

# Financial Cooperatives

## Issues in Regulation, Supervision, and Institutional Strengthening



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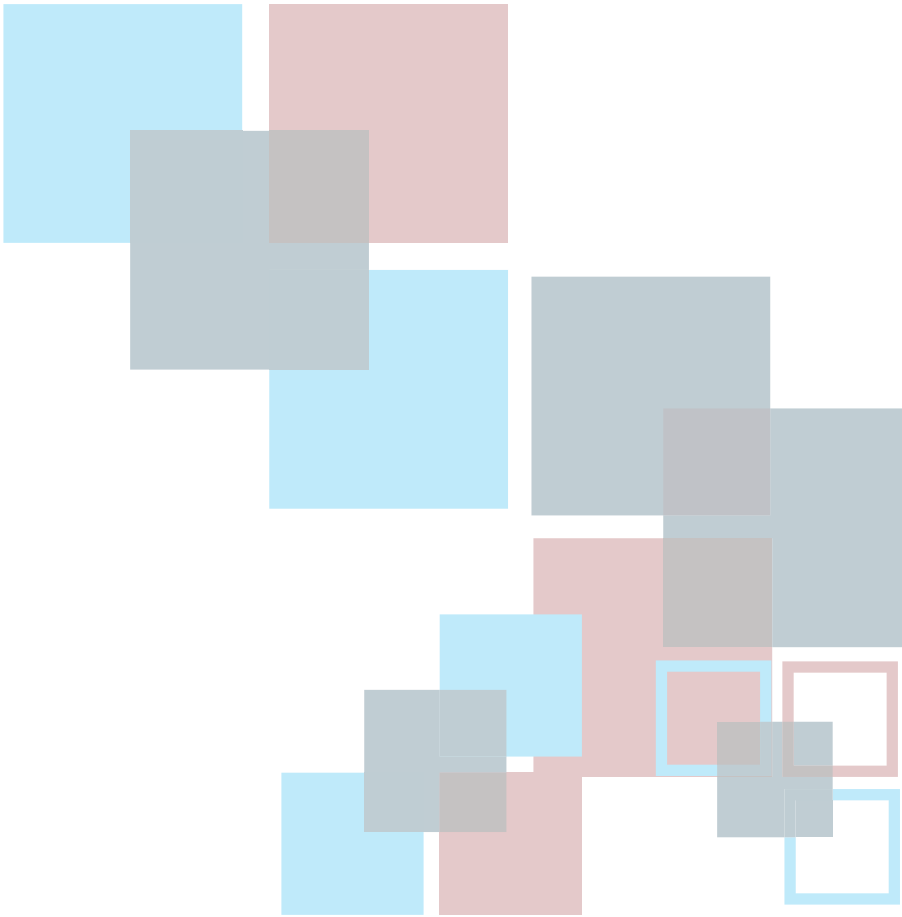
# Financial Cooperatives

## Issues in Regulation, Supervision, and Institutional Strengthening



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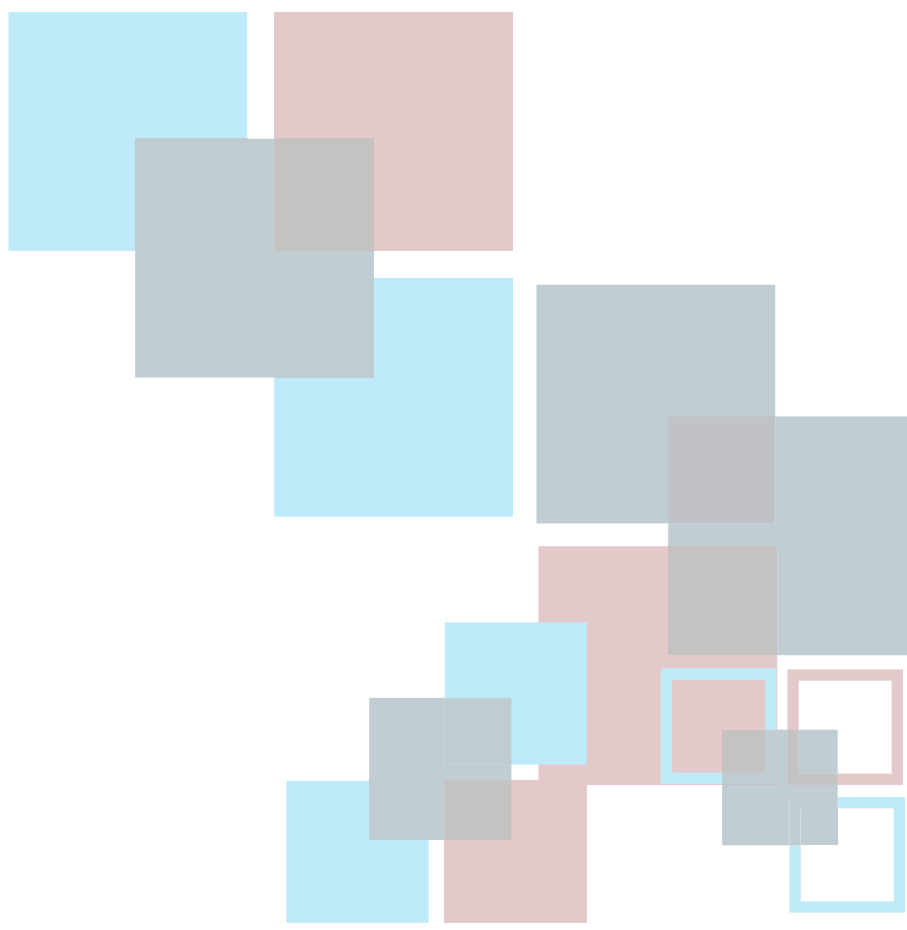
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## Abbreviations and Acronyms

<b>BANSEFI</b>	<i>Banco del Ahorro Nacional y Servicios Financieros (México)</i>
<b>BCBS</b>	Basel Committee on Banking Supervision
<b>BCEAO</b>	<i>Banque Centrale des Etats de l’Afrique de l’Ouest (West Africa Central Bank)</i>
<b>BIS</b>	Bank for International Settlements
<b>CAC</b>	<i>Cooperativa de Ahorro y Crédito (savings and credit cooperative, Guatemala)</i>
<b>CDA</b>	Cooperative Development Authority (Philippines)
<b>CNBV</b>	<i>Comisión Nacional Bancaria y de Valores (Mexico Banking Commission)</i>
<b>DiD</b>	<i>Développement International Desjardins (Québec, Canada)</i>
<b>FC</b>	Financial Cooperative
<b>ICURN</b>	International Credit Union Regulators’ Network
<b>IADI</b>	International Association of Deposit Insurers
<b>IFC</b>	International Finance Corporation
<b>LRASCAP</b>	<i>Ley para Regular las Actividades de las Sociedades Cooperativas de Ahorro y Préstamo (Mexico Financial Cooperatives Law)</i>
<b>SACCO</b>	Savings and Credit Cooperative (mainly East Africa)
<b>SCA</b>	Savings and Credit Association (Albania)
<b>WAMU</b>	West Africa Monetary Union (UMOA in the French acronym)
<b>WOCCU</b>	World Council of Credit Unions







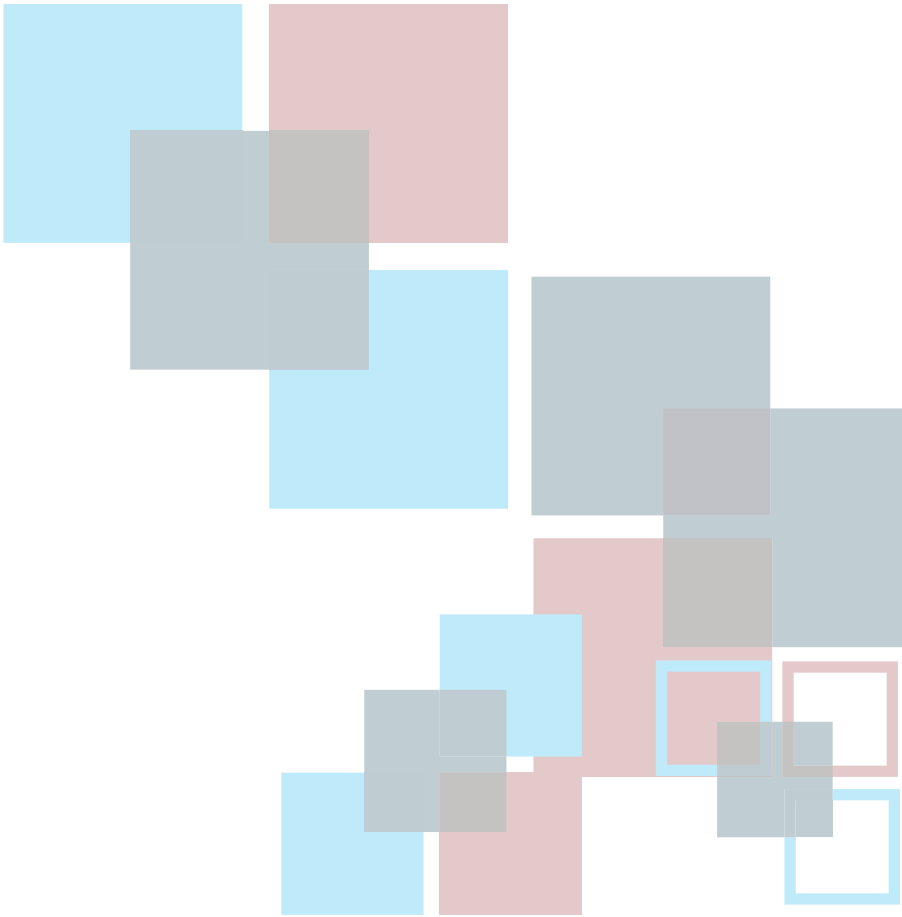
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## Executive Summary

Financial Cooperatives (FCs) are important providers of financial services to poor and middle-income people, and significant drivers of financial inclusion. Aside from their strong presence and relevance in developed economies, especially Europe and North America, the significance of financial cooperatives in terms of financial inclusion in the developing world cannot be underestimated. Their pervasive presence in rural areas, and their potential to expand financial inclusion with multiple services to under-served segments make enabling the sustainable functioning of FCs a sensible policy objective.

This issues paper reviews current knowledge about, and recent examples of FC development practice that generate lessons deemed valuable and useable in diverse contexts. The review provides background for an informed discussion around the following propositions:

- Legal and regulatory frameworks for FCs adapted to the organizational nature and institutional structure of local FC entities, especially their governance and capital structure, are essential for FC stability and growth.
- Adequate legal and regulatory frameworks including appropriate safety nets need to closely follow the development of the local FC market segment. Failure to provide an enabling framework runs the risk of stunting FC development, and undermining trust among the potential clientele/membership. In addition to ensuring financial soundness, effective regulation and supervision are essential to help FCs achieve scale by fostering mergers, or enabling the integration of individual retail entities into federated (apex) structures.
- Integrated approaches that combine legal and regulatory reforms with support to the institutional strengthening of the FC sector have shown important results in terms of financial inclusion, and fostered the modernization of financial cooperatives as effective financial institutions. Rapid introduction of electronic banking in FC networks seems to be badly needed, but requires a degree of preparedness, and a functional structure that most FC networks have yet to attain.

A previous draft of the paper served as background material for the International Workshop on Financial Cooperatives and Financial Inclusion,

held in Washington DC in April 2018. This revised version includes valuable insights emerging from this Workshop where a unique blend of financial systems specialists, financial cooperatives experts and practitioners candidly exchanged knowledge and opinions. The “way forward” put forth below greatly benefitted from that exchange.

**Regulation.** The nature of financial cooperatives ownership and basic principles – member-owners as clients, one-member/one-vote – underlies governance risks quite distinct from those associated with investor-owned banks. Agency conflicts (usually referred to as member-manager conflicts or “management capture”) are a major source of failure of financial cooperatives. Addressing these agency conflicts ought to be at the center of prudential regulation for FCs.

Recognizing the key differences with respect to commercial banks, there is apparent consensus among financial development practitioners in that regulation and supervision of FCs belong in the domain of the financial sector authority. In practice, however, many countries still maintain FCs under non-financial regulatory authorities tasked by general cooperative laws that may or may not explicitly recognize the financial nature of FCs and that can open the door for significant regulatory and supervisory arbitrage. There is little controversy around what constitutes good practice in the regulation of FCs, although adherence to good practice differs across countries and even within countries when there are split regulatory systems. Legal and regulatory frameworks need to clearly define: (a) the authority to regulate; (b) entry requirements (including tiered systems); (c) governance rules; (d) risk management controls; and (e) resolution (exit) mechanisms.

Main issues in regulation identified in this review are:

- When the licensing (entry) authority for FCs is different from, or disconnected with, the

financial regulator and the supervisory authority, thus allowing for a mismatch between entry requirements, basic prudential functioning standards, and supervisory capacity.

- When entry requirements allow the proliferation of small, unviable entities that escape supervision and place deposits of poor people at risk.
- When exit mechanisms, even if provided for in the regulation, do not exist in practice.

**Supervision.** Main challenges in the supervision of FCs are: (a) diversity of financial cooperatives both in term of size and structure (freestanding versus federated financial cooperatives); (b) weaknesses in terms of internal control, and management information systems; (c) low level of capacity of financial cooperatives’ staff and management impacting their ability to comply with regulators/supervisors’ requirements; and (d) large numbers of small retail financial cooperatives operating in remote locations, posing both time and resource challenges for the supervisory agency to enforce new requirements and monitor compliance. This review suggests that the heterogeneity of the sector is best addressed through a risk-based supervision approach that considers several tiers of entities typically defined by scale.

Implementation, costs and effectiveness, of offsite supervision and onsite inspection are heavily influenced by the type(s) of financial cooperative institutional model authorized by financial authorities. A large diversity of sector structures exists between a total free-standing, atomized FC system, and a fully federated model with integrated financial cooperatives supervised by an apex organization, and a high degree of functional specialization between the base individual (retail unit) cooperatives and the apex level (federation or confederation) where most common services are housed. The adoption of direct versus indirect (delegated, or auxiliary) supervision systems is clearly context driven. A relatively common arrangement is to directly supervise the large

individual FCs and the apex (second or third tier) organization, and to set up auxiliary or delegated supervision of the small individual FCs in a manner that prevents conflicts of interest. Ultimately, in practice, supervisors resort to different forms of risk-based approaches that attempt to optimize the use of scarce resources.

A hybrid model that provides incentives for individual FCs to meet prudential and efficiency standards even though they are not technically supervised by the banking authority relies upon some sort of guarantee or deposit insurance facility. It is imperative in this model, however, that some regulatory authority empowers the facility to enforce penalties and even liquidation upon failure to meet the prudential standards.

Arguably, a superior incentive to meet rigorous standards is access to the financial infrastructure (payments platform and such), as is the case for FCs in the USA and Europe. This incentive, however, requires that both the infrastructure platforms, and the individual institutions (FCs) have the requisite capacity and systems. Those of the FCs, this review suggests, tend to lag behind in most developing countries.

**Institutional strengthening.** Capacity building efforts are advocated given the potential for FCs to expand financial inclusion among under-served segments of the population, especially when the policy objective is to make available safe alternatives to traditional forms of asset holdings and accumulation among low-income households. A key premise is that regulators/supervisors should not be development agencies due to conflicts of interest. Given this, well-designed and monitored technical assistance by reliable providers, technology approaches that bring electronic platforms to enable modernization and cost reduction of common services, and (in very special cases) capitalization and management partnerships, are potentially powerful institutional strengthening mechanisms.

**Combining regulatory reform and capacity building.** The cases reviewed in Annex 4 suggest that a combined approach is preferable to regulatory reforms disconnected from institutional strengthening, and vice versa, to implement policies that aim at developing the FC sector. While the cases of Mexico and Albania clearly show the benefits of an integrated approach, other cases point to the limitations found when capacity building lags regulatory reforms, or worse yet when the legal and regulatory framework is stagnant and adjusts to the development of the sector sluggishly or not at all.

**Mitigating failure and dealing with failing entities.** A major issue uncovered in the study review, and specifically discussed in the International Workshop, points towards preventive actions as the preferable manner to address potentially failing entities and networks (see chapter VI). Resolution of FCs should be an exception, rather than the rule to intervene in FC networks.

**Role of government.** A commonly cited (hands-off) position on this is summarized by Seibel, 2013: *“a successful credit cooperative system requires autonomy and self-reliance, a conducive legal and regulatory environment, effective supervision and enforcement of compliance by an autonomous financial authority, ... . The role of the state may be supportive, but within limits, providing a conducive operating environment, but not intrusive.”*

State support, however, may go beyond the provision of a “conducive operating environment” without becoming “intrusive.” Institutional strengthening programs, and integrated approaches show that market-friendly state interventions are feasible in the FC sector.<sup>1</sup> In fact, this review shows that political will, and state resources, are important enablers of FC growth. Government policies to establish proportionate regulatory frameworks and capable supervisory mechanisms are essential for FC development. State support is also valuable in setting up deposit insurance or stabilization funds for FC networks.

## Main Themes and the Way Forward

Three main themes emerging from the study were put forth before participants at the International Workshop: (a) regulation and supervision; (b) dealing with failing entities; and (c) FC growth, diversification and integration through technology. Many of the guiding questions for each theme were addressed. While there seemed to be clear answers in many cases, addressing others or fine-tuning solutions in a manner that is useful for practitioners require further study or deeper understanding of the issues involved. Overarching general directions formulated in the International Workshop were “ambition,” pursuit of “smart solutions,” and “pragmatism.”

**Regulation and Supervision.** Existing systems in developed countries and in emerging economies could serve as specific guidance for large FC networks in developing countries. There is a need for diagnostic tools, so that the specific features of an emerging system can be closely matched with well-functioning existing networks. Focused interchange among the countries involved – internships, study periods – could facilitate leap-frogging through the design and implementation of suitable regulatory and supervisory systems,

A policy area where action is needed, highlighted in both the study and the Workshop, is resolving the overlapping authorities over FCs observed in many countries. While the right of free association

needs to be fully respected, entry into the practice of financial services provision needs to be properly regimented in alignment with a country’s financial sector legal and regulatory framework. Following the proportionality principle in regulation, and ensuring adequate resources for supervision are two basic tenets.

**Mitigating failure.** It seems clear that prevention is the best cure for failure. Deposit Insurance schemes, or more generally FC stabilization mechanisms could be actively promoted, and initially subsidized (e.g., to enable a lender-of-last resort role). In terms of further knowledge acquisition in this area, the example of IADI’s creation of a Subcommittee on Resolution Issues for Financial Cooperatives (SRIFC) could be extended (and encouraged) to deal with “Mitigation Issues” specific of FCs.

**Growth and technology.** There is room to improve in enabling FCs to benefit from (keep up with) the rapid pace of technological innovations. Consistent with the arguments in favor of institutional strengthening in parallel with regulatory reforms formulated in this paper, the Workshop discussions highlighted the role of solid, professional international networks in fostering that strengthening, in partnerships with FC networks, donors, and governments. Policy dialogue with governments to induce their support in a market-friendly manner is a natural component of multilateral and bi-lateral donor agendas.

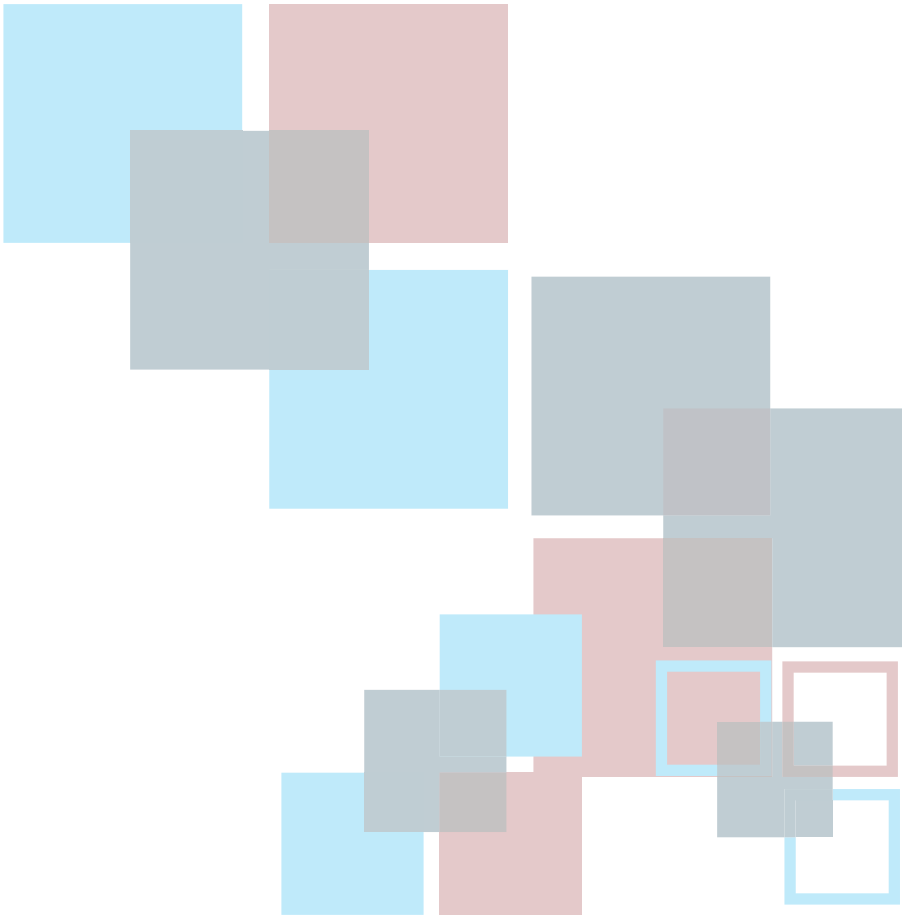


# 1. Introduction

Financial Cooperatives (FCs) are an important component of the existing institutional base for financial intermediation, and significant drivers of financial inclusion.<sup>2</sup> Aside from their strong presence and relevance in developed economies, especially Europe and North America, the significance of financial cooperatives in terms of financial inclusion in the developing world cannot be underestimated. While their “systemic” importance is usually small by standard measures (e.g., share in total financial system deposits),<sup>3</sup> their relevance in reaching poor segments of the population, their pervasive presence in rural areas, and their potential to expand financial inclusion with multiple services to under-served segments make enabling the sustainable functioning of FCs a sensible policy objective.<sup>4</sup>

This issues paper aims at taking stock of current knowledge, and especially recent examples of FC development practice, that generate lessons deemed valuable and useable in diverse contexts. The main purpose of the paper is to inform a discussion around several propositions the review identifies, that could serve as guidance for policy interventions:

- Legal and regulatory frameworks for FCs adapted to the organizational nature and institutional structure of local FC entities, especially their governance and capital structure, are essential for FC stability and growth.
- Adequate legal and regulatory frameworks as well as appropriate safety nets need to closely follow the development of the local FC market segment. Failure to provide an enabling framework runs the risk of stunting FC development and undermining their trust among the potential clientele/membership. In addition to ensuring financial soundness, effective regulation and supervision are essential to help FCs achieve scale by fostering mergers or enabling the integration of individual retail entities into federated (apex) structures.
- Integrated approaches that combine legal and regulatory reforms with support to the institutional strengthening of the FC sector have shown important results in terms of financial inclusion and fostered the modernization of financial cooperatives as effective financial institutions. Rapid introduction of electronic banking in FC networks seems to be badly needed, but requires a degree of preparedness, and a functional structure that most FC networks have yet to attain.







## 2. Overview – Financial Cooperatives Outreach and Potential

Slow and steady growth defines the evolution of financial cooperatives over time in most of the usual indicators of institutional development. The member-based nature of their organization underlies this feature, albeit modern FCs in many countries (that restrict FC services to members) are being aggressive at attracting membership in different ways, such as lowering the amount of the required share purchase to join and broadening of the common-bond definition that makes an individual eligible to become a member.

A “Global Census of Cooperatives” puts the number of cooperatives classified as “banking/credit unions” at 212,000, with 704 million members (D. Grace, 2014). Using the FINDEX 2014 results - 62 % of adults with an account - plus world demographics, FCs would therefore account for about 19 % of the “banked” adults. No time series of comparable census data is available, hence data from the World Council of Credit Unions (WOCCU) Statistical Report are used here to reflect trends in FC growth.<sup>5</sup>

WOCCU data for 2007 – 2015 suggests a steady membership (cumulative) growth rate of 2.9 % per year. Total membership growth between 2007 and 2015 was about 26 %, while membership growth reported for a slightly shorter period about a decade prior (1996 – 2003) was 40 %.<sup>6</sup> Similarly, growth of FC deposits and loans while significant between 2007 and 2015 (53 and 47 % respectively), was much less than that observed between 1996 and 2003 (about double in both deposits and loans). This comparison underscores the steady, albeit slow, nature of FC growth (see Annex 1 for further insights). Interestingly, the FC figures for 2007-2009 do not show much of a sign of being affected by the financial crisis on-going at that time. Comparing with FINDEX, that reports a 24 % increase in account holdings between 2011 and 2014 (from 50 to 62 %), FCs membership grew 10.6 % in the same period.

Proximity, a key factor in reducing user transaction costs, is arguably one of the comparative advantages of FCs.<sup>7</sup> FCs are pervasive, especially in rural areas, even in the presence of new entrants and the advent of digitization and mobile banking. In addition to providing diversified services that include credit,<sup>8</sup> FCs tend to be part of the social capital of rural communities. A key condition for this proximal/atomized presence not to work against FCs’ performance and sustainability is

that they operate in a functionally integrated network where the risks of operating in small retail markets can be shared and mitigated (see section IV).

Despite the advances in agent banking and mobile banking, there are still large gaps in the provision of basic deposit and loan services, and payments services of different kinds – remittances (domestic

and international), Government to Person (G2P) transfers, bill payments and other People to Business payments (P2B) such as school fees or other. FCs are uniquely positioned to contribute to fill these gaps, if they are able to modernize their operations (join the digital age) and are supported by conducive regulatory and business environments.

## Box 1. Agricultural and Other Multipurpose Cooperatives in Finance Provision

The financial cooperatives covered in this issues paper are just one component of the vast “world of cooperatives.” Worldwide, cooperatives in agriculture and food industries are about five times as large, by annual turnover, as banking and financial services cooperatives (the closest to our definition of FCs). Many cooperatives not considered strictly “financial” provide financing services in different segments of the economy, notably in agriculture. Farmer cooperatives (supply, marketing, services) are pervasive in many countries, and created the basis for large and powerful organizations notably in Europe (Crédit Agricole, France; Rabobank, the Netherlands), and Asia (Zen-Noh, Japan; National Agricultural Cooperative Federation, South Korea).

The story of agricultural cooperatives in the developing world is one of mixed results, dominated by government manipulation, and their use as top down “tools” in national development plans (Mercier, 2017). The India case is usually cited to portray this “misuse” of the cooperative idea (Ashtankar, 2015), but many other examples exist. On the other hand, large farmer cooperative systems in Latin America (e.g., Brazil, Argentina), and Sub-Saharan Africa (e.g., Kenya, South Africa, Uganda) have shown positive results and substantial growth in membership, as they succeed in organizing farmers’ access to inputs and markets. Both the input supply and the marketing functions involve some sort of financing role, as inputs and/or advances are provided against future harvest proceeds. Multiple other services, such as procurement of basic staples, farming equipment, home appliances and such are commonly added to the portfolios of those cooperatives.

While a thorough discussion of agriculture and other multi-purpose cooperatives that entail some level of financing to their members is far beyond the scope of this issues paper, their presence and potential need to be considered next to that of purely financial cooperatives. Accepting that the dividing line between financial and non-strictly financial cooperatives would be the ability (license) to collect deposits, all of them could play a role in enabling agricultural value-chain financing arrangements for smallholder farmers. Farmer cooperatives can be successful aggregators and processors in the multi-lateral contracting associated with value-chain finance. Further, they can serve as reliable agents in the provision of banking services by the financial partner in these arrangements.

A deeper enquiry into agriculture and multi-purpose cooperatives than what is feasible here seems warranted. Their role in serving small farmer households, and how these cooperatives could/should interact with financial services providers (FCs or not) should be documented and analyzed. The issues that emerge from the joint provision of finance and non-financial services would be part of this analysis.

Sources: International Co-operative Alliance, ICA (2017). Data compiled from about 2,500 organizations. No parallel is possible with the “global census” referred to above, or the WOCCU statistics, since the ICA data does not include membership, or total assets, and the credit union census does not report turnover. Cuevas and Pagura (2016).



### 3. Issues in Regulation and Supervision

Financial cooperative members/clients in the USA, Canada and Europe enjoy at least the same deposit and customer protection as do bank clients, provided by a sound deposit guarantee scheme and a public regulator/supervisor, e.g., the Federal Credit Union Administration (FCUA) in the USA, or an industry regulator/supervisor empowered by a government authority such as the Desjardins system in Quebec, Canada or the German Cooperative Banking System. The same is not true for most of the developing world, where large numbers of poor clients are exposed to risks inherent to the ownership/governance structure of financial cooperatives that are not adequately regulated and supervised. While systems rooted in delegated or auxiliary supervision have emerged and shown reasonable success (e.g., Mexico), even these efforts have met with diverse challenges and most of the world – notably Sub-Saharan Africa – seems to be lagging in terms of its ability to regulate and effectively supervise large numbers of (often small and remote) retail institutions.

The issues associated with regulation of FCs are different from those that can be categorized as supervisory issues. Hence, they are treated separately below.

#### **Regulation and supervision of financial cooperatives belong in the domain of the financial sector authority**

Recognizing the key differences with respect to commercial banks (see below), there is apparent consensus among financial development practitioners in that regulation and supervision of FCs belong in the domain of the financial sector authority. The BIS guidance calls for “proportionality” in regulation and supervision relative to the systemic importance and risk profile of the supervised institutions, while acknowledging the resource and capacity constraints of supervision systems commonly observed in low-income countries (BIS, 2016).

In many countries, authorities also need to address existing regulatory and supervisory arbitrage situations which may arise if FCs are overseen by non-financial regulatory authorities tasked by general cooperative laws and if the financial nature of FCs is not recognized.<sup>9</sup> The BIS Range of Practice review (2015) found numerous instances of licensing and registration of FCs by non-financial authorities, jurisdictions requiring only registration (no licensing), even though in a majority of the surveyed jurisdictions FCs were able to practice multiple “bank-

like” activities, such as issuing of checking accounts, payments cards, and insurance products. In some countries, such differences have made it possible for fraudsters to misuse FCs with the sole purpose of gaining undue access to members’ deposits that are then diverted into private investments or into pyramid schemes. Annex 2 presents a categorization of regulatory and supervisory systems for several selected countries.

## Regulation Issues

The review identifies several regulatory issues that can be deemed specific to financial cooperatives. First, the diversity of authorities involved in licensing or registration, functional and prudential regulation, and resolution (exit) is a main concern, as it creates the large atomized FC sectors that are then a nightmare to supervise. Second, the cooperative principles defining FC ownership generates governance issues that distinguish FCs from investor-owned financial institutions. Third, regulations that apply to institutions in distress or failing either do not exist in developing countries or are devoid of mechanisms to resolve these institutions in a manner that protects depositors and prevent fraud.

### Misalignment of authorities and mechanisms for entry, functional regulation, and exit

Regulatory systems for financial institutions generally distinguish between conditions that apply to entry (licensing), functioning (financial and operational standards) of licensed entities, and exit (resolution of failing entities). A major overarching issue in the regulation of financial cooperatives is the degree to which those three components are (not) aligned. A frequent misalignment in developing countries is that entry conditions are minimal or non-existent, i.e., limited to registration with a (non-financial) authority. The diverse scale of FCs also leads to tiered systems of prudential regulation that, if not properly structured and supervised, invite regulatory arbitrage. Most concerning, many FC regulatory

systems do not provide for exit mechanisms i.e., set up conditions for ceasing operations, compensate depositors and other creditors, and create resolution processes (mergers, acquisitions, interventions) properly funded and staffed. As a result, many FC sectors in developing countries have practically no entry restrictions, suffer from supervisory constraints that can only cover a fraction of the total number of entities, and have large numbers of inactive and/or failing FCs that the authority is unable to resolve.

### FC Governance issues, and their implications for regulation

The nature of financial cooperatives ownership and basic principles – member-owners as clients, one-member/one-vote – underlies governance risks quite distinct from those associated with investor-owned banks. Agency conflicts (usually referred to as member-manager conflicts or “management capture”) are a major source of failure of financial cooperatives. Stories of managers and/or board members fleeing with members’ deposits abound, while less extreme examples of weakening entities due to poor uncontested decisions are perhaps the most common situation leading to failure. Addressing these conflicts should be (as it is done in developed countries) a central theme of prudential regulation and supervision of financial cooperatives.<sup>10</sup> In FCs, the key internal conflict is the member-manager conflict, also known as the “expense preferences” (EP) by managers. EP control should be at the center of prudential regulation for FCs.<sup>11</sup>

The member-owned nature of FCs also determines a key difference between FCs and investor-owned banks in terms of the alignment of interests of owners with those of the regulator. For FCs, the interests of the members-shareholders and those of the regulators are essentially aligned, since members are also the primary depositors (i.e., creditors of the institution). In investor-owned banks, in contrast, regulators seek to protect depositors, while shareholders are keen on management seeking profits, even as they take new risks.

Governance rules, therefore, are a critical and distinctive component of FCs' legal and regulatory framework.<sup>102</sup> A clear definition of the composition of governance bodies is essential. Fit and proper requirements for both governance bodies, and the selection of senior management and their succession, are crucial albeit often loosely defined or simply not observed. A BIS survey found that one-third of FC supervisors observed weaknesses in this respect.<sup>13</sup> While it may be unrealistic to expect fit and proper requirements to be met in many contexts, mandatory training and certification could be required, and/or allow for the hiring of qualified people for governance functions.

**Governance bodies.** The composition, and requirements, for Board of Directors, Credit Committee, and Audit (Supervision) Committee need to be clearly established. The rules should address and prevent all possible conflicts of interest, e.g., board members deciding on loans to themselves or close relatives. As FCs grow in scale and complexity, fit and proper rules need to be adapted, management will typically become (or include) professional hired personnel, hence the governance bodies overseeing management ought to be able to prevent and monitor “expense preference” behavior.

**Sector structure – single tier, multiple tiers.** Laws and regulations will define whether they apply the same to all FCs, or whether they recognize multiple tiers, depending on scale (typically defined by asset size; see Annex 3, Box 3.1))<sup>14</sup> Likewise, the law may distinguish between clauses that apply to individual FCs, from those that pertain to second-tier (network) entities such as federations.<sup>15</sup> It is important to recognize that the existence of networks and apexes entails governance questions beyond those associated with that of individual FCs. Depending on the nature of the network apexes, from purely representation and advocacy roles to specialized business entities where common services are housed (see below), the regulatory system may establish governance rules that apply to the apexes to prevent dominance and abuse of power of the large entities in the network.

### **Regulating risk mitigation, and failure – deposit protection and early warning systems**

An entire paper could be written just on this subject. Most regulatory systems establish off-site and on-site assessment and rating systems intended to track the performance of FCs.<sup>16</sup> The regulatory side of the issue (there is also a supervisory side) relates to the nature of the tracking system chosen for the FCs and their apexes, the frequency of reporting, and the system's ability to detect signs of distress when there is still time to do something about it. In the absence of explicit deposit insurance, many regulators turn to deposit protection through guaranteeing the stability of the institutions (i.e., a network would ensure that an individual institution does not fail) by providing for mergers and acquisitions as recourse to individual FC failure. The extent to which this mechanism truly protects the depositors, i.e., their ability to withdraw their funds when distress is apparent, varies widely across the systems this review has covered.<sup>17</sup>

Early Warning Systems (EWS) have been advocated as tools to prevent institutional or network failures that work better than CAMELS or other systems by tracking risk indicators not included in these systems.<sup>18</sup> While EWS seem advisable for every system, their installation beyond a pilot program (usually donor funded) have not been widespread.

Resolution tools do exist for FCs, in most cases adapted from those used for the resolution of banks. Their use and effectiveness vary widely across jurisdictions.<sup>19</sup> On-going work at the International Association of Deposit Insurers (IADI) aiming at providing guidance in this respect is to be encouraged.<sup>20</sup>

### **Other elements of functional regulation**

Aside from governance, the features that matter in the regulation of FCs are outlined below. There is little controversy around what constitutes good practice in the regulation of FCs, although adherence to good practice differs across countries and even within countries when there are split regulatory systems (e.g., Colombia, Philippines). Compliance

with regulatory standards, and enforcement, are **matters dealt with in the section on supervision.**

**Membership.** Laws and regulations define the criteria for membership in FCs. These criteria are typically broad and flexible, recognizing the usual “bottom-up” nature of FC creation. Closed-bond FCs such as those defined by a workplace are sometimes specifically recognized.

**Capital.** The legal and regulatory framework defines capital rules – minimum capital, capital adequacy – and what is considered FC capital for regulatory purposes. It is generally accepted that “regulatory capital means the broadest scope of (FCs’) capital that can be used to absorb losses and to grow the institution” (WOCCU, 2015, p. 12). It encompasses both institutional capital and secondary capital. Institutional capital refers for the most part to non-distributable reserves associated with retained earnings, as well as ownership shares; it is generally equivalent to Basel III’s “Common Equity Tier 1” capital.<sup>21</sup> Secondary capital includes subordinated debt and general provisions, generally equivalent to Basel III’s “Tier 2” capital.

Capital clauses in FC laws may define “minimum capital” requirements (multiple levels in tiered systems) and establish a timeframe for a new FC to meet the requirement. The framework will (should) also indicate minimum capital adequacy ratios, and whether risk-weighting of assets to calculate the ratio is needed.<sup>22</sup> This ratio is usually set in the 8 to 10 % range, i.e., like the capital adequacy that is required from similar entities (e.g. MFIs, finance companies).

**Liquidity.** FC laws typically define a minimum liquidity ratio, as a proportion of short-term liabilities (10 % is a common standard). FCs tend to operate on the liquid side.

**Loan portfolio quality.** In some countries, FC laws and regulations also establish a maximum rate of default (Non-Performing Loans), which can lead to sanctions and supervisory measures if exceeded.

**Consumer protection.** Responsible finance and consumer protection principles are also important in an inclusive framework for FCs. A peculiar feature of FCs in this respect is the other type of internal conflict – borrower dominance – which tended to prevail for some time in many FC systems until governance rules protecting depositors were established.

## Supervision Issues

In developing countries, even when adequate legislation and regulations have been enacted, a key challenge remains to enable effective supervision and ensure compliance. In most countries, financial cooperatives compete for “supervisory attention” not only with the established commercial banks, but often with large numbers of small scale financial institutions that serve clienteles like those of the FCs. India, Indonesia are good examples of thousands of FCs and non-FCs functioning under diverse regulatory systems, and no feasible effective supervision given their numbers and locations. Supervision issues, therefore, are not unique of FCs, but addressing these is in many cases a good way to start given their numbers, scale of membership, and especially the fact that FCs are deposit-taking institutions, a function many other providers in low-income markets cannot legally perform.

### Large numbers of supervisees, inadequate supervisory resources

For FCs, among other challenges, we can highlight: (a) diversity of financial cooperatives both in term of size and structure (such as freestanding non-affiliated retail financial cooperative and federated institutions in the same market); (b) weaknesses in terms of internal control, and management information systems; (c) low level of capacity/expertise of financial cooperatives’ staff and management impacting their ability to effectively be in compliance with regulators/supervisors’ requirements; and (d) large numbers of small retail financial cooperatives operating in remote locations, posing both time and resource challenges for the supervisory agency to enforce new requirements and monitor compliance.

The type of financial cooperative institutional model authorized by financial authorities and the structure of the sector has a great impact on how offsite supervision and onsite inspection will (could) be effectively implemented. Two models can be outlined as the polar extremes in a continuum of financial cooperative systems:

- **Free-standing (atomized) financial cooperatives**<sup>23</sup> which have relatively limited relationships with each other in terms of resource sharing, harmonized governance and systems. In theory, this type of institution would require direct supervision by the financial authority, though in practice this is often impossible, particularly in the case of smaller and more remote cooperatives and capacity-constrained countries. As a result, in several jurisdictions regulators opt to leave smaller and more remote financial cooperatives outside of the scope of mandatory supervision.
- **Federated model**<sup>24</sup> with integrated financial cooperatives supervised by an apex organization, and a high degree of functional specialization between the base individual (retail unit) cooperatives and the apex level (federation or confederation)<sup>25</sup> where most common services are housed, e.g., back office processing, IT services, technical assistance, training. The regulator may empower and “delegate” oversight to second- or third-tier entities when there is reasonable evidence that an effective structure of integration and specialized business relationships exists, and there is clear separation of supervision functions from services provision to avoid conflicts of interest. This will enable feasible and cost-effective indirect (delegated or auxiliary) supervision for large numbers of small retail units (see Box 2 for the distinction between delegated and auxiliary).

Between these two extremes there are many types of intermediate levels of integration and functional specialization. The literature distinguishes “consensual” networks of otherwise free-standing financial cooperatives which perform mostly

representation functions (e.g., the Credit Union National Association in the USA), from “strategic” networks where formal multilateral agreements exist between first-tier and upper-tier bodies, with the apex becoming a “hub-node” with meta coordination functions (*Rabobank*, and *Desjardins* portray this type of organization well, albeit with different features). It is the latter – “strategic” – networks that hold promise, or rather could be deemed “necessary,” to establish functional delegated or auxiliary supervision systems that make supervising large numbers of retail entities cost-effective. Annex 3 (Box 4) summarizes international experience in auxiliary supervision.

### Supervision: direct or indirect?

Unlike regulation, there is no clear consensus on what supervision arrangements are adequate. Advocates of atomized free-standing systems favor direct supervision, yet supervisory capacity quickly becomes a limiting factor when there are many FCs to oversee.<sup>26</sup> Highly integrated strategic networks will tend to establish auxiliary (Germany, Mexico) or delegated (Quebec) supervision arrangements. Supervisory autonomy and independence, and prevention of conflicts of interest are important factors in this arrangement. Ultimately, solutions tend to be largely context-specific, where supervisors resort to different forms of risk-based approaches that attempt to optimize the use of scarce resources. A relatively common arrangement is to directly supervise the large individual FCs and the apex (second or third tier) organization and set up auxiliary supervision in a manner that prevents conflicts of interest.

A special case of this “hybrid” approach is that followed by the West Africa Monetary Union (WAMU) where all FCs with outstanding loan portfolio above around USD 4 million fall under the direct supervision of the regional Central Bank (BCEAO) and the regional Banking Commission (see Annex 4). FCs with loan portfolios below that threshold are the responsibility of the respective Ministry of Finance of the WAMU member country

## Box 2. Indirect – Delegated/Auxiliary – Supervision

Indirect supervision is a regulatory regime in which an agent (the *delegated or auxiliary supervisor*) performs certain tasks associated to the supervisory function on behalf of the state authority (the *principal supervisor*). The agent may be (and usually is) a body specially setup by the network of FCs but could potentially be any other independent party like an auditing firm or a rating agency. The ultimate responsibility of the functioning of the regime rests squarely with the principal supervisor, and no indirect supervision regime should be expected to work without a commitment of the latter to make it work.

How is “delegated” different from “auxiliary” supervision? In the former case, in addition to the execution of functions of data collection, processing and information, and recommendations for action, the delegated supervisor is empowered to enforce corrective actions, cease and desist, or, rarely, intervention and or liquidation orders (see Annex 2 for examples). No such empowerment exists in auxiliary systems.

Source: Cuevas and Fischer, 2006.

(8 in total). It is possible, therefore, that in a country that has one major federation (union) with say 20 affiliated cooperatives, of which 5 have loan portfolios above USD 4 million, the BCEAO and Banking Commission will directly supervise those 5 plus the apex, typically in joint supervision missions. Coordination issues are important in this kind of arrangement, not only between the BCEAO and the Banking Commission, but also with the respective Ministry of Finance.

### Incentive models

A model that provides incentives for individual FCs to meet prudential and efficiency standards even though they are not technically supervised by the banking authority, such as most Colombian FCs, and some of Guatemala FCs, relies upon some sort of guarantee or deposit insurance facility (see case summaries in Annex 4). Under this model, FCs may access the guarantee or deposit insurance facility if they meet a number of requirements fairly close to what a formal banking regulatory authority would establish. The problem with this approach is that participation is not mandatory, and an entity may simply avoid compliance and withdraw from the facility with no penalty.<sup>27</sup> This is perhaps the clearest case of formal regulation and supervision lagging behind sector development, and compromising the

stability of the FC sector by not providing a strong, formal backing that would enforce discipline and by that greatly enhance the trust current and prospective members can place in the system.

Arguably, a superior incentive to meet rigorous standards is access to the financial infrastructure (payments platform and such), as is the case for FCs in the USA and Europe. This incentive, however, requires that both the infrastructure platforms, and the individual institutions (FCs) have the requisite capacity and systems. Those of the FCs, this review suggests, tend to lag in most developing countries, a matter where institutional strengthening could/should make a difference (see below).

While “cost-effectiveness” is always a concern in supervisory models, this paper could not find a reliable study that compares costs across alternative systems – direct, delegated, auxiliary, mixed. The “costs” part is not that difficult to measure, but there seems to be a need to define what constitute “effectiveness” and how it can be measured. Basic indicators would be the degree of compliance with prudential rules, e.g., proportion of the supervisees that meet the standards, but further refinement would be needed to arrive at reliable measures of risk-reduction in the system under different supervisory models. This is an area where clearly further research is warranted.





## 4. Institutional Strengthening

Strengthening FCs has been a mantra of governments and development agencies for a long time, albeit with a mixed performance record. This section highlights what seem to be accepted principles and good practice in this area. Section V below covers in greater depth those strengthening efforts that are combined with legal and regulatory reforms.

Why it matters? What typically drives capacity building efforts that target FCs is the perception, or the expectation, that they represent a stable form of outreach with multiple services to under-served segments of the population. Hence, FC components are found in general financial inclusion efforts (e.g., Kenya), microfinance and poverty reduction using microcredit programs (e.g., the Philippines), or programs aimed at improving financial access for agriculture smallholders (Philippines). FC are especially targeted when the purpose is to reach low-income sectors with formal financial services, as a means of making available safe alternatives to traditional forms of asset holdings and accumulation (part of the Mexico motivation). See country-cases highlights in Annex 4. Important issues, principles, and good practice are outlined below.

**Institutional development agencies that are also regulators/supervisors, not a good combination.** Conflicts of interest in this kind of initiatives are clear, as the promoter finds itself in the position of judging as regulator/supervisor the outcomes of its own promotion efforts (South Africa Cooperative Banks Development Agency, CBDA, Philippines Cooperative Development Authority, CDA).

**Technical assistance.** High power, high quality technical assistance (TA) driven by goal-based incentives and penalties, with clear milestones regularly monitored, seems to work well although it may be expensive, and will usually take time. The Mexico experience suggests that the expense is worth it when a substantial expansion of financial inclusion, and a significant broadening and upgrade of financial infrastructure are adequately valued. Although the TA work of large international networks such as *Développement International Desjardins (DiD)*, *France's Crédit Mutuel*, Germany's DGRV, Netherland's Rabobank International Advisory Services (RIAS), the Irish League of Credit Unions International Development Foundation (ILCU-F), and USA's WOCCU, has not always

excelled, it does include several success stories on which new initiatives can (and do) capitalize. These international entities have a reputation to protect, and this makes a difference in terms of their commitment to achieve results.

Of interest for the effectiveness of indirect supervision is how these TA interventions affect the relative strength and capabilities of second- and third-tier (apex) structures in FC networks. The member-based, community-based nature of FCs seems to make progress slow, a factor that tends to discourage sponsors seeking quick results that will tend to discontinue programs long before they begin to show positive outcomes.

**Technology approaches.** The BANSEFI platform in Mexico, WOCCU's common IT services platform with Kenya's savings and credit cooperatives (SACCOs), and the "*Temenos proposition*" and its feasibility in the Philippines and other Asian countries members of the Asian Confederation of Credit Unions (ACCU) represent examples of highly promising means of building capacity and integrating FCs into the fast-moving evolution of electronic platforms supporting financial

transactions (see Annex 4). The challenge, one could argue given the experience in Mexico and Kenya, is the absorption capacity of individual entities and their apex organizations to acquire and operate modern technology (sophisticated) systems. On the other hand, the new systems may have room for improvement in making them intuitive enough for small entities. Federated systems (described above) have a relative advantage in that the more complex technology is handled at the apex by specialized staff, while the retail affiliates only need to master the customer transactions modules.

**Capitalization and management partnerships.** Rabobank has carried out important investment and management interventions with large FC networks, notably Rwanda (see Annex 4), but also in China with large Regional Rural Credit Cooperatives. These interventions amount to "modernizing" traditional cooperative membership rules (namely one-member one-vote) by introducing voting rights proportional to capital contributions.<sup>28</sup> In addition, and perhaps more importantly, the intervention brings about management agreements that confer the senior partner (Rabo Development) full control over the business functioning of the organization.



## 5. Combining Regulatory/ Supervisory Reform with Institutional Strengthening

The cases reviewed in Annex 4 suggest that a combined approach is preferable to regulatory reforms disconnected from institutional strengthening, and vice versa, to implement policies that aim at developing the FC sector. While the cases of Mexico and Albania clearly show the benefits of an integrated approach, other cases point to the limitations found when capacity building lags regulatory reforms, or worse yet when the legal and regulatory framework is stagnant and adjusts to the development of the sector sluggishly or not at all (Guatemala, Kenya, Philippines).<sup>29</sup>

### **A non-intrusive role for government**

The Mexico experience highlights the role of political will among leading agencies to sustain a capacity building and regulatory reform effort for longer than a decade. In spite of political pressures in different directions, the process maintained its impetus through three administrations. The savings and credit sector in Mexico evolved from about 650 retail entities in the year 2000, of which only about 40 were under supervision by the financial authority (CNBV in the Spanish acronym), with 2.6 million members, to a fairly solid sector with 133 entities supervised by the CNBV in 2014 (76 % of all members in the system, 82 % of the assets), and 6.5 million members. Two major legal and regulatory reforms, a strong institution charged with a development mandate for the sector (BANSEFI), and specialized technical assistance by internationally recognized providers were key components in the process (see Annex 4).

Albania, on the other hand, with the advantage of having two dominant FC networks, completed a consolidation of the sector in parallel with a law reform in about 18 months between 2014 and 2016. A coherent approach supported by the Bank of Albania, the World Bank Group, RIAS and ILCU-F as technical assistance providers was at the root of this rapid development.

### **Good data and effective technical assistance**

The importance of data gathering, understanding the diversity of the sector, and expert advice to delineate and implement a growth strategy cannot be underestimated. Further, the capacity building that accompanied the regulatory reforms, mainly TA provided by international FC networks, was an essential enabling component

especially for those entities initially in a rather rudimentary financial and operational state. Making an electronic platform available for the sector was an important cooperating factor.

### **Addressing risks and resolving failures**

Deposit insurance, guarantees, early warning systems, and other sector-wide systems/bodies may play important roles in developing/strengthening the sector. In addition to the Mexico example, Albania, Colombia, and with some limitations Guatemala,

suggest the advantages of setting up deposit insurance facilities to encourage adoption of prudential standards by FCs. Making the regulatory system consistent with the adoption of these mechanisms remains the key challenge in many countries.

As suggested earlier, resolution mechanisms for failing FCs is an important area where good practice and guidance are needed. Clear exit mechanisms are about as important as entry standards to enable healthy FC systems.



## 6. An Agenda for Discussion and the Way Forward

We conclude this issues paper outlining an agenda for discussion suggested by the findings of this review, and several valuable comments received on a previous draft. Three main themes emerged where the expert opinion of colleagues from diverse backgrounds was sought at the International Workshop on Financial Cooperatives in Financial Inclusion held in Washington DC in April 2018: (a) regulation and supervision; (b) dealing with failing entities; and (c) FC growth, diversification and integration through technology. The guiding questions for the discussion of these themes, and the presentations and debate among a unique blend of financial systems and financial cooperatives experts and practitioners are summarized below.

The study findings, enriched by the contributions at the International Workshop help establish: first, guidelines for FC development and support already warranted by existing knowledge and recent experiences; and second, areas where additional evidence is needed, or where digging deep into cases of high learning value will be required to best define strategies and mechanisms for improving FCs' performance as financial intermediaries, and enhancing their role in financial inclusion. Our closing remarks focus on these two areas.

### **Regulation and Supervision of Financial Cooperatives**

What are suitable approaches to regulate and supervise heterogeneous FC sectors?

- Should all FCs be part of the formal financial system or only the largest?
- Entry: how to ensure that only viable entities are licensed?
- Can regulatory and supervisory approaches foster the integration and consolidation of FC systems? How?
- Limited supervisory capacity and heterogeneous sectors with many (mostly small) entities: Can tiered approaches work? What are the experiences with the delegation of supervision to apex entities? With the delegation to government agencies?
- Experiences with information technology to facilitate reporting and risk-based oversight.

A key concept in regulation and supervision is “proportionality:” minimizing the regulatory intervention necessary to achieve policy objectives.<sup>30</sup> In regulation, this means avoiding unnecessary complexity that lead to excessive compliance costs, while for supervision it entails adjusting its intensity to risk profiles, so that supervision costs are minimized. Proportionality is deemed helpful in leveling the playing field for relatively small financial institutions (such as FCs), since compliance costs associated with complex rules (intended for complex large banks) unduly burden small entities.

The specific case of FC regulation would preferably be embedded in a general proportionality regime, as opposed to a separate special FC regime. Yet the general regime should consider specific risks associated with FCs, such as their governance features, and risk concentration, as well as the exposures of Institutional Protection Systems.<sup>31</sup> Recognizing the uniqueness of FCs should not lead to overprotection from competitive forces. Instead, tailoring regulation and supervision to the specific country context, including due consideration of the diverse scale of FCs, and resolving issues of multiple overlapping authorities over FCs are important areas of concern for financial authorities, and FC practitioners.

### **Mitigating failure and dealing with failing entities**

- Mitigating failure, design of financial safety nets.
  - What are the experiences with safety net instruments for FCs such as solvency funds, liquidity funds and deposit insurance? How useful are they?
  - When does it make sense to establish such schemes? Where should they be hosted? How should they be funded?
  - Which FCs should be covered? What happens with those FCs that are not covered?
- Dealing with troubled entities:

- What are the experiences in cleaning up troubled FC sectors?
- How can failing FCs be resolved best in absence of deposit insurance? How can the costs of resolution be minimized?
- Which early actions have proven useful to help turn-around viable but troubled entities? Which actions can facilitate the merger of viable but troubled entities with sound FCs?

Mitigating and preventing failures constitute preferred ways of dealing with troubled entities.<sup>32</sup> Resolution of FCs should be a last resort exception, and not the rule. Umbrella (apex) organizations with proper governance, and able to provide technical, legal, and financial assistance are important sources of stability in FC networks. Mandatory participation in an apex-based stabilization fund (e.g., Ireland), and/or in a deposit insurance fund (e.g., Sicredi, Brazil) has been found to be an effective tool in preventing FC distress. Institutional Protection Schemes (IPSS) can be established at the umbrella level to host a liquidity or solvency fund, as a “first line of defense” against failure.

Likewise, Deposit Insurance (DI) could be an effective stabilization tool when established under sound regulation, robust supervision, and with participation of a lender of last resort. In this respect, cooperation between supervisors and deposit insurers is key. While DI schemes have typically been established as a response to distress, there is clearly no need to wait for a crisis to design a DI scheme for financial cooperatives.

Resolution of FCs, as an exception, could use some but not all, of the usual bank resolution tools, due in part to the specific features and broad diversity of FCs.<sup>33</sup> Traditional resolution tools in developed countries may not be available or relevant in developing countries. For example, an extreme resolution tool specific to FCs – demutualization – may not be feasible in the absence of interested private investors.

## **Growth, diversification and integration through technology**

Financial cooperatives are part of the local social capital, they have a close relationship with their members, a strong focus on savings and on fostering their members' financial literacy, but are they still relevant as providers of financial services in rural and marginal – urban areas considering the evolution of digital finance and branchless banking?

Guiding questions for this discussion are:

- Which are the best ways for FCs to achieve scale, add value to members/clients and diversify services so that they can succeed in increasingly competitive financial landscapes?
- Is it their merger into large entities? Is it their integration into tightly knit networks?
- What are the experiences in using information technology to enhance cooperatives' performance, relations with members and governance?
- How can IT help address the challenges faced by FC sectors with large numbers of small (and relatively unsophisticated) entities?
- What are viable arrangements to work with third-party IT providers?

As stated earlier, FCs are highly diverse in scale, in their institutional capacity to deliver financial services and, importantly, in their degree of integration into networks, as opposed to atomized operations.<sup>34</sup> Understanding FCs as essentially retail financial institutions, desirable directions for FC system to pursue are: vertical integration, delinking governance from operational structure, and full diversification of the financial services they provide, a necessary condition to adequately manage risk, and be competitive. While FCs do have comparative advantages providing services in rural areas, their services ought not to be limited to agricultural credit. On the contrary, FCs need to be able to cross-sell deposit, payments, and other services to their rural base, taking advantage of readily available digital means of delivery

Investing in technology, a powerful tool for financial inclusion, is a priority. Technology is not only important to modernize transactional services – deposits, payments, remittances, loan disbursements and repayments – and gather and process operational data, but it should be emphasized to make management and controls more efficient, and facilitate effective, transparent governance. Recent successful experiences are the operational integration of FCs in Andhra Pradesh and Telangana in India (Rabobank), the reorganization of Fedinvest Albania (Rabobank, World Bank), the common banking and payments platform of the Association of Asian Confederation of Credit Unions in the Philippines (Temenos and Software Group), financial centers for entrepreneurs in Africa (DiD), and a service bureau in Haiti (WOCCU).

The list of recent examples underscores the importance of effective partnerships. These will typically involve FC networks, donors, technical assistance and managerial services providers. They will benefit from government involvement in reducing the costs of technology adoption, setting up regulatory and supervisory standards using the proportionality principle, and creating or improving the environment for secured transactions, especially those involving movable property.

## **The Way Forward**

Overarching general directions formulated in the International Workshop were “ambition,” pursuit of “smart solutions,” and “pragmatism.” Other key words such as “proportionality” and “partnerships” were deemed significant in guiding subsequent work. On the three main themes put forth at the beginning of this chapter, the International Workshop addressed many of the guiding questions for each theme. While there seemed to be clear answers in many cases, addressing others or fine-tuning solutions in a manner that is useful for practitioners require further study or deeper understanding of the issues involved.

**Regulation and Supervision.** Existing systems in developed countries and in emerging economies could serve as specific guidance for large FC networks in developing countries. There is a need for diagnostic tools, so that the specific features of an emerging system can be closely matched with well-functioning existing networks. Focused interchange among the countries involved – internships, study periods – could facilitate leap-frogging through the design and implementation of suitable regulatory and supervisory systems,

A policy area where action is needed, highlighted in both the study and the Workshop, is resolving the overlapping authorities over FCs observed in many countries. While the right of free association needs to be fully respected, entry into the practice of financial services provision needs to be properly regimented in alignment with a country’s financial sector legal and regulatory framework. Following the proportionality principle in regulation and ensuring adequate resources for supervision are two basic tenets.

**Mitigating failure.** It seems clear that prevention is the best cure for failure. Deposit Insurance schemes, or more generally FC stabilization mechanisms could be actively promoted, and initially subsidized (e.g., to enable a lender-of-last resort role). In terms of further knowledge acquisition in this area, the example of IADI’s creation of a Subcommittee on Resolution Issues for Financial Cooperatives (SRIFC) could be extended (and encouraged) to deal with “Mitigation Issues” specific of FCs.

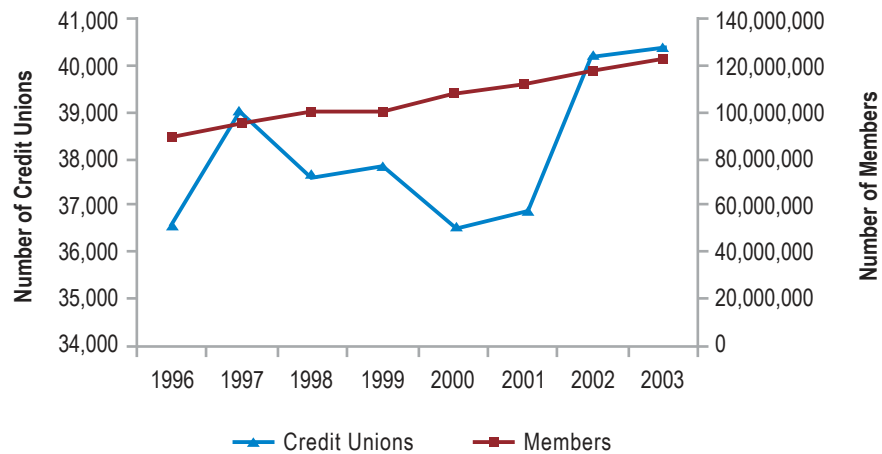
**Growth and technology.** There is room to improve in enabling FCs to benefit from (keep up with) the rapid pace of technological innovations. Consistent with the arguments in favor of institutional strengthening in parallel with regulatory reforms formulated earlier in this paper, the Workshop discussions highlighted the role of solid, professional international networks in fostering that strengthening, in partnerships with FC networks, donors, and governments. Policy dialogue with governments to induce their support in a market-friendly manner is a natural component of multilateral and bi-lateral donor agendas.





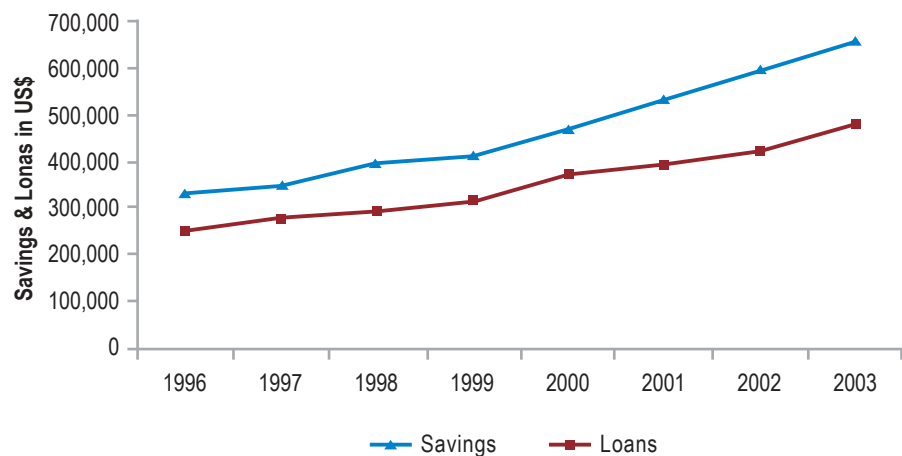
## Annex 1. Financial Cooperatives Growth

Figure 1. Credit Unions and Members Evolution, 1996 – 2003



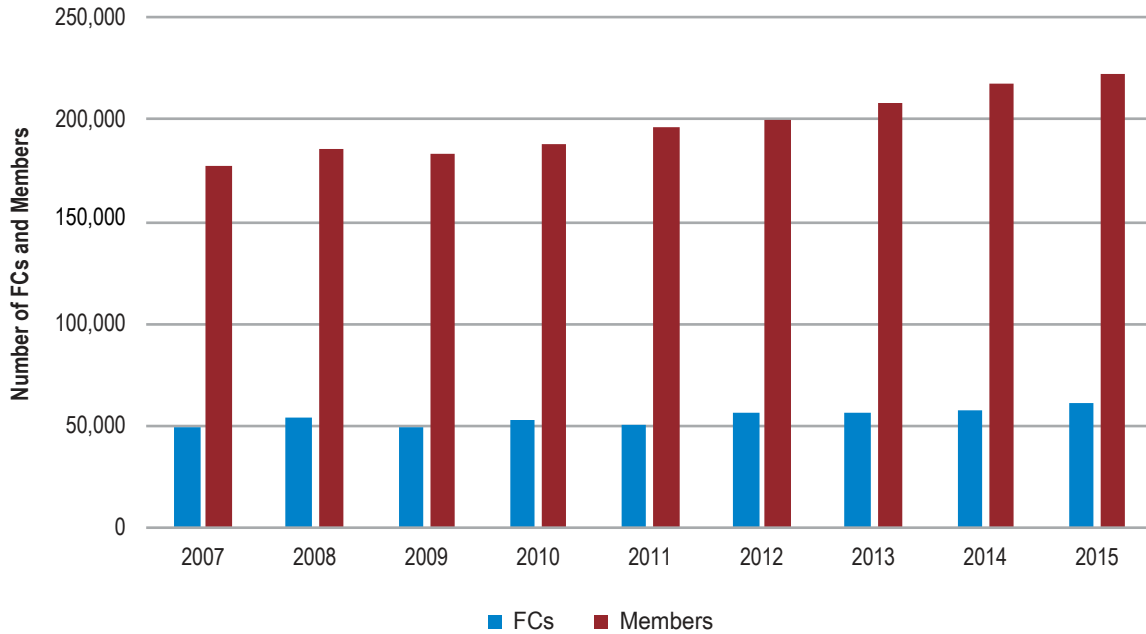
Source: Cuevas and Fischer, 2006, using WOCCU data.

Figure 2. Savings and Loans Evolution, 1996 – 2003



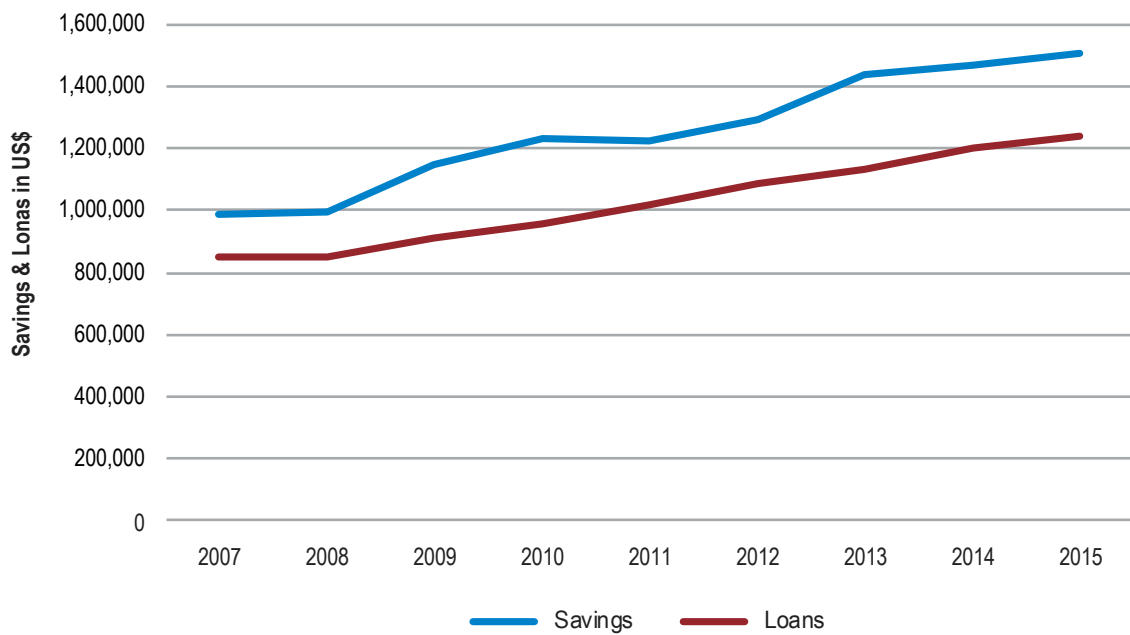
Source: Cuevas and Fischer, 2006, using WOCCU data.

**Figure 3. WOCCU: FCs and Membership, 2007 – 2015**



Source: Authors' based on WOCCU 2015.

**Figure 4. WOCCU: FCs Savings and Loans, 2007 – 2015**



Source: Authors' based on WOCCU 2015.



## Annex 2. FC Regulation and Supervision Categories – Selected Countries

Supervision Mode/ Country Category <sup>2</sup>	Regulatory and Supervisory Authority		
	General Cooperative	Specialized Financial Cooperatives	Banking
<b>Direct</b>			
Developed countries	New Zealand; UK	Ontario, Saskatchewan, Canada; <sup>1</sup> United States	Italy (B. Popolari); Switzerland
Developing countries	Bangladesh, Botswana, Bolivia, Chile (DECOOP), Colombia, Costa Rica, Ecuador, Ghana, Guatemala, India, Kenya (CSA), Malaysia, Nigeria, Panama, Paraguay, Philippines, Thailand	Belize, Colombia (SES), Kenya (SASRA)	Albania, Bolivia, Brazil, Chile (SBIF), Colombia (SFC), Costa Rica, Ecuador, Jamaica, Guinea, Nigeria, WAMU countries
<b>Indirect</b>			WAMU countries <sup>3</sup>
<b>Auxiliary</b>			
Developed countries			Australia, Austria, British Columbia, Canada; France, Germany, Ireland, Italy (BCC)

## Box 2. Indirect– Delegated/Auxiliary – Supervision

Supervision Mode/ Country Category <sup>2</sup>	Regulatory and Supervisory Authority		
	General Cooperative	Specialized Financial Cooperatives	Banking
Developing countries			Brazil, Lithuania, Madagascar, Mexico, S. Korea
<b>Delegated</b>			
Developed countries			Quebec, Canada
Developing countries			Argentina, Uruguay; <sup>4</sup> Peru

Source: Updated by authors, from Cuevas and Fisher, 2006. Countries change across categories, as regulatory regimes and definitions evolve.

Notes: 1. The Deposit Insurance Corporation performs the supervision on behalf of the state.

2. Countries entered in more than one cell are under a split regime in which large FCs are under direct banking authority supervision, and "small" or "closed" FCs are under cooperative authority supervision.

3. The WAMU (UMOA in the French acronym) is categorized as a "hybrid" of indirect supervision given the roles assigned to individual country Finance ministries, under the overall regional authority of the BCEAO, along with the functional delegation to second- and third-tier entities.

4. Argentina and Uruguay are categorized as delegated since the federations are regarded as networks forced to merge by the regulators.



## Annex 3. Supervision of FCs

### Box 3. Tiers for Supervision in Different Countries

The tiered supervisory approach has been implemented in Latin America region since the mid-1990s and it is currently implemented in Bolivia, Chile, Colombia, Ecuador, El Salvador, and Mexico. In those countries the central bank or banking supervision authority provides direct supervision services to the larger credit unions subject to certain thresholds. In some instances, as Ecuador and El Salvador, smaller institutions that the regulator does not oversee receive limited non-prudential oversight from a government agency not responsible for banking matters. In Chile and in Uruguay a ministry responsible for other non-bank institutions such as the regulator for mortgage brokers, insurance and money transfer firms supervises the smaller institutors, which small FCs are overseen in Mexico by the supervisory agency that operates under the deposit insurance.

Country	Conditions to Include Credit Unions Under Formal Supervision	Tiers by Asset Size	Minimum Capital in USD
Bolivia	Financial intermediation	Cooperatives (CUs) with assets above USD 84,000	Open bond CUs USD 169,000 Closed bond <sup>35</sup> CUs USD 85,000
Chile	Paid capital		USD 19.1 million
Mexico	All CUs authorized by the banking commission with assets equal or above USD 1 million	IV – USD 8.3 million III – USD 1.5 million II – USS 189,000 I – USD 38,000 Basic – Not	1 million USD
Uruguay	Cooperatives (CUs) providing multiple, or limited, financial services.		USD 17.1 million USD 2.6 million

Source: WOCCU, Technical guide, credit union regulation and supervision.  
DGRV. 2013. Regulation and supervision of savings and credit cooperatives in Latin America and the Caribbean. Costa Rica

## Box 4. International Experience in Auxiliary / Delegated Supervision for Credit Unions

### Auxiliary Supervision

According to the Basel Committee on Banking Supervision (BCBS) survey on MFIs supervision (BIS, 2015), while the supervisor has the authority to perform on-site supervision in banks, not all are authorized to examine other deposit taking institutions (ODTIs), and except for those countries with a specialized microfinance unit, supervisory processes and techniques are largely identical to those used for monitoring banks.

BCBS found out that only seven supervisory authorities are explicitly allowed to delegate supervisory roles to another entity. None of them are high income countries, reflecting an emerging arrangement to deal with the burden of supervising large numbers of small institutions such as financial cooperatives. Such delegated or auxiliary supervision arrangements can be found in Brazil, Mexico, Colombia, Chile, and Ecuador. It should be noted that neither supervisors have authorization to delegate entirely their supervisory responsibilities. Supervisors are still fully liable for prudential soundness of these institutions.

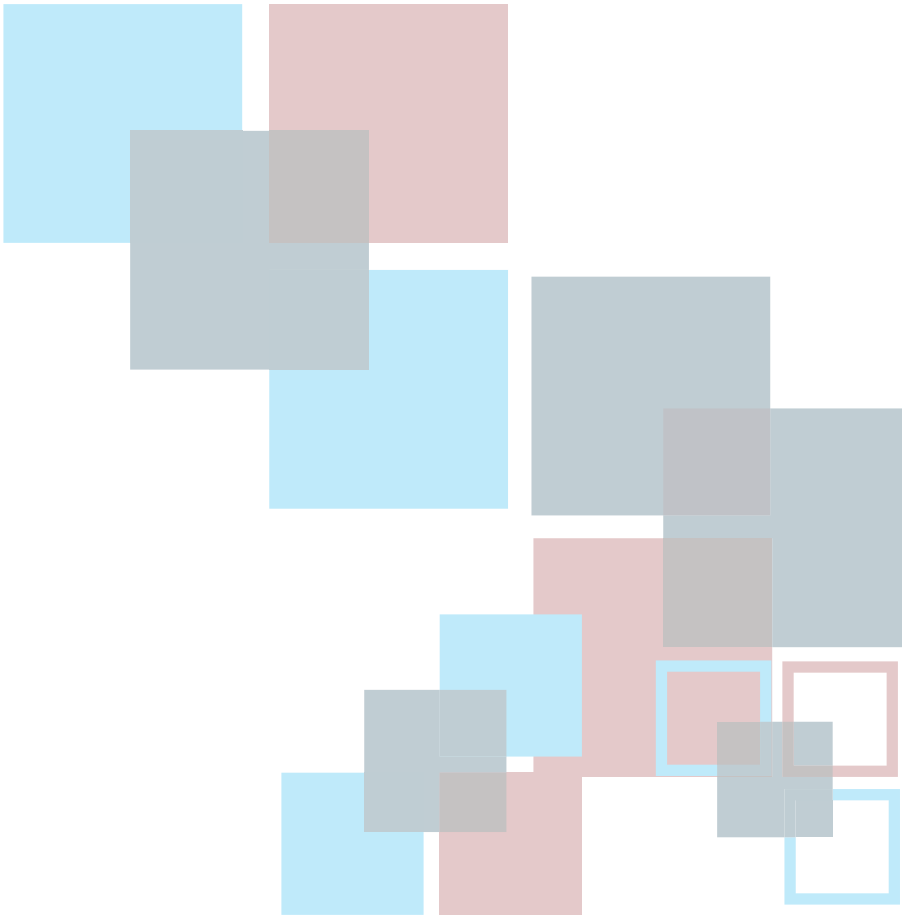
Brazil relies certain supervisory activities to the Central Cooperatives (second tier organizations), Colombia delegates to a confederation of cooperatives (CONFECOOP), Mexican authorities created an Auxiliary Supervision Committee attached to the deposit insurance fund for the credit unions, Chilean authorities rely in two external auditors, and Ecuador delegates in other wholesale organization.

Mexican banking commission (CNBV) directly supervise the larger financial cooperative institutions (second tier), whilst auxiliary supervision is responsible for monitoring the larger group of smallest institutions and regularly disclose the financial and managerial information of all entities that they monitor.

Country	Legal Arrangement	Auxiliary/ Supervision	Possibility to Issue Norms by AS	Monitoring Methods from AS	Main Supervisor	Payment by the State. to the Auxiliary Supervisor
Brazil	Resolution 3859 CMN	Central Cooperatives	No	Specific sets from each Central Cooperatives	Banco Central do Brazil (Special Unit)	No
Colombia	Law 454 (1998) legal figure of “technical advisor”	CONFECOOP (regional associations and others)	No	N/A	Solidarity Economic Superintendence	No
Chile	Resolution 540 from the Economy Ministry; General Cooperatives Law Art. 11	Two private external auditors	No	N/A	Economy Ministry	Yes (50% of contributions for supervision)

Ecuador	Popular and Solidary Economic Law	Wholesale organizations	No	Early Warnings Direct Sup. CAMELS	Popular and Economic Superintendence	Yes
Mexico	Savings and Loans Cooperatives Law (2009)	(Auxiliary Supervision Protection Committee Fund)	No	Early Warnings Direct Sup. CNBV's methodology	National Banking and Securities Commission (CNBV)	No

Source: DGRV. 2013, Regulation and supervision of savings and credit cooperatives in Latin America and the Caribbean. Costa Rica.







## Annex 4. Selected Country-Cases Highlights

### Albania<sup>36</sup>

#### Context

Rapid growth of the Savings and Credit Association (SCA) in recent years. SCAs organized mainly in two Credit Unions (In Albania, the term “Credit Union” refers to a federation of SCAs)– the Albania Savings and Credit Union (ASCU) with about 80 % of the SCA market, and the Jehona Credit Union. Market penetration is still relatively low, just under 3 % of the working age population (compared to 8 – 10 % globally).

Financial performance of the main two Unions had been weak, with high levels of non-performing loans (NPL)s, and significant losses. NPL levels had been reduced via consolidation and liquidation of troubled SCAs.

#### Salient features (why this case is relevant)

A new SCA Law has been in the works in recent years, and was enacted by the Bank of Albania in 2016. An important feature of the new law was the establishment of large minimum size requirements, forcing small FCs to consolidate. In addition, in discussions with the sector during law preparation, it was made clear that the supervisor would enforce the new, stricter rules, including reporting rules. This motivated the two federations to decide implementing a full merger of their affiliates into two new first-tier entities in which operations became largely centralized (while maintaining a tiered governance structure).

With technical assistance an operational support from Rabobank (RIAS), and the Irish League of Credit Unions Foundation (ILCU-F), and the backing of major development funders - World Bank, IFC, KfW, European Fund for Southeast Europe (EFSE) – a major consolidation of small FCs into one large FC had been completed in late 2015 even before the new cooperative law had been ratified. Under the scheme that was pursued, participating SCAs became operationally branches of the new entity, which is now governed by a council that is composed from delegates who are elected in the local assemblies of the SCAs. Access to a deposit insurance system for their members was a major driver for this relatively fast consolidation.

The regulatory reforms would enable verification of financial and governance soundness of the SCAs and their Unions prior to joining the deposit insurance system. Subsequently, the legal and regulatory framework will set a roadmap for scaling-up and consolidation of the sector.

## Colombia<sup>37</sup>

### Context

Important sector in terms of financial inclusion. About 6 million cooperative members (in cooperatives that take deposits), which represents about 20 % of the “banked” in Colombia, relative to the FINDEX statistics for 2014. The entire savings and credit cooperative system was fully reorganized after a major crisis in the late 1990s.

Currently, the sector is structured as a “tiered” or mixed system where large FCs (“Cooperativas Financieras,” 5 in total) are under the banking supervisory authority – “Superintendencia Financiera” - while small FCs are under a different supervisory authority – the “Superintendencia de Economía Solidaria.” The latter supervises all cooperatives, including “employee funds,”<sup>38</sup> but for the purposes of this report what counts is that it oversees about 180 savings and credit cooperatives.

### Salient features (why this case is relevant)

The system relies upon a guarantee/deposit insurance fund – “Fondo de Garantía de Cooperativas” (FOGACOO) – to encourage adoption of and enforce prudential standards. FOGACOO has been in existence for 16 years, grown from 60 members (i.e., FC users) to 186 FCs in 2014. During this period FOGACOO has handled liquidation of 11 cooperatives, with no losses to the deposit insurance fund.

FOGACOO follows accepted good practice for this type of funds, relying upon stress tests and

expert opinion to adjust coinsurance, coverage and premium parameters. It has been shown to be way above international standards in fund size, and in good position to expand coverage, lower premiums, and/or eliminate coinsurance.

The Colombia system (unlike Guatemala) seems well established and mature, in that the functioning of the deposit-insurance fund is backed up by the legislation that created the “SuperSolidaria” and established the mandate and attributions of FOGACOO.

## Guatemala

### Context

Savings and credit cooperatives (CACs in the Spanish acronym) are important in Guatemala. About 300 active CACs have 1.7 million members, just about 26 % of the active economic population.<sup>39</sup> Yet for decades the CAC sector has not been considered part of the financial system, and has been ruled by the same General Law of Cooperatives and its regulations, issued in the late 1970s. The two autonomous public institutions provided for in the law to register, regulate and sanction (INACOP) as well as to supervise (INGECOP) the estimated 900 active non-financial and financial cooperatives in Guatemala clearly do not have the resources to reliably carry out their functions.<sup>40</sup>

25 of the 300 financial cooperatives (CACs) are self-regulated under mechanisms established by their Federation – FENACOAC – which operates as a central finance facility. A deposit insurance fund – “Fondo de Garantía MICOOPE” – provides an incentive for the voluntary adoption of prudential oversight by FENACOAC/MICOOPE. It also requires adherence to a commercial brand MICOOPE. Non-compliance with prudential standards, however, carries no penalties, other than the loss of deposit insurance coverage.

### **Salient features (why this case is relevant)**

The Guatemala FC sector, in spite of the deficiencies of its formal regulatory system, is relatively stable, and has survived a number of crises. It is a case of the sector developing way ahead of the legal and regulatory framework, reaching the point at which the absence of an adequate framework is impeding growth and impinging upon the ability of the FCs to compete.

The relative strength of the main federation, FENACOAC, and the MICOOPE guarantee fund provide a basis for reforms that would approximate the system to that of Colombia's FOGACOOPE, in which failure to meet regulatory standards carries serious sanctions. The legal framework in Guatemala is in urgent need to catch up.

### **India**

This section relies on excerpts from Seibel, Hans D. 2013. *Financial Cooperatives – What Role for Government? The Rise and Fall of the Credit Cooperative System in India*. In Onafowokan O. Oluyombo (ed). *Cooperative and Microfinance Revolution*. Lagos, Soma Prints. Its main intent is to highlight the kinds of roles government should NOT play in the development of the FC sector.

### **Context**

The rise of the credit cooperative system stemmed from the Governor of Madras sending an emissary to study the mutualist credit emerging at the time (1894) in Europe, as a means to confront what was perceived as a dominance of (evil) moneylenders in rural areas of India. "Ten years later, in 1904, the *Co-operative Credit Societies Act* was passed in India, ... 'replacing the money lender by... the Raiffeisen Bank'." Thus, credit cooperatives in India started with a legal framework. "In 1912 the original act was replaced by the *Co-operative Societies Act*, aiming at societies dealing not only

with credit, but also with bulk purchasing and sale, insurance and various specialized functions."

"Since then the credit cooperative system (CCS) has continued to grow in quantity and complexity. After a century, by 2006, the CCS comprised almost 15,000 banking outlets and 106,000 primary credit cooperatives, with a total number of 135m shareholders. However, while cooperative finance is part of a self-help movement, its establishment and expansion in India involved the government as an active participant and promoter from inception. This stood in sharp contrast to countries like Germany, the Netherlands and others where the state was kept at bay, entering only in due course upon the request of the movement to provide a legal framework."

### **Salient features (why this case is relevant)**

The contrast indicated above did not escape the attention of contemporary observers. B. Huss (quoted by Seibel) stated in 1924 that "The fact that the British Government planted the idea of co-operative credit in the minds of the Indian people and guided the movement through the last twenty years is now considered by the Indians as a >pre-natal defect<." A decade later, in 1934, the Reserve Bank of India Act included provisions for refinancing the cooperative credit system." This was the beginning of a steep downturn. "State cooperative laws passed in the mid-1950s providing for *state partnership* in terms of equity, governance and management worsened the disease.<sup>41</sup> Encumbered by an ideology of central planning, the state assumed full control over all institutions including cooperatives. Governance was alienated from members and local communities. Instead, state governments were given full authority in matters such as appointment of chief executives, suspension of elected boards of directors, fusion or fission of co-operative banks, amendment of bylaws, vetoing of bank decisions, issuing of directives, supervision and enforcement of regulation, or rather the politically expedient absence of enforcement."

“As stated by the Committee on Financial Inclusion, in the 1990s “an increasing realization of the disruptive effects of intrusive state patronage and politicisation of the cooperatives, especially financial cooperatives... resulted in poor governance and management and the consequent impairment of their financial health.” The system became borrower-driven, and the concept of mutuality and self-reliance was lost.” “The results have been disastrous: by 2006 large numbers of cooperative banks, and more than 50% of primary credit cooperatives (PACS), were loss-making – probably many more if international accounting standards were applied.”

The author concludes that the one core problem underlying the fall of the credit cooperative system in India is the lack of effective supervision and regulation. “... which in turn is due to fuzzy delineation of authority and to political control over the cooperative sector. Nabard, an agricultural central bank carved out of RBI in 1982, **supervises the cooperative banks, providing at the same time refinance and capacity-building.** The district central cooperative banks (DCCBs) supervise the PACS; but no one possesses the authority of enforcing compliance.” (emphasis added).

Seibel’s “conclusion is unequivocal: a successful credit cooperative system requires autonomy and self-reliance, a conducive legal and regulatory environment, effective supervision and enforcement of compliance by an autonomous financial authority, which may be paralleled by auxiliary supervision by cooperative auditing federations. The role of the state may be supportive, but within limits, providing a conducive operating environment, but not intrusive, taking over the operation of the system.”

## Kenya

### Context

It is difficult to accurately characterize the size of the FC sector in Kenya, known as savings and credit cooperatives (SACCOs), mainly due to the

distinction between “deposit-taking” SACCOs (DT-SACCOs) and non-deposit taking SACCOs.<sup>42</sup> Hence, a WOCCU web report in 2013 refers to “over 13 million Kenyan SACCO members” while another WOCCU posting in 2015 talks about 5.4 million members.<sup>43</sup> The Kenyan supervisory authority for DT-SACCOs, however, reports 3.1 million members in 176 licensed DT-SACCOs for the same year (SASRA, 2015). The 5.4 million figure would represent about 21 % of the “active adult population” (ages 15-64), a high penetration rate by WOCCU standards.

The (overall) SACCO movement in Kenya is deemed to be the largest in Africa, and among the top ten globally. It mobilizes savings equivalent to 33 % of national savings, and is considered a “major driver of the economy.”<sup>44</sup> It is therefore rather puzzling that a solid legal and regulatory framework is not yet in place for a majority of the SACCOs, and that capacity building efforts seem atomized and piecemeal.

### Salient features (why this case is relevant)

The rather sluggish adjustment of the legal and regulatory framework to the size and growth of the overall SACCO sector is noteworthy in that it may be the reason why no major scaling-up and consolidation has taken place. The law created to regulate SACCOs was passed in late 2008, setting the stage for the SACCO Societies Regulatory Authority (SASRA). Nine years later SASRA has licensed 176 DT-SACCOs, of which 103 are in the “small-scale” category (assets under KSh 1 billion, about USD 962 thousand). A reasonable question is the cost-effectiveness of SASRA directly supervising a large number of small-scale entities. A follow-up question is whether the direct supervision approach is limiting the capacity of SASRA to license additional SACCOs.

Another interesting feature of the Kenya case is the apparent limited success of technology solutions for the SACCO sector. WOCCU’s 2010 effort

funded by the Bill & Melinda Gates Foundation has yet to report major indicators of performance in the intended technology development and deployment. In the country of M-Pesa, one wonders what kinds of technology developments hold real promise of success.

## Mexico

### Context

The savings and credit sector in Mexico evolved from about 650 retail entities in the year 2000, of which only about 40 were under supervision by the financial authority (CNBV in the Spanish acronym), with 2.6 million members, to a fairly solid sector with 133 entities supervised by the CNBV in 2014 (76 % of all members in the system, 82 % of the assets), and 6.5 million members. The figure in the next page portrays the evolution of the sector. Entities not supervised by CNBV mainly due to their small scale do have a set of rules to follow.

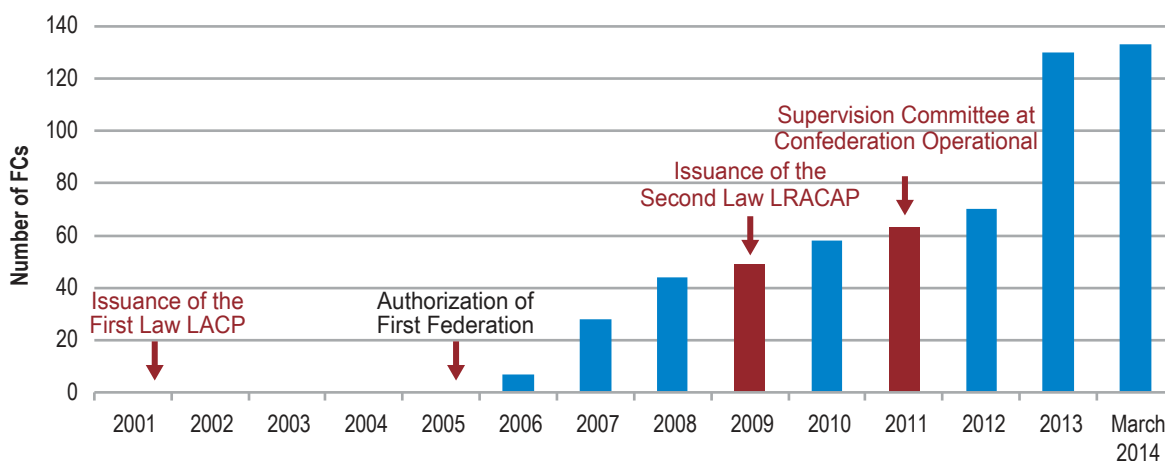
Many adjustments occurred after the issuance of the “Ley de Ahorro y Crédito Popular” (LACP) in 2001, and the creation of BANSEFI, a state-owned savings bank with a mandate to serve as development agent for the savings and credit sector – broadly defined at

the time as “Sector de Ahorro y Crédito Popular” that included FCs and for-profit microfinance entities. These two events, however, can be considered the foundations of the process that ensued. The LACP was replaced by a specific law for FCs – the LARSCAP in 2009 – and specialized agencies were created to deal with resolutions of failing entities (FIPAGO), and with the auxiliary supervision and deposit protection mechanism (FOCOOP) provided for upon the passage of the LARSCAP. The transition of the larger FCs under the oversight of CNBV was completed early in 2014, almost 13 years after the first efforts were undertaken.

### Salient features (why this case is relevant)

The Mexico case of FC development has lasted, and remained supported, through three administrations. Political pressures have been exercised in several different directions, but overall there has been political will to consolidate and modernize the sector in the Ministry of Finance, the regulator (CNBV), and the main development agency (BANSEFI). Significant delays and rescheduling of important milestones were forced over the years by pressures from some politically well connected federations, that translated into motions by legislators.

**Figure 5. Mexico: FCs Authorized by CNBV 2001 – 2014**



Source: Buchenau, Juan. 2014. “Designing a Path to Regulation and Consolidation for CFIs in Nepal and Guatemala: Lessons from Mexico. World Bank presentation. Unpublished.

Throughout the process, both CNBV and BANSEFI gathered extensive data on the sector, of particular importance given the diversity of entities in terms of scale and level of sophistication, and were able to establish a progression from initial state to licensing in the appropriate tier, and supervision either directly by CNBV or through an auxiliary mechanism. Establishing a process to liquidate failing entities (or upgrading since FIPAGO existed before the LACP) is a crucial component in a “complete” regulatory/supervisory system.

Finally, the capacity building that accompanied the regulatory reforms, mainly technical assistance provided by international FC networks, was an essential enabling component especially for those entities initially in a rather rudimentary financial and operational state. Making an electronic platform available for the sector (housed at BANSEFI) was a cooperating factor that many FCs utilized.

## Philippines

Two main federations of FCs exist in the Philippines – the National Confederation of Cooperatives (NATCCO), and the Philippine Federation of Credit Cooperatives (PFCCO).

NATCCO is the largest cooperative federation, with 760 member cooperatives and non-governmental organizations (NGOs) in 77 Provinces and 130 Cities and Municipalities as of June 2015. It reaches an estimated 3.7 million members. As early as the 1950s cooperative sector leaders were aware that in order to succeed they could not rely on government alone. Instead, coops had to be driven and patronized by their members and it is only through co-op education that this level of member patronage and responsibility can be established. Thus the creation of NATCCO as the National Association of Training Centers for Cooperatives, to coordinate the training and educational services for cooperatives at the national level.

In response to the growing needs of primary cooperative affiliates, in 1986 NATCCO was

transformed into a multi-service national federation while the regional training centers were transformed into multi-service cooperative development centers. The acronym NATCCO was retained and its meaning converted to the present, National Confederation of Cooperatives. NATCCO has been involved in a number of programs ranging from microfinance to cash transfers.<sup>45</sup>

PFCCO, the Philippine Federation of Credit Cooperatives is comprised by more than 100 Primary Cooperative comprises the NCRL-PFCCO. These cooperatives are clustered into different regional Chapters.<sup>46</sup>

Both federations fall under the oversight of the Cooperative Development Authority (CDA), along with many other types of cooperatives. However, CDA has limited powers that hinder it from intervening in single cooperatives, unless complaints are filed by members and has thus not effectively performed this function. In addition, CDA is mostly involved in development activities, which creates a conflict of interest with its supervisory activities. Even with the intervention of the National Credit Council (NCC) the regulation and supervision of credit cooperatives is deemed “weak and patchy.” (Llanto, 2015, p. 8).

### Salient features (why this case is relevant)

Both NATCCO and PFCCO “are kicking off a regional strategy developed by ACCU to modernize and standardize the credit union sector in Asia through a common payments platform for its members.” (CU Today release 05/19/2016). Under a multi-party agreement technology services partner Temenos will provide a cloud-based banking and payment service. The service will run on Microsoft Azure. The provider presents the “ACCU Payment Platform” (APP) as a preferable alternative for financial cooperatives over joining a third-party platform (such as that of a bank, or an MNO). It will be relevant to follow the development of this platform in the Philippines, among the leading countries in Asia in digital finance. The capacity and sophistication of the primary FCs members of NATCCO and PFCCO will be put to test.

## Rwanda

### Context

Banque Populaire du Rwanda (BPR) today is by far the largest retail bank in Rwanda with the most customers (about 1.4 million) and branches/outlets (190), licensed as a full-service commercial bank. Its origin, however, dates back to 1975 when the first “*banque populaire*” – a savings and credit cooperative – was created in rural Rwanda. In the ensuing years, other community based savings and credit organizations were established elsewhere in Rwanda as autonomous “*banques populaires*.”

The “*Union des Banques Populaires du Rwanda*” (UBPR) was established in 1986 as an umbrella organization for the many autonomous savings and credit cooperatives. About 41 years later in early 2008 UBPR transformed from a cooperative bank into a commercial bank – Banque Populaire du Rwanda S.A. Later that same year, Rabobank acquired 35 % of the shares in BPR, and took over management responsibilities.

Today, BPR majority shareholder is Atlas Mara Limited (62 %), a Dutch consortium including Rabobank, Norfund, and FMO owns 15 % of the shares, and the remaining 23 % remain in the hands of minority shareholders, presumably the original savings and credit cooperatives.

### Salient features (why this case is relevant)

This case is brought up here as an example of a “possible” evolution of FC systems, especially when a federated entity (as UBPR) was effective in integrating common functions for its affiliates, while maintaining the democratic governance typical of financial cooperatives. This model, similar to the one applied in Albania, distinguishes governance structure from functional structure and is a promising one for FCs in financial systems that grow more competitive and modern.

## West Africa Monetary Union (WAMU)

### Context

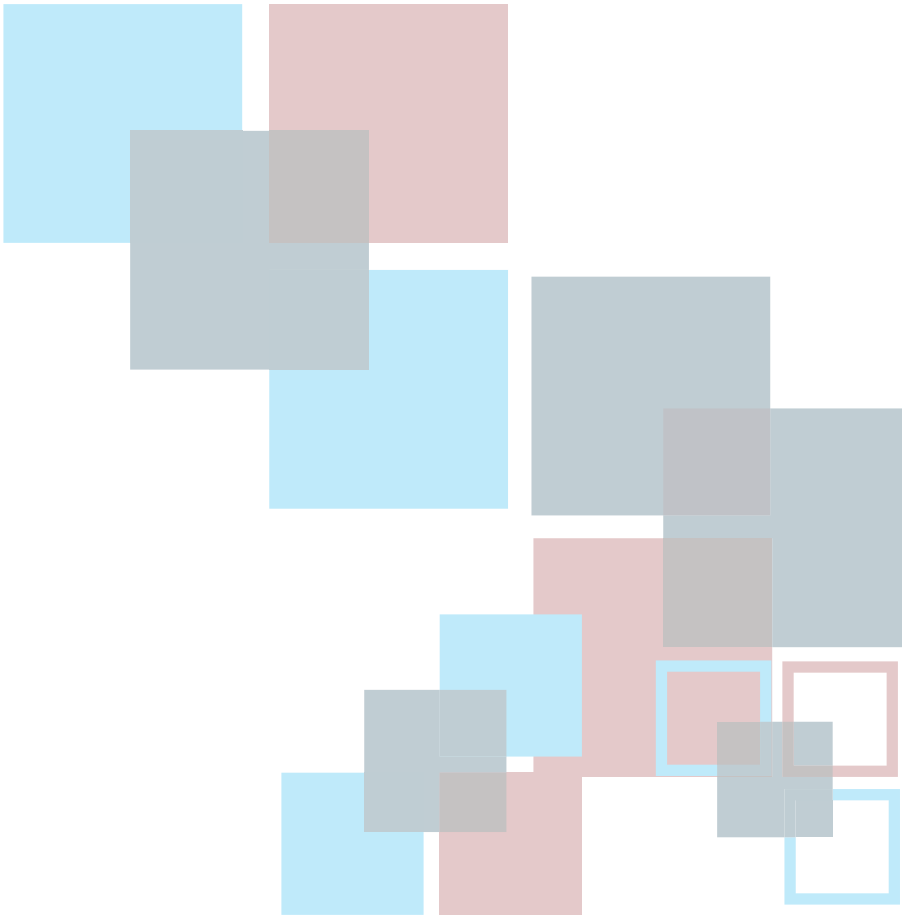
Financial cooperatives are particularly important providers of financial services to low-income people in the WAMU region.<sup>47</sup> Total membership is estimated at close to 13 million in the region. In most member countries the share of FC membership in the economically active population is estimated at at least one-third (e.g., Senegal), reaching as high as 59 % (Togo).<sup>48</sup> Typically federated in “unions” in most countries, FCs are pervasive in rural areas.

While entry into the FC sector (registration and licensing) falls under the authority of the individual country’s finance ministry, regulation and supervision are primarily under the authority of the regional central bank (BCEAO), and the regional Banking Commission (see below).

### Salient features (why this case is relevant)

The West Africa Monetary Union (WAMU) portrays a special case of a regional authority with a “hybrid” approach to regulation and supervision where all FCs with outstanding loan portfolio above USD 4 million fall under the direct supervision of the regional Central Bank (BCEAO) and the regional Banking Commission (see Annex 4). FCs with loan portfolios below that threshold are the responsibility of the respective Ministry of Finance of the WAMU member country (8 in total).

It is possible, therefore, that in a country that has one major federation (union) with say 20 affiliated cooperatives, of which 5 have loan portfolios above USD 4 million, the BCEAO and Banking Commission will directly supervise those 5 plus the apex, typically in joint supervision missions. Needless to say, coordination issues are important in this kind of arrangement, not only between the BCEAO and the Banking Commission, but also with the respective Ministry of Finance.





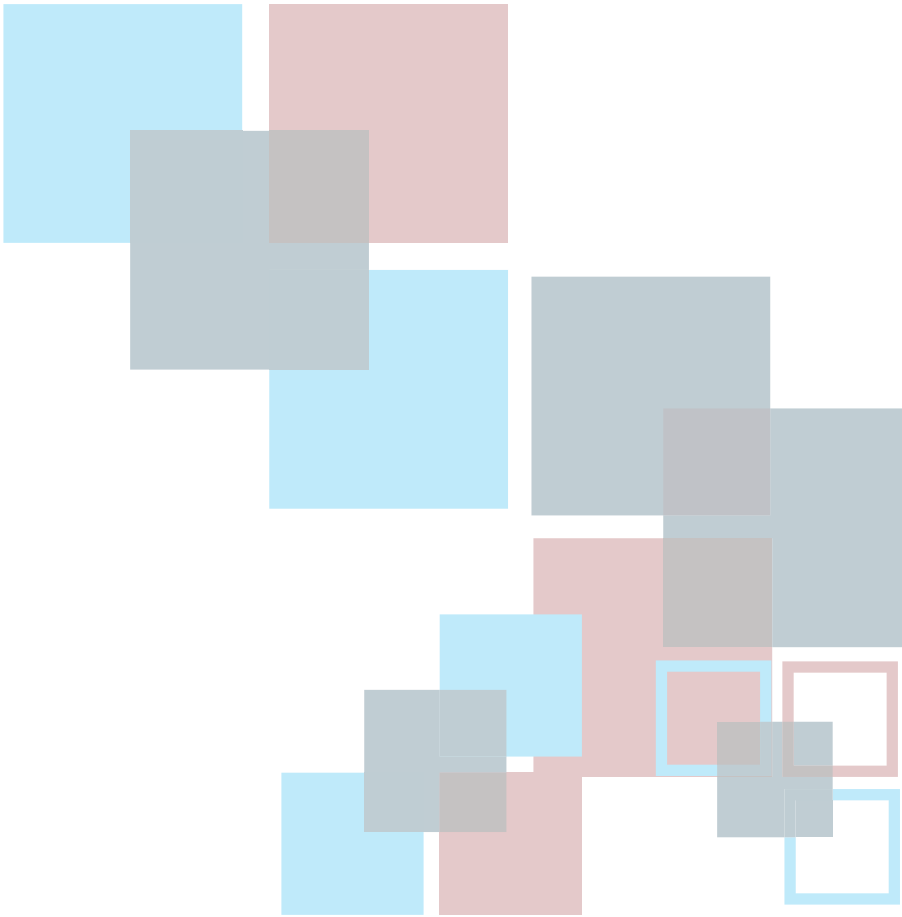


## Endnotes

1. See De la Torre, Gozzi, and Schmukler (2007) for market-friendly interventions in access to finance.
2. This paper uses the term “financial cooperatives” in line with the definitions used by the Bank for International Settlements (BIS): “A member owned and member-controlled financial institution governed by the “one member one vote” rule.” “The term includes credit unions, building societies, *caisses*, *cajas*, cooperative banks, mutual banks, and savings and credit cooperatives.” Bank for International Settlements. 2015, p. 6. Another similar all-encompassing term frequently used is “Cooperative Financial Institutions” (CFIs).
3. Systemic relevance of FCs is nonetheless fairly high in certain regions, such as West and Central Africa, where an important share of total deposits is held in FCs. See also WOCCU 2013.
4. This relevance had been underscored in a recent BIS document: “in some countries, non-bank financial institutions, while not systemic based on the value of funds they intermediate, may present a systemic dimension due to the number and type of customers they serve.” Bank for International Settlements. 2016, p. 2.
5. WOCCU Statistical Report figures cover an important sub-segment of the 2014 census data. It reports membership of about 223 million individuals in 2015, in 61 thousand FCs in 109 countries. These data include WOCCU members, affiliates, associates and “other credit union countries.” They do not include European regional/local cooperative banks, about 81 million members as of December 2014 in the WOCCU report. The European Association of Cooperative Banks, however, reports 210 million clients as of December 2015 ([www.eacb.eu](http://www.eacb.eu)).
6. Cuevas, Carlos E., and Klaus P. Fischer. 2006. *Cooperative Financial Institutions: Issues in Governance, Regulation and Supervision*. World Bank Working Paper 82.
7. “Too far away” was the fourth barrier in importance to use formal accounts (20 percent of respondents) in both FINDEX surveys, 2011 and 2014. If two of the other barriers are set aside (not enough money, no need) then proximity is the second barrier in importance, after “account too expensive.”

8. The structure and functioning rules of of FCs “break the market failure that leads to credit rationing.” (Cuevas and Fischer, 2016).
9. Guatemala, for example, places savings and credit cooperatives (CACs) in the “self-regulated” category, and does not consider them part of the formal financial system. They operate under a “General Cooperatives Law” that recognizes CACs as “specialized” in savings and credit activities.
10. Cuevas and Fischer, 2006.
11. Cuevas and Fischer, 2006.
12. See ICURN, 2013.
13. BIS 2015.
14. See for example Mexico’s “Ley para Regular las Actividades de las Sociedades Cooperativas de Ahorro y Préstamo” (LRASCAP) (CNBV, 2017).
15. For example, the West Africa Monetary Union (WAMU) framework (BCEAO, 2011).
16. CAMELS, PEARLS, BAKIS, are examples of rating systems used with FCs as well as with other financial institutions, based on a number of ratios and peer group analysis.
17. Explicit or implicit government guarantees when an entire system is in distress create perverse incentives (e.g., ghost accounts, inflated deposit slips), especially when the resolution of the failed system drags on for a long time. The example of Crédit Mutuel du Guinée (CMG, Conakry) is a classic in this respect. In distress since the mid-1990s, CMG was only declared bankrupt and closed in 2001, with compensation to depositors following a rather complex mechanism that included verifying the validity of account balances (Godquin, 2002).
18. See Ehard (2014).
19. IADI, 2018.
20. See outcomes of International Workshop discussion in the last section.
21. A common good practice clause makes shares non-redeemable if this would mean falling below the regulatory capital-adequacy requirement.
22. Mexico’s LRASCAP, for example, does not require risk-weighting for the smallest tier of regulated FCs, but it does for all other tiers.
23. Characteristic of credit unions in the United States, English-speaking Canada, and in some Latin America countries. East Africa “SACCOs” are also mainly in this category yet with rather loose national alliances, and practically non-existent reliable supervision.
24. The federated model can be found in Quebec, Canada, and Europe (Germany, France, and The Netherlands). West Africa and Central Africa FCs are influenced by the French and Quebec model.
25. The term Confederation is used when the apex entity regroups federations of financial cooperatives operating in different countries, e.g. CIF- Confédération des Institutions Financières regrouping financial cooperatives in 5 WAMU (UMOA) countries.
26. This “first best” of every FC being directly supervised by the financial authority is in fact not observed in any Latin American country (Arzbach, 2014). We venture to say that this is true everywhere in the developing world.
27. The Colombia system, however, is backed by a Superintendence, and failure to meet the requirements of the deposit insurance agency may result in sanctions and liquidation (see Annex 4). No such backing exists in Guatemala.
28. Large-scale SACCOs in Kenya have been reported looking into alternative (corporate) organizational structures in pursuit of enhancing their competitive position (see Annex 4).
29. Cases of capacity building lagging regulatory reforms are not common. The WAMU example in West Africa may be a close example in that the decisions on supervisory authority have been made without an accompanying

- concerted effort of capacity building. Selected networks in the region (e.g., FUCEC Togo, RCPB Burkina Faso) have technical assistance agreements with international providers such as DiD or *Crédit Mutuel* France but they are not part of a regional capacity building initiative. Kenya, interestingly, after pushing to institute WOCCU's "model law of credit unions" for the country's SACCOs, it has not followed up with comprehensive capacity building.
30. Excerpts from, and discussion of Workshop presentation by Fernando Restoy, Financial Stability Institute, Bank for International Settlements, April 2018.
  31. Institutional Protection Systems (IPs), while currently relevant mainly in Europe, are a not-so-distant cousin of risk-mitigation structures existing in some developing economies, also designated as Institutional Protection Schemes (see below).
  32. Excerpts from, and discussion of Workshop presentation by Julien Reid, *Autorité des Marchés Financiers*, April 2018.
  33. (IADI, 2018).
  34. Excerpts from, and discussion of Workshop presentation by Bjorn Schrijver, Rabo Partnerships, April 2018.
  35. "*Cooperativas de ahorro y crédito de sociedades*" meaning credit unions with membership restricted to employees of a firm.
  36. Sources: World Bank technical note (internal document, 2014), and Rabobank (2017).
  37. Main source: Seelig, Steven A. 2015. Deposit Insurance for Cooperatives in Colombia. World
  38. Bank Group, unpublished presentation.
  39. Approximately 1,600 cooperatives take deposits in Colombia, most of them are "employee funds."
  40. Guatemala Bank Superintendency, 2017.
  41. INACOP also has a promotional function that entails a conflict of interest.
  42. In line with the cooperative act of 1919, which had made "co-operation" a provincial subject (equivalent now to a subject under the control of the states).
  43. Non-deposit taking SACCOs may collect non-withdrawable deposits, used as collateral for credit to members (SASRA, 2015). Of nearly 4,000 SACCOs in Kenya just over 200 were deposit-taking institutions in 2009 (WOCCU, 2009).
  44. This figure may refer to the SACCOs members of the Kenya Union of Savings and Credit Cooperatives (KUSCCO), a WOCCU affiliate. The overlap of these SACCOs with the DT-SACCOs supervised by SASRA is unclear.
  45. Kenya Union of Savings and Credit Cooperatives (KUSCCO, 2016, [www.kuscco.com](http://www.kuscco.com)).
  46. [www.NATCCO.coop](http://www.NATCCO.coop) site.
  47. Membership statistics not available in their site, or in the Asian Confederation of Credit Unions (ACCU) annual report.
  48. The WAMU comprises Benin, Burkina Faso, Côte d'Ivoire, Guinée-Bissau, Mali, Niger, Sénégal, and Togo.
  49. Financial cooperatives in the WAMU region comprise the large majority of the so-called "*systèmes financiers décentralisés*" (SFD) which does include a few non-cooperative microfinance institutions. Even systemic relevance (in deposit balances) can be relatively high in some of the countries, e.g., in Togo FC deposits reach about 29 percent of bank deposits (estimated with BCEAO 2016 data).





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