Governance, Regulation, and Supervision of Cooperative Financial Institutions

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Outline

- Context and motivation – “the world of Cooperative Financial Institutions (CFIs)”
- Overlaps, links and confusion with “microfinance”
- Why specific regulation and supervision for CFIs?
- Governance and risk in CFIs - agency conflicts
- CFI Alliances (networking)
- The legal environment
- Regulation and supervision – addressing agency conflicts
- The debate over auxiliary/delegated supervision
- Towards a set of “core principles” of CFI regulation and supervision
Context and motivation

World Bank/FSE study of CFIs

Phase I
- Issues paper and preliminary country studies
- Focus on regulation and supervision

Phase II
- In-depth country studies and institutional analyses
- Deepening regulation and supervision – “core principles”
- CFI Performance and regulatory frameworks
- TA programs
The “world” of CFIs

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Context and motivation (3)
Overlaps, links and confusion with “microfinance”

- Microfinance
  - banking services to low-income clients (policy maker/donor definition)
  - low-value financial services and transactions (regulator/working definition)
- Diversity of services (credit, deposits, payments)
- Diversity of institutions
  - Microfinance Institution (MFI)-MF as “primary activity”
  - Financial institutions “practicing microfinance”: commercial banks, CFIs
Overlaps, links and confusion with “microfinance” (2)

- Prudential *versus* non-prudential regulation
- Specific features of CFIs
  - Deposit-taking
    - Closed-bond
    - Open-bond
  - Large numbers, diverse sizes
  - Diverse clientele (poor and less poor)
  - Geographically dispersed
Why specific regulation and supervision for CFIs?

- Specific features (previous slide)
- Owners are both suppliers and users of funds
- Usually under a combination of laws – cooperatives societies/banking
- Sources of default risk
  - governance-related risks
- Between investor-owned banks and NGOs? – Not really
Governance and risk in CFIs – agency conflicts

- Cooperative “principles”
  - One-person/one-vote
  - Member solidarity
  - Volunteer board
- Strengths: “natural” solution to adverse selection
- Weaknesses: member-manager conflicts as source of vulnerability
Governance and risk in CFIs – agency conflicts (2)
Governance and risk in CFIs – agency conflicts (3)

- Scale – governance trade-offs
  - CFI scale and perverse incentives for managers
  - What is too large? What is too small?
- Net borrower – net saver conflict
- Member – manager conflict
  - Manager’s expense preference (EP)
  - Effects of weak competition and subsidized financing
- Closer to banks than to NGOs, but different conflicts within the institution
CFI alliances (networking)

- Input pooling – mergers or alliances
- Alliances
  - Control over distribution of pay-offs
  - Private ordering (control) mechanisms
  - Consensual networks
  - Strategic networks
- Network private ordering mechanism as a base for delegated or auxiliary supervision
CFI alliances (networking) (2)

- Empirical tests in developed systems
  - Integration reduces variability of CFI performance
  - Strategic networks are more efficient and perform better in outreach than consensual networks

- Sources of stress in networks
  - Skewed size distribution of member CFIs
  - Basle II and rating agencies
Legal environment

- Learning from past mistakes – cooperatives as instruments of the state
  - India then (1904) and now (2004)
- Recognizing (and reconciling) differences with NGO-microfinance
  - Mexico’s LACP
- Dual regimes (cooperative societies law and banking law) – pros and cons
- Specialized CFI laws
Regulation and supervision - addressing agency conflicts

Key factors
- Member-manager conflict as main source of vulnerability
- Alliances and networking
- Market segment in which CFIs operate

Re-evaluating control mechanisms
- Reporting standards
- Redeemable capital and unconditional prohibition of redemption (IAS 32)
Auxiliary / Delegated Supervision

- Direct versus indirect monitoring
  - Pragmatic questions
- Indirect supervision (degrees of separation)
  - Auxiliary
  - Delegated
  - Mutual solidarity agreements and apex capacity
- The case against self-supervision
Auxiliary / Delegated Supervision (2)

- Why it might work
  - Alliance private control mechanisms
  - Incentives for shareholders to cooperate with regulators

- Why it might not work
  - Lack of regulator independence
  - Weak network governance

- Does it work?
## Auxiliary / Delegated Supervision (3)

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<th><strong>Cooperative</strong></th>
<th><strong>CFI Specialized</strong></th>
<th><strong>Banking</strong></th>
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<td><strong>Direct</strong></td>
<td>IC: New Zealand, UK</td>
<td>IC: Ontario (Ca)§, Saskatchewan (Ca)§, United States, DC: Belize(☼)</td>
<td>IC: Italy (B. Popolari), Switzerland</td>
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<td></td>
<td>DC: Argentina, Bangladesh, Benin, Botswana, Bolivia, Colombia, Costa Rica,</td>
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<td>DC: Argentina*, Bolivia, Colombia, Costa Rica, Ecuador, Jamaica, Uruguay*</td>
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<td>Ecuador, Ghana, India, Malaysia, Nigeria, Panama, Paraguay, Philippines, Thailand</td>
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<td><strong>Indirect (2)</strong></td>
<td>IC: Australia, Austria, British Columbia (Ca), France, Germany, Ireland, Italy</td>
<td>IC: QC: Quebec (Ca), DC: Peru</td>
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<td><strong>Auxiliary</strong></td>
<td>(BCC), Netherlands, DC: Benin, Brazil, Korea.</td>
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<td><strong>Delegated</strong></td>
<td>IC: Quebec (Ca), DC: Peru</td>
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<td><strong>Auto-control</strong></td>
<td>IC: Colombia, Sri Lanka</td>
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Auxiliary / Delegated Supervision (4)

- Synthesis of pros and cons
- Costs of supervision
  - Who should bear them?
  - Fixed costs and variable costs
Towards “principles” of CFI regulation and supervision

- Finding a consensus
- For
  - The experience of banking (Core Principles of Bank Supervision in Emerging Markets)
  - Experience with previous “models”
- Against
  - No BCBS for CFIs
  - Local politics