unión Cooperativa Nacional
UK	United Kingdom
WOCCU	World Council of Credit Unions
WSBI	World Savings Banks Institute

CHAPTER 1

Introduction

"Subject to little, if any, pressure from savers, management is a self-perpetuating autocracy."

—Nicols (1967: 337)

"In terms of supervision equal treatment does not mean uniform treatment but non-discriminatory treatment which recognizes the distinct character of cooperatives."

—United Nations (2003) report (p. 10).

Cooperative financial institutions (CFIs), albeit highly pervasive in most countries, are among the poorly understood entities that comprise the existing institutional base for financial intermediation. CFIs include diverse member-owned financial intermediaries referred to as credit unions, savings and credit cooperatives, cooperative banks, and other terms that differ across regions of the world.[1] Their institutional structure and governance, legal and regulatory status, and scale and services portfolio also vary widely across regions and especially between industrialized countries and developing economies. A most basic common denominator is that they collect deposits and do business often solely with members.[2] Existing literature already supports the notion that CFIs serve many poor people, even though middle-income clients are also among their membership, a feature that in fact allows CFIs to reach poor segments of the population without necessarily compromising their sustainability. In many cases CFIs serve larger numbers of poor people than specialized ("targeted-to-the-poor") microfinance institutions, without relying on donor support as the latter do.[3]

1. For example, Savings and Credit Cooperatives (SACCOs) in East Africa; "Caisses populaires" or "Caisses d'épargne et de crédit" in West and Central Africa; "Cooperativas de ahorro y crédito" or "cajas de ahorro y crédito" in Latin America; credit unions in the UK, USA and parts of Canada.
2. Although in some cases they also serve non-member users; the distinction between members and non-members is often a small share purchase.
3. See Appendix for a more extensive background on CFI.

Box 1: What Do We Mean By "CFI"?

Under the term CFI (cooperative financial institutions) we include institutions that bear different names but are essentially identical. Only in few cases do they have special organizational features. The most common expressions used for CFI are financial cooperative (FC) with it Spanish translation *cooperativa financiera*, savings and credit cooperative (SACCO) with its Spanish translation *cooperativa de ahorro y crédito, CAC* or *COPAC*, and credit union (CU) with its Spanish translation *union de crédito*. There are also the non-English expressions such as the French *caisse* with its variations—*agricole, populaire, mutuelle*—of which *populaire* is probably the most common, with its Spanish translation of *caja* or in Portuguese *caixa*. Under CFI we also include a number of institutions known as cooperative banks (CB). The expression cooperative 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 cooperative network (U.K., Swizerland); or an entire network of CFI, 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 know as a "savings and loans association" (S&L) of mutual ownership, which are strictly speaking not cooperatives. These latter are not the subject of this document although we refer to them in several occasions.

Why an issues paper on governance, regulation, and supervision? First, because lack of knowledge of these matters has been a recurrent obstacle in development finance, resulting in widespread neglect of the CFI sector in spite of its pervasiveness and potential. Second, because there are topics related to organization, governance, legislation, regulation, and supervision of cooperative financial institutions over which there is no agreement but over which one is needed if we are to facilitate the growth of these institutions and realize their potential for serving the poor. The "issues" are not about the (group of) ratio(s) to use in inspection, or whether there should be an early warning system in place, or how much provisioning to make on how many months of interest arrears, or the frequency for site-inspection, or the content of an audit report and many other technical details pertaining to the monitoring of CFIs. Over these points a group of experts could rapidly converge on opinions and make well thought-out recommendations. On these points most internationally known technical advisers (DGRV, DID, WOCCU, and others) usually have precise opinions and schemes, and they are all reasonable and well thought out. The true "issues" over which large disagreements exist are not those. They address more fundamental questions such as: what are the main strengths and weaknesses of CFIs, what is the role of integration (in networks), how much of it is good and should it be encouraged, what is the role of the legal framework in doing this, should the legal framework be a specialized one covering uniformly all CFIs or should the system be tiered, should CFIs fall under banking authority supervision—most agree that yes, it should—but then how: direct, delegated or auxiliary supervision? And what are the differences, if any, between these schema, and the effects they have on performance of CFIs? What should the role of the sector itself be in the design and implementation of any new legal or regulatory framework?

Addressing these issues is fundamental. The best implemented CFI management and control systems may be rendered useless by a flawed regulatory framework. What is the good of having excellent management tools implemented if suddenly the banking authority demands that the minimum capital of a CFI must be US$5.0 or 10.0 million and that reports must include values for 1500 accounting items as all the rest of the investor-owned banking system (such as Argentina, Uruguay, Colombia)? Or the central cooperative bank of a network fails, with the concomitant loss of substantial investments (Colombia, Costa Rica)? Or the banking authorities consistently refuse to take charge of the supervision of the sector (Nicaragua)? What good is it to implement a "delegated monitoring system" if it is riddled by interest conflicts that make it totally ineffectual? What if there are sound economic arguments, and experiences, that support the notion that this is an effective mechanism that overcomes banking authority reticence to engage in CFI supervision in addition to facilitating several other positive developments?

Thus, the goal of this issues paper is to address directly those topics on which *no agreement* exists but over which *an agreement is necessary* to arrive to some consensus "guidelines," or even better "core principles," of regulation and supervision (R&S) of CFIs in developing countries, something that exists now for over seven years for the investor-owned banking system.

To assess the specific needs in terms of R&S of CFIs we will make three fundamental assumptions:

1. Using principles of agency theory we view the institutions as bundle of contracts between different principals and agents. Failures result from situations where agency conflicts reach unsustainable levels that put the stability of the institution in peril. This includes an analysis of the governance structures build within and between CFIs and their degree of efficiency in controlling conflicts between contracting parties and to facilitate its role to deliver financial services to members.
2. Employing an "incentive-conflict justification for regulation" approach, we assess the needs of regulatory intervention to increase fairness, efficiency, and enforceability of contracts, and reduce failure risk by focusing on those agency conflicts among all possible candidates that contribute most to that risk.[4]
3. Regulation is viewed as a mechanism to control agency conflicts that complements three other mechanisms: internal (governance bodies, design of contracts), market based (prices of shares, market for corporate control), and private ordering mechanisms used by bureaucracies to whom the enterprise may belong (trade association, auto-regulatory body or alliance). These four mechanisms, as shown in Figure 1, act in complementary fashion, the higher the efficiency of one, the lower will be the marginal contribution of the other three to control the conflict.

Thus, to analyze the specific needs of CFIs in terms of a regulatory response by the state we employ a theoretical framework that is based on the following central idea: *financial regulation exists to insure that contracts between stakeholders of an institution are fair, efficient, and enforceable.* A reliable regulator can improve the fairness, efficiency, and enforceability of agreements by offering to mediate transactions in which the interests of stakeholders diverge.

4. The approach was proposed and explained by Kane (1997).