Chapter 6. The origin and rationale for financial cooperative regulation in underdeveloped economies

Amr Khafagy

6.1. Introduction

The financial crisis brought attention to the damaging consequences of rapid financial expansion without an adequate regulatory and supervisory environment, which could have drastic consequences that go beyond the financial sector threaten the stability of the whole economy. In most underdeveloped economies, nonbank financial institutions are the main providers of financial services to small businesses and middle- and low-income households. In some regions, financial cooperatives are the main providers of microfinance services. An enabling regulatory framework is essential to ensure the effectiveness and sustainability of financial cooperatives in providing the financial services needed by their members, and to support the expansion of the sector. Particularly as the sector expands and becomes more complex, regulators must be responsive to ensure the stability of the sector and protect the interest of the members. This chapter reviews the origin of and rationale behind financial cooperative regulations. It complements the findings of chapter 7 and is highly inspired by Cuevas and Fischer (2006). The chapter starts by giving a brief overview of the history of financial cooperative laws and the current approaches adopted to regulate the sector in underdeveloped economies. It then discusses the rationale behind regulating financial cooperatives differently from other financial institutions, given their unique institutional characteristics and the main challenges commonly faced by that sector. This chapter focuses on how regulations should maintain the autonomy of financial cooperatives and protect the sector from destructive government interference; how regulations can address agency problems inherited in their governance structure; and why regulations must support institutional integration between financial cooperatives themselves and facilitate the creation of second-tier cooperatives or federations. It also addresses the importance of capital requirements and the challenges these requirements impose on the growth of financial

cooperatives. Finally, it discusses the suitability of deposit insurance schemes to protect members' deposits.

The key objective of financial regulation is to achieve overall economic efficiency, stability and fairness through controlling market failures in the financial sector caused by externalities, monopolies, and information problems (Vittas, 1992: 40). The key objective of financial regulations is to limit the power of monopolies that lead to serious market distortions. Financial regulations are important to avoid having an oligopolistic financial system controlled by a few 'champions' who are too big to fail but also very costly to safe, as was the case during the 2007-08 financial crisis. Financial regulations are also crucial to safeguard the interests and rights of ordinary people by protecting their deposits, and to internalise the externality caused by the failure of an individual bank from spreading to other banks, thus mitigating the social and economic costs arising from the insufficient performance of an individual bank (Brunnermeier, et al., 2009: 2-5). Vittas (1992: 41) identified six reasons for government intervention in the financial sector through regulation. First, to control the level of aggregate economic activity, and adjust major market imbalances using macroeconomic controls. Second, to redistribute financial resources among different sectors, geographic areas and social or economic classes, using targeted credit programs and subsidised interest rates, through allocative controls. Third, to shape the structure of the financial system by setting market entry requirements, regulating mergers and controlling the activities undertaken by different types of financial institutions through structural controls. Fourth, to maintain public trust in the financial system by guaranteeing the safety and soundness of individual banks through means of prudential controls like licensing criteria, capital requirements and risk management standards. Fifth, to enforce disclosure of market information using organisational controls to ensure transparency and equality in financial transactions. Sixth, to protect consumers through protective controls, especially individual depositors and nonprofessional borrowers.

Small primary financial cooperatives with few members are similar to a formalised type of rotating savings and credit associations (ROSCAs). They benefit from the strong social relations that exist among members of a small group to overcome information asymmetry problems and provide financial services to the members at lower operational costs. However, the comparative advantages of these social relations weaken as the number of members increase, and it becomes

important to establish an adequate regulatory framework to organise and oversee their activities (Poyo, 2000: 140). Münkner (1986: 123) recommended that cooperative laws in general should be developed via a participatory law-making process. Cooperative representatives (second-tier cooperatives or federations) directly contribute, along with the legislator, to framing the cooperative legislation. There is a growing trend to regulate financial cooperatives with a specialised regulation, as by 2014, a specialised law regulates 40 out of 64 underdeveloped economies. That takes place in the form of a separate financial cooperative law or under a special or detailed provision in a non-specialised financial cooperative law. This chapter argues that specialised regulation is more suitable for financial cooperatives, rather than traditional bank or cooperative society regulations. Financial cooperatives have different economic objectives and ownership structures, and are exposed to different risks and challenges, such as destructive government interference, low capital accumulation, access to liquidity facilities, net savers against net borrowers agency problems and low compensation for managers. The rest of the essay is organised as follows: section 6.2 present a brief overview of the historical origins of financial cooperative laws in underdeveloped economies, section 6.3 discusses current models of financial cooperative laws in underdeveloped economies. Section 5.4 discusses the rationale for financial cooperative regulations, while Section 5.5 compromises the conclusion.

6.2. The historical origins of financial cooperative laws in underdeveloped economies

Hermann Schulze-Delitzsch (1808-1883) established the first credit cooperative in 1850 under the name “Vorschußverein” (advance association), and by 1858 there were more than 100 credit cooperatives in Germany, commonly known as “Volksbanken” (people’s banks) and attracting mostly the middle class. Schulze-Delitzsch was an important promoter of financial cooperatives, and his background as a politician and judge helped him in writing the first cooperative law, which was imitated later, and spread easily across Europe. His vision for a cooperative law was very practical, as he developed it from the by-laws and guidelines of already functioning credit cooperatives. By 1868, Schulze-Delitzsch’s Cooperative Societies Act became an official law in “Norddeutscher Bund” (the Northern German Federation) and was effective in all of Germany by 1889. Although the law followed the German legal tradition of being a full codification, it respected the cooperatives’ autonomy to adjust their by-laws based on their needs. The law defined cooperatives as a special type of association that aims to serve the economic benefits of

its members based on the principles of self-help, self-administration and self-responsibility (Münkner, 2013: 6). The German model reflected the evolution of cooperatives in Germany, as self-help associations that developed in local conditions, and were able to integrate and create an advanced structure that still exists today. For that, the German cooperative law aimed to provide autonomy for the cooperative movement, and to support a self-governance structure that was necessary for the movement's development (Cuevas and Fischer, 2006: 27).

The British interpretation of the German cooperative law model—which evolved earlier, in the mid-nineteenth century—is now considered the most widely applied cooperative legislation in underdeveloped economies (Cuevas and Fischer, 2006, pp. 27; Münkner 2013: 13). It started with the Indian Credit Co-operative Societies Act that was passed in 1904 and further expanded to regulate all Indian cooperative societies in 1912. According to Münkner (2013:13), this British-Indian Pattern of Co-operation (BICP) was the origin of the Co-operative Model Law of 1946 that was initiated and recommended by the British Colonial Office to be applied in all colonies under the British rule. However, unlike the grassroots and autonomous German cooperative model, the British vision changed the core principals of the cooperative movement. The British vision was to create cooperatives as channels to implement development policies in its colonies. Thus, it changed the organisational nature of cooperatives: from instruments intended to create alternative contractual arrangements that govern the relationship between the members and the market, and between the members themselves, into governmental instruments that transfer credit and subsidies to mass populations and follow state policies (Cuevas and Fischer, 2006: 28).

This vision for cooperatives spread all over the underdeveloped world. Cuevas and Fischer (2006: 28) noticed that, in the 1960s, the British-Indian cooperative law was carbon-copied in most Latin American countries to enable the creation of legal frameworks that allow governments and donors to channel funds to small farmers. Similarly, Develtere et al. (2008) highlighted that most post-independent governments in Africa perceived cooperatives as instruments for implementing state policies. The British cooperative law is still applied, with modifications, in many former British colonies in Africa, Asia, and Pacific and Caribbean countries as well as European countries such as Cyprus in 1910 and Malta in 1946 (Münkner,

2013: 13). In addition, the British cooperative model is applied in some Latin American countries through the influence of the United States (Cuevas and Fischer, 2006: 28).

6.3. Current models of financial cooperative laws

Cuevas and Fischer (2006: 30) identified three main legal approaches adopted to govern the operations of financial cooperatives in most countries. These are a specialised financial cooperative law, a general cooperative society law, and a banking law. A banking law is usually applied either to all financial cooperatives in the country—the European cooperative banking sector is an example—or applied only to the largest cooperatives while smaller ones are regulated by the cooperative society law. Cuevas and Fischer (2006) called this legal approach a "dual regime", widely common in Latin America, where all financial cooperatives are under the cooperative law and only a few of them are also governed by the banking authorities based on specific criteria. There are some arguments in favour of regulating financial cooperatives by specialised regulation. Branch and Grace (2008: 3-4) argued that specialised regulation could guarantee the adaptation of adequate financial management provisions and governance controls, as well as facilitating capital accumulation and distribution and setting up a well-functioning prudential supervisory framework for a large number of small institutions. On the other hand, the regulation of financial cooperatives within a broader legal framework that targets other non-financial cooperatives, banks or microfinance institutions usually fails to recognise the governance structure of financial cooperatives and their deposit-taking function as well as their small scale, narrow scope and the specific risks they face. General banking regulations without different provisions for financial cooperatives are generally inadequate because, for instance, high initial capital requirements may be unreasonably challenging for financial cooperatives, as low- and middle-income classes will probably be unable to raise large initial start-up capital. General banking regulations may be irrelevant for financial cooperatives also because cooperatives do not have access to capital markets and have limited options for safeguarding their liquidity positions. Moreover, financial cooperatives are not-for-profit organisations with members (shareholders) that are more concerned with receiving adequate financial services than end-of-year profits, and voting power is distributed equally among members (one-member, one-vote vs. one-share, one-vote). Similarly, cooperative society regulations that govern non-financial cooperatives, without specialised provisions for financial cooperatives, are inadequate.

Financial cooperatives mobilise deposits from their members and need deposit-safety measures, and regulations should enforce a minimum capital base to absorb and cover unexpected losses. Cooperative society regulations also neglect financial intermediation services, which require prudential financial standards and supervision, and may fail in organising access to liquidity facilities, money transfer, payment, settlement and clearing networks, all of which must be regulated for a well-functioning financial cooperative sector.

The World Council for Credit Unions (WOCCU) has designed a "Model Law for Credit Unions" that reflects WOCCU's extensive experience. The WOCCU (2002) model recommends that prudential regulations for financial cooperatives should at least cover the following 16 areas. These are capital adequacy, asset classifications and allowance for asset losses, licensing and entry requirements, liquidity risk, fixed assets, portfolio diversification, calculation of loan delinquency, external credit, investment activities, standardised accounting, external audits, multipurpose cooperatives, non-member deposits, records preservation, voluntary and involuntary liquidation and merger, and supervisory body sanctions.

While setting guidelines for financial cooperatives regulatory frameworks is definitely desirable, Cuevas and Fischer (2006: 33) highlight the shortcomings of setting a concrete model law, along with many development law theorists, who have criticised the implantation of standardised Western laws in underdeveloped economies, ignoring the legal culture of each country. Moreover, the aforementioned model law reflects only the Anglo-Saxon financial cooperative experience. Describing the long experience of inadequate regulatory framework, Cuevas and Fischer (2006: 37) stated that "in all countries where the CFI [financial cooperatives] sector is a significant player, the regulator has not attempted to put the institution into a straitjacket designed for another institutional form as has increasingly been the case in developing countries."

6.4. Rationale for financial cooperative regulations

Financial Cooperatives benefit from strong social relations between small-group members. Small financial cooperatives with few members are similar to formalised rotating savings and credit associations (ROSCAs) that are able to provide financial services to their members at low operational costs, by reducing information asymmetry problems associated with any financial

intermediation. However, social relations and informational advantage weaken as the number of members grows, and establishing an efficient regulatory framework becomes necessary (Poyo 2000: 140). There are strong incentives to put the financial cooperative sector under a prudential regulatory and supervisory framework regardless of their size. Jansson et al. (2004: 51) explained that large financial cooperatives should be regulated under prudential regulation and supervision in order to protect the deposits of large number of cooperative members. Furthermore, common bond is probably weak in large cooperatives making self-supervision more difficult, besides that large financial cooperatives may impose systematic risk to the whole sector. While acknowledging the challenges of applying prudential regulation and supervision on small financial cooperatives, Jansson et al. (2004: 51) does not undermine the importance of putting them as well under the supervision of a qualified authority. In addition to the delegated/auxiliary approach—explained below—they even recommend charging small financial cooperatives a cost-covering supervision fees to ensure adequate supervision and to avoid cross-subsidising by commercial banks.

The most desired approach for designing a cooperative law is participatory law-making process as suggested by (Münkner 1986: 123) in which cooperative representatives (e.g. second-tier cooperatives or federations) directly contribute, along with the legislator, in framing the cooperative legislation. Poprawa (2009: 2) argued that the evolution of FCs' regulatory and supervisory frameworks in most countries is highly associated with the development stage of the movement. In early stages, regulations focus on licensing and registration only. While in more advanced stages, policy makers introduce prudential measurements, financial and regulatory reporting standards, through the establishment of prudential standards and risk-based supervision framework that aims to assess capital adequacy and mitigate liquidity risks. Finally, in a well-developed financial cooperative system, the regulatory framework enforces a deposit guarantee system that creates confidence to depositors that their money is protected partly or fully.

The underlying objective of financial cooperative regulation is to ensure that contracts between different stakeholders are fair and enforceable (Cuevas and Fischer, 2006: 3). In most cases, financial cooperatives deal solely with their members, as members are both depositors and borrowers; however, any economic analysis of financial cooperatives has to consider various important relationships between different stakeholders. On one hand, there is the relationship

between the members and the cooperative itself, and on the other hand, the relationship between the cooperative and the market (Taylor, 1971: 207). The ownership structure of financial cooperatives differs from investor-owned financial institutions in five key features. First, the principle of one member having only one vote. Second, it is not possible to split shares or memberships. Third, owners or the residual claimants are the main suppliers as well as users of funds. Fourth, dividends are distributed to depositors as well as borrowers based on the monetary value of transactions carried out by the member through the cooperative (patronage dividends). Fifth, members' shares are redeemable (Krahnen and Schmidt, 1999: 19; Cuevas and Fischer, 2006: 10).

Cuevas and Fischer (2006: 28-29) pointed out that any supportive legal framework for financial cooperatives must recognise and address main facts about their nature. Financial cooperatives are institutional arrangements created to fix market deficiencies by means of self-governance contractual arrangements, rather than instruments for passing governmental policies. The change in perception from a self-help institution to a government's political instrument significantly changes the contractual arrangements between its stakeholders, thus affecting the cooperative's functioning and objectives. Moreover, there are governance-related problems rooted in the nature of financial cooperatives, which can lead to their failure, such as borrower-saver conflict, member-manager conflict, and/or board-manager conflict. Finally, legal frameworks must enable financial cooperatives to create alliances and networks that help to improve their bargaining power, mitigate market risks, and develop their managerial capacities. Branch and Grace (2008: 3) suggest that any resilient regulatory and supervisory framework for financial cooperatives should be prudential, proportional and predictable. This means that cooperatives must adhere to prudential regulations that protect members' deposits and the soundness of the financial cooperative sector. Regulations should be proportional, by recognising the distinction risks imposed by financial cooperatives to the entire financial system. Finally, regulations should be predictable to provide financial cooperatives with the stability and certainty that enable them to design their plans and investments.

Financial cooperatives regulation should guide basic credit operations such as—among other things—internal credit policy, pricing, defining collaterals, contractual transparency, legal reserves, documentation, risk classification and risk weighting, non-performing loans, loan loss

provisions and write-offs (Jansson et al. 2004: 27–48). In addition, Financial cooperatives regulation should maintain the autonomy of cooperatives and protect the sector from unsupportive government interference (Bamrungwon 1994: 55–56; Musumal 1994: 157–158; Münkner 2014), mitigate agency problems inherited in cooperatives governance structure (Taylor 1971; Westley and Shaffer 2000: 87; Branch and Baker 2000: 210–211; Cuevas and Fischer 2006). Regulations should also support institutional integration between financial cooperatives and facilitate the creation of second-tier cooperatives or federations (Poyo 1995: 31; Guinnane 1997: 251–252; Desrochers and Fischer 2003; Cuevas and Fischer 2006: 16–17), and set adequate capital requirements (Davis 1994; BCBS 2012, 2015a, b). This chapter only focus on regulatory issues that are relevant to the distinctive feature of financial cooperatives, and highlight the need for specialised financial regulation that is different from regulations targeting investor-owned financial institutions or other types of cooperative organisations. In the following sub-sections, I will try to highlight the rationale behind specialised financial cooperative regulation, focusing on protection from government interference, overcoming agency problems, enabling institutional integration, setting adequate capital requirements, and protecting members' deposits through the introduction of deposit insurance.

6.4.1. Protection from government interference

The main role of a law for cooperative organisations in general is to reflect and protect internationally recognised cooperative principles, which must be adhered to by cooperative organisations, by translating these principles into practical legal standards (Münkner, 2014: 3). Cooperative organisations may represent groups of producers, such as farmers organised in an agricultural cooperative, or groups of consumers, such as food or housing cooperatives, and since financial cooperatives can be recognised as both producer and consumer cooperatives, they are considered the "purest form of cooperation" (Taylor, 1971: 213). In line with cooperative principles, regulations must give individual cooperatives the autonomy to adjust their by-laws according to the needs of their members (Münkner, 2014: 3); especially since historical evidence shows how excessive government intervention is one of the main reasons for the failure of financial cooperatives (Krahnen and Schmidt, 1999: 18). Chapters 4 and 5 of this book suggest that non-democratic regimes have incentives to shape policies that are unsupportive of the development of financial cooperatives, to maintain political control over the movement to extend

their popularity, and to avoid any political role that cooperatives can play while representing the true interest of their members. Bamrungwon (1994: 62) observes that excessive control by the state is strongly supported by regulations, which can be observed in similarities in cooperative laws among several underdeveloped economies. In these cases, cooperative regulations do not only place emphasis on statutory provisions such as licensing, membership, governance structure, and property and equity, etc., but also included several provisions concerning the powers and authority of the registrar of cooperatives. It is not uncommon that the powers given to registrars can be very extensive, going beyond supervision to include a degree of managerial control over cooperatives, without appropriate channels for appealing on their decisions (Bamrungwon, 1994: 55-56).

An International Labour Organization colloquium was held in Geneva in 1993 under the general theme of 'the Relationship between the State and Cooperatives in Cooperative Legislation.' The colloquium concluded that excessive state control over cooperatives is usually costly and ineffective. It undermines the autonomy and self-dependence of cooperatives. The colloquium concluded that there was an urgent need to introduce significant reforms to cooperative legislations, as these legislations are the major instruments of state control. Furthermore, the colloquium recommends that state control should be limited to basic regulatory functions reflected in 'normative controls' only, similar to state control over any other private economic entities, focusing on registration, supervision, sanctioning, and liquidation, without weakening cooperatives' ability to function well and grow. Most importantly, cooperative legislation must not include provisions that give unrestricted powers to state registrars or authorities, such as appointing or removing cooperative directors or management boards. In addition, cooperative legislation should not facilitate the intervention of state authorities in daily operations or allow compulsory membership (Musumal, 1994: 157-158).

6.4.2. Overcoming agency problems

The conflict between depositors and shareholders is the main agency conflict that stimulates the risk of bank failure in investor-owned financial institutions. Depositors prefer the bank to invest in safe assets that do not threat their savings, while shareholders would prefer investing in more risky assets that bear higher returns for their investments. However, depositor-shareholder

agency conflict is not relevant to financial cooperatives, as depositors are usually the shareholders, and members in cooperatives have no incentive to increase the risk of the mutual institution, since—at least theoretically—they are more interested in having access to financial services in the long run, rather than in short-term gains (Cuevas and Fischer, 2006: 37). Cuevas and Fischer (2006: 8) thoroughly discuss the two main agency conflicts inherited in financial cooperatives' mutual ownership: these are member-manager conflict and net borrowers against net depositors' conflict. There is relatively little attention given to borrower-depositor conflict, as it is considered to be less significant. The objectives of financial cooperative members are not homogeneous and may change over time based on the nature of their transactions with the cooperative, unlike shareholders of traditional joint-stock banks whose primary interests are homogenous as they seek to maximise the returns on their capital. Thus, the preference of a net-saver member contradicts that of a net-borrower member (Poyo, 2000: 147). Taylor (1971) provides a theoretical explanation for the conflict between borrowers and savers, explaining that borrower-dominated cooperatives may maintain ineffective lending requirements and conditions, which may increase default rates, whereas saver-dominated cooperatives may impose extremely restrictive lending conditions and high interest rates. Providing loans with low interest rates can reduce the cooperative's ability to offer high dividends or interest rates on deposits, while providing higher dividend rates may require higher interest rates on loans as well. The opposing motives of these two objectives usually lead to conflict between net-saver members and net-borrower members. The member conflict can produce biased behaviour in favour of one group against the other, and the cooperative can end up adopting either borrower-orientated or saver-orientated behaviour (McKillop and Ferguson, 1998). The saver-borrower agency conflict can impose significant risks on the sustainability of financial cooperatives and may increase failure rates, as has happened previously in Latin America. Therefore, it is crucial that financial cooperative regulations protect the interests of all members, and ensure that financial cooperatives are not biased towards either their depositors or their borrowers (Westley and Shaffer, 2000: 87; Cuevas and Fischer, 2006: 10).

On the other hand, the not-for-profit nature of cooperatives may not give satisfactory financial incentives for their managers, and there are always potential conflicts of interest between managers and members. The member-manager conflict, the classical agency problem, has been widely studied within the idea of 'expense preference behaviour.' Cuevas and Fischer (2006: 9-

11) identified two main attitudes of expense preference behaviour in financial cooperatives: 'performance structure hypothesis' and 'ownership structure hypothesis.' The 'performance structure hypothesis' is when rent increases because of the failure of market competitiveness, and weak monitoring of managers' decisions, which increases the rents of the management board. Moreover, Jensen's (1986) 'free cash flow hypothesis' explains how free or uncommitted funds may increase the possibility that managers will inefficiently invest in unprofitable areas. Therefore, supporting policies, especially government subsidies, may harm the performance of financial cooperatives and encourage opportunistic behaviour by management, thus increasing insolvency risk. Meanwhile, the 'ownership structure hypothesis' maintains that weak ownership leads mangers to perform for their own interests rather than members' interests. That is because the 'one member one vote' principle tends to reduce members' engagement in the organisation, as each member individually does not have enough influence and so may not have the incentive to actively participate in the decision-making process. According to Cuevas and Fischer (2006: 11), expense preference behaviour by management is the primary reason for the failure of financial cooperatives, and prudential regulatory and supervisory frameworks should closely focus on controlling expense preferences.

Branch and Baker (2000: 210-211) have proposed seven principles that should be considered in financial cooperative regulations or bylaws to mitigate agency problems. First, regulations and bylaws should separate between decision oversight and decision-making, through clarifying the monitoring and decision oversight roles of the board of directors and not confusing it with daily operational decision-making, which is the management's role. Second, regulations and bylaws should set clear criteria for the necessary qualifications of board members, in order for directors to have sufficient experience that enables them to set the necessary policies and provide valuable guidance to the cooperative. Third, regulations and bylaws must establish clear functions for the supervision committee. Generally, the supervision committee should be responsible for ensuring that the operations of the cooperative are in compliance with its bylaws, that adequate internal controls are established and applied, and that an external audit takes place annually. Fourth, credit analysis and loan approval procedures should be established in detail in a separate credit policy. Nevertheless, regulations and bylaws should clearly identify the responsible body for credit analysis and loan approval, and the required qualifications of the members of the credit committee. Fifth, the board of directors should be accountable to the general assembly for the

operating results of the financial cooperative, thus, regulations and bylaws should clearly state the responsibilities of the board of directors, as well as penalties and sanctions for failure to meet their responsibilities. Sixth, regulation and bylaws must create ethical codes and clear criteria for issuing and evaluation insider loans as well as strict controls to avoid conflicts of interest. Insider loans are loans issued to board members, executives and employees, or to their relatives. Finally, regulations and bylaws should set a policy for the rotation of board members, setting a limit on the maximum terms allowed for a board member in order to benefit from new ideas and to avoid the domination of a few board members.

6.4.3. Setting adequate capital requirements

Capital requirements are the most crucial element in financial regulation, because one of the essential reasons to regulate the financial sector is to internalise the social costs of possible bank failures (Brunnermeier, et al., 2009: vii and 45). According to the Core Principles of the Basel Committee for Banking Supervisions (BCBS), capital adequacy requirements should consider four main aspects. These are the ability of the capital base to absorb potential losses; the appropriateness of risk weight indicators to accurately reflect the risk profile of an institution’s exposures; the ability of reserves and provisions to cover expected losses; and finally, the quality of risk management and controls. However, the Basel Committee does not stipulate full compliance with the capital adequacy requirements of Basel I, II or III for all types of financial institutions, and it recommends a proportionate approach for setting capital adequacy ratios (BCBS, 2012: 45)[1]. This approach is practical because, compared to traditional banks, low capital requirements can be adequate for other non-bank depository institutions giving the simplicity of their activities and their risk exposure. In addition, full compliance with advanced measurement techniques of capital adequacy may be beyond the capability of many small depository institutions, in terms of expertise and costs (BCBS, 2015b: 21). Besides, a proportionate approach does not necessarily mean lower capital adequacy ratios. High capital adequacy requirements might be unavoidable, sometimes just temporarily, to compensate for low monitoring capacity or macroeconomic factors.

[1] Footnote no. 59 page 45.

In a recent survey by BCBS, 20 out of 34 financial regulatory authorities stated that they require financial cooperatives to maintain minimum regulatory capital adequacy ratios (BCBS, 2015a). High capital adequacy requirements may, however, restrain the growth rate of financial cooperatives compared to other investor-owned financial institutions (Davis, 1994: 13), as these requirements tie the growth of total assets—including income-generating assets, such as loans—to the growth of the capital base, which may severely restrict the ability of financial cooperatives to expand quickly. Since financial cooperatives cannot raise their equity from the capital market, because their shares are usually untradeable, the only source for cooperatives to obtain additional capital is through operating surpluses. Thus, for financial cooperatives to achieve rapid growth they need to accumulate large surpluses, which is quite challenging because cooperatives are not-for-profit organisations aiming to provide financial services at competitive prices, and large surpluses implies reducing deposit interest rates and increasing loan interest rates (Davis, 1994: 40). Equity in financial cooperatives is the part of capital solely owned by the cooperative and cannot be claimed by any member or external parties, thus, accumulated reserves are usually considered as the core of cooperatives' equity. In many cases, the shares held by the members are not treated as part of the equity. Members' shares are redeemable and members have the right to withdraw their shares, or part of them, at any time upon terminating their membership in the cooperative. In addition, since these shares are also non-tradeable, membership termination reduces the total equity (Balkenhol, 1999: 5). The low equity base in financial cooperatives reduces their ability to seek external debt funding as well (Balkenhol, 1999: 6), which explains why classical cooperative theory suggests that the output of a cooperative increases exclusively by the enrolment of new members (Taylor, 1971: 209). More importantly, there is no difference between equity stakeholders and depositors in a cooperative, thus high capital adequacy requirements aimed at protecting creditors, especially depositors, may be questioned. Since capital reserves are the property of members in the first place, any protection maintained by these reserves to cooperative depositors is a form of self-insurance by the members of the cooperative themselves. Most often, high losses incurred by a financial cooperative affects its members only, such that accumulating a significant capital base implies that members' accumulated capital rather than their deposits will absorb these losses (Davis, 1994: 35)—taking into account that capital reserves should only absorb abnormal default rates, as provisions for loan losses are

normally incorporated in interest rates on loans. Provisions for loan losses are determined to cover normal, expected credit default risks (Davis, 1994: 39).

Under Basel III, “shares issued by mutual and cooperative banks could be treated as common equity for regulatory purposes provided that they meet the permanence and loss absorption criteria” (BCBS, 2015b: 22). However, this matter is quite controversial, and remains under discussion, alongside the ongoing development of international capital standards. That is because, unlike common shares issued by joint-stock entities, capital invested by the members of the cooperative “is redeemable, and usually not considered high-quality capital” (BCBS, 2015a: 22), according to the Basel Committee. For that, BCBS (2015b: 22) recommended additional measurements that can be adopted by the supervisory authority of financial cooperatives, depending on the size, structure and complexity of the sector. The Basel Committee suggests that increasing attention should be given to increasing financial cooperatives’ retained earnings. However, that is also controversial since cooperatives are not-for-profit and capital accumulation through retained earnings could be slow or insufficient. Another recommendation is to limit redemptions of shares if the capital adequacy ratio is close to or below a minimum level, which can be equivalent to or higher than the regulatory requirements. Moreover, the Basel Committee suggests that financial cooperatives should be required to keep cash deposits at a second-tier organisation (e.g. federation or apex). The last recommendation by the Basel Committee is to implement capital adequacy requirements at the second-tier level or on larger cooperatives, rather than on all cooperatives, including primary and small ones. The latter two recommendations rely heavily on the solvency and liquidity of the second-tier organisation, and thus, the entities must be subject to good regulation and supervision. Generally, capital requirements for financial cooperatives are sufficient as long as they are high enough to absorb and cover unexpected losses, to cover initial set-up costs that support sustainable operations, and indicate the minimum expected financial commitment from new applicants. Start-up requirements for financial cooperatives can also specify the minimum number of members and geographic scope, and financial cooperative regulation should clearly include statutory provisions on member withdrawal and the resulting redemption of shares (BCBS, 2015b: 10).

6.4.4. Enabling institutional integration

By their nature, primary cooperatives are small and bound to geographic or sectorial concentration, making them more vulnerable to liquidity risks and mismanagement. For instance, maturity mismatch is more likely to increase in rural cooperatives as they depend on short-term deposits to finance seasonal loans or agricultural machineries. For that, having access to external finance is crucial for their growth, as it may allow financial cooperatives to lower their savings requirements. Financial cooperatives usually have savings requirements that members must fulfil in order to be eligible for acquiring loans. Savings requirements are calculated relative to the desired loan size and can be pledged as collateral for the loan. Accordingly, lowering the savings requirements may increase the demand for the financial cooperative's services and may consequently increase the total share savings, either by existing members or by attracting new members—keeping in mind, however, that lowering the savings requirements may lead to a demobilisation of deposits in the longer term (Krahnen and Schmidt, 1999: 21).

Thus, integration among primary financial cooperatives to form second-tier cooperatives or federations is a fundamental institutional practice since the emerging of German's credit cooperatives in the nineteenth century. Guinnane (1997: 251-252) highlighted how regional integrations helped small German cooperatives to overcome their structural challenges, and increased public confidence in the financial viability of cooperatives, even in the absence of reliable regulation. Small credit cooperatives relied on regional cooperative banks to secure their liquidity positions through short- or long-term borrowing, acting like lenders of last resort, and on regional auditing associations to monitor their performance closely. Regional banks also accepted deposits from their affiliated cooperatives and they were able to borrow and lend from and to other financial institutions, helping small cooperatives benefit from economies of scale. Similarly, Poyo (1995: 31) described how well-established second-tier institutions supported the development of Dominican Republic financial cooperatives in the 1950-60s. The national federation was, to a large extent, efficient in channelling external technical assistance and subsidised credit.

Primary financial cooperatives can effectively assess their members' demands because they are governed by the members themselves. Through pooling resources from their members,

cooperatives should obtain essential inputs that it can transform into outputs of financial services and products for their members. Nevertheless, the small scale of inputs demanded by each individual cooperative produces natural uncertainties. Inputs required by a financial cooperative can be, but are not limited to, capital goods such as land, buildings, furniture, computing equipment, etc.; financial products such as external borrowing, deposit and insurance; and many other services including clearing services for cheque, remittances, technical assistance and liquidity management (Cuevas and Fischer, 2006: 16-17). Desrochers and Fischer (2003) explain that the degree of integration in financial cooperative systems is determined by the risks associated with the procurement of necessary inputs for the financial intermediation process, and that cooperatives form inter-financial cooperative alliances to mitigate these risks by collectively obtaining the necessary inputs. These alliances can be for a short period based on repeated contracts, hybrid relations that target long-term alliances, or can result in a hierarchical integration with full merger of all activities. For these reasons, regulatory frameworks must support and enable the voluntary institutional integration among financial cooperatives that enables them to exploit economies of scale and to limit uncertainties arising from obtaining intermediation inputs (Cuevas and Fischer 2006: 22).

6.4.5. Protecting members' deposits

Although it is generally recommended to protect depositors' money by setting explicit deposit insurance schemes, the impact of deposit insurance remains quite debatable. The general economic theory proposes that deposit insurance can improve the stability of banks by reducing the possibility of depositor runs caused by imperfect information. However, such an explicit safety net of insurance may reduce market discipline and create a moral hazard by providing incentives for banks to invest in riskier assets, without monitoring by depositors, as losses are shifted from depositors to the insurance fund.

The 1980s savings and loan crisis in the United States has been attributed by many economists to moral hazard created by deposit insurance, regulatory failure and financial liberalisation (Demirgüç-Kunt and Detragiache, 2002: 1378). Grossman (1992) suggests that American thrift institutions covered by deposit insurance schemes were more likely to engage in risky loans than uninsured institutions during the 1930s. Likewise, Alston et al. (1994) investigated the United

States rural banking crisis of the 1920s, finding that failure rates were higher in states that suffered from agricultural distress and had deposit insurance schemes. Wheelock and Wilson (1995) drew similar results after analysing banks performance in Kansas state for the period 1910–28, suggesting that banks covered by deposit insurance schemes had higher probability for failure. Demirgüç-Kunt and Detragiache (2002) found that the presence of deposit insurance in a financial system tends to increase bank instability, especially in countries with weak institutional structure, after analysing data from more than 60 countries for the period from 1980 to 1997. Similarly, Ioannidou and Penas (2010) analysed risk-taking behaviour of Bolivian banks before and after the introduction of a deposit insurance scheme, suggesting that banks were more likely to invest in riskier loans after being covered by the deposit insurance scheme. Banks imposed higher interest rates on these riskier loans but without additional collateral requirements or reduced maturities, and thus these loans were associated with higher default and delinquency rates. Moreover, Ioannidou and Penas (2010) found that large depositors reduced their pressure on banks after the introduction of the deposit insurance scheme compared to pre-deposit insurance periods. Generally, large depositors had more incentives to closely monitor banks' loan portfolios, and to withdraw large sum of their deposits if the risk-taking behaviour of banks increased, as financial safety nets adopted by governments usually have coverage limits per account, which compensates small depositors in the event of bank insolvency, while large depositors are rarely compensated.

Gropp and Vesala (2004) argue that these results should not be generalised, as these studies relied on very early historical data from the 1920-30s (Alston et al., 1994; Grossman, 1992; Wheelock and Wilson, 1995), or data from emerging markets, where underdeveloped institutions may aggravate banks' risk shifting after the introduction of deposit insurance schemes. This argument is partly in line with the results of Demirgüç-Kunt and Detragiache (2002), and supported by Cull et al. (2004). Both found that explicit deposit insurance might increase banks' instability and will negatively affect their growth rates in the long run. Similarly, Hovakimian et al. (2003) found that introducing deposit insurance schemes might increase risk-taking behaviour for banks operating in countries with weaker institutional structures such as low political and economic freedoms, high corruption and poor contract enforcement mechanisms.

In addition, Gropp and Vesala (2004) found that European banks' risk-taking behaviour had significantly decreased after the introduction of explicit deposit insurance. They argued that the probability of banking failure might decrease after the introduction of credible explicit deposit insurance in two cases. First, if there is a strong implicit safety net prior to the introduction of the deposit insurance scheme, in which there is a high commitment from the government to protect claim-holders. Second, if banks' liabilities contain a relatively high proportion of subordinated debt holders or other uninsured claim-holders, who have a strong incentive to monitor the bank's risk behaviour especially after the introduction of deposit insurance. Esty (1997) found that investor-owned thrifts in the United States had higher profit volatility compared to mutual thrifts during the period 1982–88, and that mutual thrifts who transformed into investor-owned thrifts were more likely to invest in high-risk assets and to have increased profit volatility. Esty (1997: 26) argues that investor-owned financial institutions are more likely to adopt high-risk financial strategies compared to mutual-owned institutions. Without appropriate monitoring, owners of financial institutions will take high-risk decisions in in the hope of gaining higher returns. The incentive to adopt high-risk behaviour is determined mainly by whether or not the residual and fixed claims are separable. Because claims are not separable in the case of mutual organisations such as cooperatives, the total wealth of members would not be affected by the increase of the institution's risk behaviour, as the residual claim's possible gains is balanced by the possible losses on the fixed claim. Karels and McClatchey (1999) found no evidence that credit unions' risk-taking behaviour in the United States had increased after the adoption of the deposit insurance scheme during the period 1971–1990. Their results showed that liquidity and asset quality improved, suggesting a decrease in risk–taking behaviour during the post deposit insurance period. However, Karels and McClatchey (1999: 132) suggest that the ownership structure that limits risk-taking behaviour is not the only reason for the stability of credit unions, but also the strong regulatory environment adopted in the 1970s that had restricted credit unions' investment strategies, as regulations at that time imposed limitations on the maximum loan size that can be offered by credit unions, and the maximum maturity for secured and unsecured loans. Similarly, Hannafin and McKillop (2007) found no evidence of risk-shifting behaviour in the performance of Irish credit unions after the introduction of a deposit insurance scheme in 1989.

Unlike investor-owned financial institutions, there is no strong evidence in financial cooperative literature that supports the argument that the adoption of deposit insurance schemes increases the

likelihood of institutions adopting risk-taking behaviour. That is because, in theory, the mutual ownership structure implies limited risk-taking behaviour. In investor-owned firms, shareholders are only residual claimants, thus they have incentives to adopt riskier behaviour as they can gain benefits from higher dividends or selling shares at market value. Shares in investor-owned financial institutions are considered highly leveraged claims on the institution's residual profits, unlike mutual institutions where shareholders are also depositors, thus their shares are unleveraged (Karels and McClatchey, 1999: 107-108). Moreover, several approaches can make deposit insurance schemes for financial cooperatives more incentive compatible, and reduce agency costs and moral hazard. One approach is limited coverage that makes the insurance force large depositors to closely monitor the performance of the institutions, and which will increase market discipline. A similar approach is coinsurance, in which depositors are not compensated for their total deposits, and thus some of the depositors will be forced to monitor the institutions' risk strategy as they are exposed to losses (Beck, 2004). Another common approach is risk-based deposit insurance, where insurance premiums are adjusted to reflect the risk of the institution's assets or capital adequacy performance (Hannafin and McKillop, 2007: 47).

6.5. Conclusion

In this review, I attempted to highlight the main reasoning behind regulating financial cooperatives differently from other financial institutions, focusing on their unique institutional characteristics and the main challenges and risks that they commonly face. The key points and recommendations of this review can be summarised as follows.

First, regulation for financial cooperatives must protect the sector from destructive government control. Cooperative regulations in several countries give unrestricted powers to state registrars or authorities, including intervention in daily operations or allowing compulsory membership, whereas a supportive regulatory framework should maintain legal control over financial cooperatives similar to other private economic entities, focusing on registration, liquidation monitoring, capital requirements, and other risk management mechanisms, without weakening cooperatives' ability to function well and grow. Second, financial cooperative regulations need to pay close attention to the two main agency conflicts that are inseparable from financial cooperatives' mutual-ownership structure. These are member-manager conflict and net

borrowers against net depositors conflict. Regulations should ensure that the decision oversight and decision-making roles of the board are clearly defined and not confused with the management's role of daily operations. Penalties and sanctions on the board or the management for failure to meet their responsibilities should be clearly defined too, in addition to a policy for the rotation of board members. Moreover, regulation should ensure that there are clear criteria for the necessary qualifications of board members, and clear functions for the internal supervision committee. In addition, regulations should insist on the establishment of a credit committee in financial cooperatives, and clearly identify the committee's responsibilities for credit analysis and loan approval.

Third, it is undeniably essential in financial cooperative regulations to set minimum capital requirements; however, high capital adequacy requirements may not be the optimum approach, given the simplicity of their activities and their risk exposure. High capital requirements may restrict the growth of financial cooperatives, whereas low capital requirements can be adequate as long as they are high enough to absorb and cover unexpected losses, cover initial set-up costs that support sustainable operations, and indicate the minimum expected financial commitment from new applicants. Fourth, regulations should support and enable the voluntary institutional integration among financial cooperatives to help them deal with maturity mismatch and liquidity risks, to allow small primary cooperatives to benefit from external technical assistance provided by bigger cooperatives or federations, and to increase public confidence in the sector. Finally, regulations may include the creation of deposit insurance schemes for financial cooperatives to protect members' deposits and to build confidence, as well as to attract new depositors (members) or to encourage existing members to invest more in their cooperative.

Bibliography

Alston L. J., Grove W. A. and Wheelock D. C. (1994), 'Why do banks fail? Evidence from the 1920s', *Explorations in Economic History, 31*(4), 409-431.

Balkenhol B. (1999), 'Introduction: Background and issues', in Balkenhol B. (eds.), *'Credit Unions and the Poverty Challenge: Extending outreach, enhancing sustainability',* Geneva: International Labour Organisation, pp. 1-15.

Bamrungwon, C. (1994), 'State Control over Cooperatives in Co-operative Legislation', Background Paper No. 2a in *The Relationship between the State and Cooperatives in Cooperative Legislation*, Geneva: International Labour Organisation, pp. 55-63.

Basel Committee on Banking Supervision (2012), *'Core Principles for Effective Banking Supervision',* Basel: Bank for International Settlements, September.

Basel Committee on Banking Supervision (2015a), *'Range of practice in the regulation and supervision of institutions relevant to financial inclusion',* Basel: Bank for International Settlements, January.

Basel Committee on Banking Supervision (2015b), *'Guidance on the application of the Core principles for effective banking supervision to the regulation and supervision of institutions relevant to financial inclusion,* Basel: Bank for International Settlements, December.

Beck T. (2004), 'The incentive-compatible design of deposit insurance and bank failure resolution: concepts and country studies', in Mayes, D.G. and Liuksila, A (eds.), *'Who Pays for Bank Insolvency?*', London: Palgrave Macmillan, pp. 118–141.

Branch B. and Baker C. (2000), 'Overcoming governance problems', in Westley, G. and Branch, B. (eds.), *'Safe Money: Building Effective Credit Unions in Latin America',* Washington DC: Inter-American Development Bank, pp. 203-223.

Branch B. and Grace D. (2008), *'Technical guide: Credit union regulation and supervision',* Wisconsin: World Council of Credit Unions.

Brunnermeier M., Crockett A., Goodhart C., Hellwig M., Persaud, A. and Shin H., (2009), 'The Fundamental Principles of Financial Regulation', Geneva Reports on the World Economy, No. 11.

Cuevas, C. E. and Fischer, K. P. (2006), *'Cooperative financial institutions: Issues in governance, regulation, and supervision*', Washington DC: World Bank.

Cull R., Sorge M. and Senbet L. W. (2004), *'Deposit insurance and bank intermediation in the long run',* Working Papers No 156, Basel: Bank for International Settlements.

Davis K. (1994), 'Prudential regulation and Australian credit unions', *Australian Journal of Management 19*(1), 31-46.

Demirgüç-Kunt A. and Detragiache E. (2002), 'Does deposit insurance increase banking system stability? An empirical investigation', *Journal of Monetary Economics 49*(7), 1373–1406.

Desrochers M. and Fischer K. P. (2003), 'Theory and test on the corporate governance of financial cooperative systems: Merger vs. networks', Working Paper 03-34. Vancouver: CIRPÉE.

Develtere P., Pollet I. and Wanyama F. eds. (2008), *'Cooperating out of poverty'*, Geneva: International Labour Organisation.

Develtere, P. and Pollet, I (2008), 'Renaissance of African Cooperatives inthe 21st Century: Lessons from the Field', In Develtere, P., Pollet, I. and Wanyama, F. (eds), *Cooperating out of Poverty: The renaissance of the African cooperative movement*, pp. 38-90, Geneva: International Labour Office.

Esty B. C. (1997), 'Organizational form and risk taking in the savings and loan industry', *Journal of Financial Economics, 44*(1), 25-55.

Gropp R. and Vesala J. (2004), 'Deposit insurance, moral hazard and market monitoring' *Review of Finance 8*(4), 571-602.

Grossman R. S. (1992), 'Deposit Insurance, Regulation, and Moral Hazard in the Thrift Industry: Evidence from the 1930's', *The American Economic Review*, 800-821.

Guinnane, T. W. (1997), 'Regional organizations in the German cooperative banking system in the late 19th century', *Research in Economics, 51*(3), 251-274.

Hannafin K. and Mckillop D. (2007), 'Deposit insurance and credit unions: an international perspective', *Journal of Financial Regulation and Compliance, 15(*1), 42 – 62.

Hovakimian A., Kane E. J. and Laeven, L. (2003), 'How country and safety-net characteristics affect bank risk-shifting', *Journal of financial services research, 23*(3), 177-204.

Ioannidou V. P. and Penas, M. F. (2010), 'Deposit insurance and bank risk-taking: Evidence from internal loan ratings' *Journal of Financial Intermediation 19*(1), 95-115.

Jansson, T., Rosales, R. and Westley, G.D. (2004), *'Principles and Practices for Regulating and Supervising Microfinance*', Washington, DC: Inter-American Development Bank.

Jensen M. (1986), ‘Agency costs of free cash flow, corporate finance, and takeovers’, *The American Economic Review, 76*(2), 323-329.

Karels G. V. and Mcclatchey C. A. (1999), ‘Deposit insurance and risk-taking behavior in the credit union industry’, *Journal of Banking and Finance, 23*(1), 105-134.

Krahnen J. and Schmidt R. (1999), ‘On the theory of credit unions’, in Balkenhol B. (eds.), *‘Credit Unions and the Poverty Challenge: Extending outreach, enhancing sustainability’,* Geneva: International Labour Organisation, pp. 17–24.

Mckillop D. and Ferguson C. (1998), ‘An examination of borrower orientation and scale effects in UK credit unions’, *Annals of Public and Cooperative Economics, 69*(2), 219-242.

Münkner H. H. (1986), ‘Participative Law-Making: A New Approach to Drafting Cooperative Law in Developing Countries’, *Verfassung und Recht in Übersee/Law and Politics in Africa, Asia and Latin America*, 123-137.

Münkner, H. H. (2013), ‘Worldwide Regulation of Co-operative Societies - An Overview’, Euricse Working Paper n. 53|13.

Münkner H. H. (2014), ‘Ensuring Supportive Legal Frameworks for Co-operative Growth’, Nairobi: International Co-operative Alliance. Paper presented at the ICA 11th Regional Assembly.

Musumal C. (1994), ‘Summary of the Discussions. In the Relationship between the State and Cooperatives in Cooperative Legislation’, Geneva: International Labour Organisation, pp. 155-162. Report of a Colloquium held at Geneva, 14-15, December 1993.

Poprawa, A. (2009), ‘Regulation and legislation of cooperative banks and credit union’,. New York: Paper Prepared for United Nations Expert Group Meeting on Cooperatives, pp. 28–30.

Poyo, J. (1995),*‘Expansion of rural financial services: The development of a community-based rural credit union network in the Dominican Republic (1984-1993)’,* Geneva: International Labour Office.

Poyo J. (2000), ‘Regulation and supervision of credit unions’, In Westley G. and Branch B. (ed.), *‘Safe Money: Building Effective Credit Unions in Latin America*’, Washington DC: Inter-American Development Bank, pp. 137-160.

Taylor, R. A. (1971), ‘The credit union as a cooperative institution’, *Review of social economy, 29*(2), 207-217.

Vittas D., ed. (1992), *‘Financial Regulation: Changing the Rules of the Game’*, Washington, DC: World Bank Economic Development Institute.

Westley G. and Shaffer S. (2000), 'Credit Union Delinquency and Profitability', in Westley G. and Branch B. (eds.), *'Safe Money: Building Effective Credit Unions in Latin America',* Washington DC: Inter-American Development Bank, pp. 61-90.

Wheelock D. C. and Wilson P. W. (1995), 'Explaining bank failures: Deposit insurance, regulation, and efficiency', *The Review of Economics and Statistics,* 689-700.

World Council of Credit Unions. (2015), '*Model Law for Credit Unions*', 2015 edition, Wisconsin: World Council of Credit Unions.