

Cooperative Financial Institutions

Issues in Governance, Regulation, and Supervision

Carlos E. Cuevas
Klaus P. Fischer



THE WORLD BANK

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Washington, D.C.

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Abstract

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

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

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

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

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

Preface

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

Abbreviations and Acronyms

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

Introduction

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

—Nicols (1967: 337)

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

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

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

1. For example, Savings and Credit Cooperatives (SACCOs) in East Africa; “Caisses populaires” or “Caisses d’épargne et de crédit” in West and Central Africa; “Cooperativas de ahorro y crédito” or “cajas de ahorro y crédito” in Latin America; credit unions in the UK, USA and parts of Canada.

2. Although in some cases they also serve non-member users; the distinction between members and non-members is often a small share purchase.

3. See Appendix for a more extensive background on CFI.

Box 1: What Do We Mean By “CFI”?

Under the term CFI (cooperative financial institutions) we include institutions that bear different names but are essentially identical. Only in few cases do they have special organizational features. The most common expressions used for CFI are financial cooperative (FC) with its Spanish translation *cooperativa financiera*, savings and credit cooperative (SACCO) with its Spanish translation *cooperativa de ahorro y crédito*, CAC or COPAC, and credit union (CU) with its Spanish translation *union de crédito*. There are also the non-English expressions such as the French *caisse* with its variations—*agricole*, *populaire*, *mutuelle*—of which *populaire* is probably the most common, with its Spanish translation of *caja* or in Portuguese *caixa*. Under CFI we also include a number of institutions known as cooperative banks (CB). The expression cooperative bank is often used to represent a CFI that holds a banking licence, but also a number of other very disparate structures, such as: the apex of a CFI network that holds a banking licence (Germany, Colombia); a joint stock banking subsidiary of an apex of a CFI network (Brazil, Finland); a joint-stock bank subsidiary of an apex of a non-financial cooperative network (U.K., Switzerland); or an entire network of CFI, usually with a relatively high level of integration that holds a banking licence (Netherlands’ *Rabobank*). On the other hand, the expression *caisse*, *caja*, *caixa* is also often used to represent what in English is known as a “savings and loans association” (S&L) of mutual ownership, which are strictly speaking not cooperatives. These latter are not the subject of this document although we refer to them in several occasions.

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

Addressing these issues is fundamental. The best implemented CFI management and control systems may be rendered useless by a flawed regulatory framework. What is the

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

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

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

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

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

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

Figure 1. Mechanisms to Enforce Contracts in a Firm

Finally, in absence of theoretical and empirical arguments against and several in favor, we propose the hypothesis that much of what is said in this document applies to both cooperatives and mutual savings banks. It might be useful to consult with organizations such as the World Savings Banks Institute (WSBI) on the validity of this hypothesis rather than just go on assuming it holds.⁵ Such a debate is even more worthwhile if one considers that mutual savings banks are institutions that have already demonstrated their ability to reach vast numbers of people, including poor people, with financial services, and actually have a longer history of doing so than cooperatives.

To stress issues alone is not sufficient. We must seek mechanisms to settle differences and articulate policies that find support by different stakeholders involved in the debate. Thus, another goal of this paper is to set the stage for a research program, by identifying those issues for which an answer can be found through direct testing on data for existing systems. This work is underway. Once it is completed the next task is to start proposing concrete policy recommendations regarding the governance and regulation of CFIs.⁶

5. The WSBI with 101 member organizations in 85 countries represent the entire range of savings banks on all continents. Among the member organizations, many are large networks of individual savings banks with market shares that may exceed that investor-owned banks and cooperatives.

6. While we have attempted to cover what we understand to be the key issues related to the governance, legislation and regulation of CFI, the coverage is, by necessity, incomplete. Comments received suggest that other topics such as examination practices, tiered systems and sequencing of legal, regulatory and institutional reform may be ranking right behind those raised here. They remain, therefore, to be addressed in subsequent work.

Governance and Risk

The literature on the microeconomic theory of mutual intermediaries diverges from that for investor-owned banks due to the differing features that determine the way in which the institution must be modeled. These differences stem from the contrasting governance structure of these two types of institutions that result from ownership. For mutual intermediaries the key features are:

1. The principle of one-man/one-vote;
2. Unbundling votes and membership is not allowed;
3. Residual claimants (owners) both supply and use funds; and
4. Dividends (if any) are distributed to both savers and borrowers in proportion to their share of intermediation activity.

These features also drive a gap between the governance mechanisms observable in joint-stock and mutual intermediaries.

A CFI, like every mutual, is an institution that presents eminent advantages over other types of financial intermediaries, but also weaknesses which if ignored often lead to failures. On the advantage side, the most important is that the mutual is a “natural solution” to the problem of adverse selection (credit rationing) breaking the exclusion from access to financial services for agents (micro and small enterprises, poor individuals, small farmers) otherwise rationed out in an investor-owned banking system. It is both a matter of contract design and of governance. The section on “strengths” presents a brief summary of the advantages of mutuals as a device to break adverse selection and as a mechanism that allow the contracting parties to “govern” the relationship. We then address the “weak” side of the mutual, the governance of the contractual relations between certain stakeholders of a CFI.

In analyzing this aspect of the operations of a CFI we will find that it presents fragilities that are specific to the nature of the mutual ownership form and that are of crucial importance from the point of view of a regulator.

Strengths

The dominant economic theories that explain, and the policies designed to expand the role of the financial system in the reduction of poverty and in the promotion of small enterprise have been hindered by two shortcomings associated with the very nature of the evolution of economic thinking. These handicaps are:

1. These theories ignore the internal structure of the organizations performing the intermediation function or are fixed to be of the investor-owned type. Organizations are no more than a generic technology transforming inputs into outputs. All organizations, regardless of particularities are equally endowed to perform the intermediation function and they all offer the same contracts.
2. Customers of intermediaries are indifferent with respect to the institution offering them, accepting or rejecting products specifications and prices established by it. Customers themselves have no way to change (“govern”) either the institution’s production function, product specification or prices.

Under a fixed-institution and frictionless theoretical framework an agent (micro-enterprise or a poor person) is rationed or not of credit—or insurance—by an institution regardless of: (i) whether an alternative institutional form would provide a contract that prevents market failure; and (ii) whether this agent wants to engage in exchange with the institution. This is the case in both reputed theorems of provision of financial services in the credit (Stiglitz and Weiss 1981) and insurance (Rothschild and Stiglitz 1976) markets in which the institution has been “fixed” to be of the investor type. The handicaps are thus directly related to the standard assumptions of fixed institutions, frictionless markets and ex-ante (full) specifiability of contracts that underlie the paradigm of neoclassical economic theory and still guide most policy formulation. In such a world imperfections such as transaction costs and governance structures are irrelevant, as all decisions are based on price and product attributes in competitive markets. The problem amounts to a focus that imposes externally organizational structure of institutions on an environment, rather than permitting the structure to be determined endogenously by the interaction of agents.

Different currents within the New Institutional Economics (NIE) relax a combination of these three assumptions (frictionless markets, ex-ante fully specifiable contracts and externally fixed design) seeking to make the institutions and endogenous choice. There are three currents of thought that seek to understand how institutional features affect the way they operate and are known under the labels of the property rights theory, transaction cost economics, and agency theory.⁷ From our perspective the most important idea generated

7. The pertinent literature addressing issues of financial intermediation are: in the property rights theory Hart and Moore (1998), Smith and Stutzer (1990, 1995) and Boyd, Prescott and Smith (1988); in the TCE theory Merton and Bodie (2004) and Bonus (1986, 1994); in the agency theory Cummins, Rubio-Misas and Zi (2004).

by this entire literature is that an exogenously-fixed institutional design leads to market failure of some sort, that is, transactions fail to occur. Unfortunately, policy formulation lags behind and is still strongly influenced by the neo-classical perspective of financial intermediation. Policies guided by this framework that attempt to reduce the severity of market failure, by ignoring that the solution depends on the existence of a variety of institutional forms—of which the investor-owned type and the mutual are the two most important ones—may alleviate but not eliminate market failure.

There are two remarkable constants in the results of these models: (i) The “natural” solutions to the contract problem that breaks down market failure involves an endogenous institutional arrangement in which contracting parties (in credit and insurance transactions) in one segment of the market become carriers of the residual risk, in an arrangement that resemble remarkably mutual institutions. This is the portion of the market that in neo-classical models is rationed. Another segment of the market contracts with the classical investor-owned intermediary; (ii) the legal and regulatory environment plays a key role in making the solutions feasible, either by influencing transaction costs, providing the legal basis to make contracts credible, or simply to permit the formation of such institutional forms. Yet, it is not just any regulatory environment, this must be adapted to the specificities of the contracts that are at the heart of the institution that results. These arguments lead us to the following propositions:

Proposition 1: The CFI present advantages over investor-owned financial intermediaries in the provision of financial services (through breaking the market failure that leads to credit rationing), contributing to a “functional financial system” in the sense of Merton and Bodie (2004).

And by extension,

Proposition 2: A financial system that presents a diversified institutional structure, including institutional types, among others CFIs, will be more efficient in promoting economic growth and reducing poverty.

Weaknesses: The Sources of Default Risk in a CFI

Main Ideas

CFIs also present glaring weaknesses. The same organizational design that gives the mutual its strength to undo market failure is at the root of its main weakness with significant impact on default risk.⁸ To avoid being misunderstood, we hasten to add that presenting weaknesses due to agency conflicts is not a feature exclusive to CFIs. Cooperatives have lost a minuscule fraction of the assets lost by investor-owned banks as a result of risk-taking driven by the shareholder-depositor conflict that characterizes the latter. However, this does not disqualify banks as key factors in economic development. That a particular agency conflict is at the source of most failures does not disqualify CFIs either. As a summary, there are four main conclusions that can be drawn from reviewing the quite large literature on agency conflicts *within* a CFI:

8. “Default risk” is used here to mean institutional failure rather than “loan default”, although both are usually correlated.

1. Two main agency conflicts dominate the CFI, the *net-borrower vs. net-saver* and the *members vs. managers* conflict. Both have been studied at the theoretical and empirical level. There is remarkably little empirical work focusing on the first—with mild results in terms of the severity of impact, provided that externally-induced distortions are not too severe.⁹ On the contrary, there is a large literature on the second—with strong results in terms of severity of impact on CFIs performance. Figure 2 (later) illustrates these two conflicts. This does not mean that the net-borrower vs. net saver conflict is of no consequence to sustainability of CFIs, but rather that the member vs. manager appears to be of more significant impact.
2. The member vs. manager conflict is an important source of vulnerability in the governance of CFIs which has largely been ignored in the practice of promotion of CFIs in developing countries. Following United Nations and ILO assembly declarations, there is currently a thrust to give cooperatives a renewed role in promoting development. If the new promotion policies ignore this often overlooked source of vulnerability, we risk repeating the spectacular failures of CFIs that occurred in the 1970–80 (in Latin America). In the past, these failures have led to a loss of interest by policymakers and donor agencies in CFIs as instruments to solve the problem of supply of financial services to poor communities. Without that loss of interest, perhaps CFIs would today be more ubiquitous than they are, to the benefit of the poor.
3. Often supervisors and promoters will be inclined to shield CFIs from competition in the market through e.g. preferential tax treatment, control of rates, and subsidized credit. This is an unwise policy that is likely to encourage opportunistic behavior by management of the CFI, *while not benefiting members* since the rent generated by the protection is usually captured by the former. In fact, such policies are likely to increase the risk of insolvency of CFIs by making them more vulnerable to management opportunism. There is solid empirical evidence that CFIs will perform best in a competitive—but appropriately regulated—environment!
4. Empirical tests suggest, contrary to common belief, that larger CFIs are, on average, less efficient than small ones, shedding doubts on the current wave, and often-heard recommendation in favor, of mergers of CFIs. In effect, an increase of the size of operations, though possibly valuable for a profit maximizing investor-owned financial intermediary, might in fact create perverse incentives for managers of a CFI. More precisely, growth in size of mutuals is likely to weaken corporate governance to the point of leading to failure. Corporate governance is particularly impaired when the mutual attempts to diversify its sources of funding to sustain rapid growth. That is, in the trade-off between beneficial and prejudicial effects of growth in scale of CFIs, on average the latter dominate.

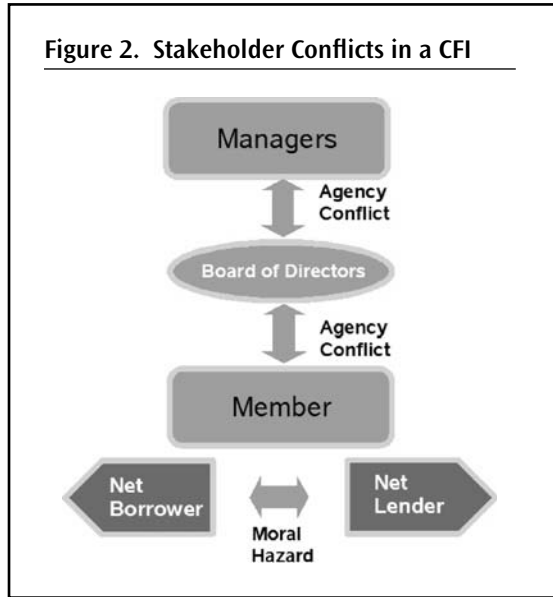
Although many empirical studies reported here focus on mutual savings banks, not cooperatives, we do not know of any theoretical arguments or empirical evidence in support

9. When CFI are “used” as tools of governments to channel funds to target sectors, they distort the necessary equilibrium between member-borrowers and member-savers. Under those conditions, the saver-borrower conflict gains indeed in weight, but it may also mask the severity of the member-manager conflict.

of a hypothesis that one might be more efficient than the other. Thus, one could at least hypothetically take these results as representative of all CFIs, mutual savings and loans banks and financial cooperatives.

The CFI as a Bundle of Contracts

As in banking, the bundle of contracts that constitute the firm “CFI” connects different parties with diverging interest depending upon their position in the contracts. Two modeling currents that coincide with two key contracts in the bundle, have dominated. These two main currents correspond to:



1. *The borrower-lender relationship.* The conflict that exist between net-borrower and net savers of a mutual intermediary. Throughout this paper we will simply use the expression borrower and savers respectively meaning with it that members take a net position as such.
2. *The member-manager relationship.* The conflict that exists between the members of a mutual intermediary (principals) and the managers of the same (agents) has been studied under two differing theoretical frameworks. Much of the literature focusing on this conflict uses concepts that find their roots in organization theory under the name of *expense preferences* (EP) of managers. Some recent studies have focused on the conflict using the perspective of the *agency cost theory*.

The member-manager conflict is actually a rather complex phenomenon. The governance structure that serves to represent members within the institution and supervise on a more regular basis management is the Board of Directors (BoD). The members of this body, just like managers, will advance their own interests subject to constraints imposed by the function. Thus, the conflict can be broken down in two components: the member-BoD conflict and the BoD-manager conflict. Further, members of the BoD, in the pursuit of their own interest or that of members they represent, may be inclined to interfere with the responsibilities of managers on a regular basis, thus depriving the latter of the required autonomy to execute efficiently their responsibility. However, these refinements have not been the object of orderly treatment that leads to testable propositions that may be subjected to empirical tests, at least not in the field of CFIs.

Probably surprising to some, the borrower-saver conflict has received relatively little attention from empirical researchers, and the results obtained could be considered as “mild” at best. These mild results contradict somewhat the extensive literature studying the issue from a theoretical perspective. This is so even in the United States where historically the

regulatory environment encouraged borrower bias through the control of interest rates. The strongest empirical evidence that this conflict can be significant and contribute to CFI failure was found in Latin America.¹⁰ There, a number of distortions contributed to create a strong “borrower bias” among CFIs which translated into a high failure rate. Thus, it is crucial to protect both savers and borrowers and the survival of the CFI preventing board of directors to become borrower-controlled. However, while this conflict should not be ignored, in practice it is less significant than theory suggests. In fact, many of the reported failures occurred in an environment of low competitiveness—which, as we will see below, aggravates the member-manager conflict. It is thus possible that many failures attributed to “borrower bias” may be due to a combination of both.

The member-manager conflict, by contrast, has generated a surprising amount of studies with strong support for theories that explain the phenomenon. The conflict between members and managers has been studied under no less than four distinctive *approaches*. Two are related to the notion of expense preferences (EP) and the other two to the more “modern” approach of agency theory. Among those currents based on the notion of EP, the first, focuses on the impact of market structure on the efficiency of institutions, and is usually called the “performance structure hypothesis.” The central element of this hypothesis is that as the competitiveness in markets fall, rents increase, and when managers are subject to weak control, those rents will not go to shareholders but to management through increased wasteful expenses. The second, which we call the “ownership structure hypothesis” studies how ownership structure affects institution efficiency. As ownership dilution increases the behavior of the intermediary emerges as a product of the managers’ rather than the shareholders’ effort to secure the greatest personal satisfaction, while meeting some minimum performance constraints that make this behavior “acceptable” to shareholders. While the second hypothesis addresses directly the question of impact of ownership differences on performance, the first also has important implications for two reasons: (i) the level of competition in the market has an effect on performance both in mutual and stock firms; (ii) several studies on CFIs were performed using this hypothesis as point of reference, finding support for it.

The conclusion we draw from this literature is that weaker competition enables managers of CFIs to adopt EP behavior. Thus, creating a protective environment through mechanisms such as regulation that isolates the institution from competition or through subsidized financing, may enhance the detrimental effect of managerial discretion on performance. This reveals another source of possible failure which can occur when CFIs are created as a mechanism for distribution of subsidized government credit as was common, for example, in Latin America, throughout the 1960–70. Subsidized credit is known to distort the indispensable internal equilibrium required to insure prudent credit risk management, producing what is known as the “borrower bias” leading to high loan failure rates. The tests of the performance structure hypothesis suggest that as competition falls the vulnerability of CFIs to failure is enhanced by EP, made possible by the lack of competition that managers face.

Tests of the ownership structure hypothesis more often than not provide support to the notion that the dilution of ownership in the CFI aggravates EP and failure risk.¹¹ Not

10. This evidence was reported in Westley and Shaffer (1999, 2000).

11. The list of references is long and thus will not be presented here. For a thorough review of this literature see Desrocher, Fischer, and Solé (2006).

surprisingly given these results, researchers in the North American context often draw conclusions about the mutual intermediary, qualifying it as a source of “hidden monopolies” or “obsolete institutions sustained by a regulatory environment.”¹² Most European researchers, although not ignoring the presence and the effects of EP, have a less disparaging perception of the CFI—not least because their macro-organization leads to performance measures that are comparable to those of stock-owned intermediaries and thus may be less beset of EP problems than their North American counterparts,¹³ but also due to the often massive presence of CFIs in the form of mutual savings banks or financial cooperatives still gaining market share in several countries.

Among the works based on agency theory, two variants exist. The first focuses on the effect of separation of ownership (members) and control (managers) and the fact that the interest of both diverge on some key points. In particular, owners are interested in maximum level of efforts and frugality in the management of the enterprise. These are two goals that contradict manager’s interests. As with EP theories, agency cost theory predicts that diffusion of ownership leads to increasing severity of owner-manager conflict. Because management participation in the CFI ownership is impossible, mutuals cannot exploit the alignment of incentives that occurs when managers become co-owners. Still within the same theoretical tradition, a variant called the “free cash flow hypothesis” proposes that as the availability of free or uncommitted funds increases, managers will invest in unprofitable projects.¹⁴ Tests applied specifically to CFIs using agency theory or the free cash flow hypothesis concur with the findings obtained using the EP framework and provide one more evidence that size is positively related with the severity of the owner-manager conflict. This allows us to formulate the following proposition:

Proposition 3: Expense preferences (EP) by managers—or equivalently the member-manager conflict—is the principal source of CFI failure. Control of expense preferences should be a central theme of prudential supervision of CFIs.

Comparing CFIs, Banks and NGOs

A comparison of these three institutional forms suggests that from the perspective of agency conflicts, NGO and joint stock banks present more similarities between them—and thus should be subject to similar albeit not identical R&S—than CFIs with respect to the other two. Table 1 presents a list of the agency conflicts we consider in this paper as rows, and the institutions as columns. The cells describe the importance of the conflict for each institution and include comments about the regulator’s approach to the conflict. Take the first row focusing on the shareholder-depositor conflict, the one at the root of investor-owned bank failure risk. It is also present in NGOs that raise deposits—although most likely reduced in gravity—and absent otherwise, but absent by definition in CFIs (depositors and shareholders are the same). Similarly, the saver-borrower conflict (last row) is present in CFIs but absent in investor owned banks and NGOs. Hence, if one takes a perspective of agency conflicts as

12. The first condemnation issued by Nicols (1967), the second by O’Hara (1981) and Eggertsson (1999).

13. As reported by Altunbas, Evans, and Molyneux (2001) and Jaeger, Gurtner, and Ory (2001).

14. The main proponents of this so-called agency theory are Jensen and Meckling (1976). For the free cash flows variant, the main reference is Jensen (1986).

Table 1. Summary of Agency Conflicts by Institution

	Joint Stock Bank	NGO	CFI
Shareholder-depositor	<p>Main source of risk in a bank. All forms of risk are “good” for a profit seeking shareholder (credit risk, interest rate risk, off-balance sheet positions and others).</p> <p>The control of this conflict is the main reason to regulate and supervise banks. All forms of risk are subject to R&S.</p>	<p>Usually absent, but increasingly relevant for NGOs that reach sustainability by raising deposits. Non-profit orientation reduces severity of conflict.</p> <p>As sustainability through deposits increases, so will the need to regulate and supervise NGOs.</p>	<p>Absent in most (closed) CFIs. Theoretically present if the CFI accepts deposits from non-members with unknown significance of impact. Even in this situation member-depositors act as proxies of non-member depositors.</p> <p>No R&S necessary.</p>
Shareholder-borrower	<p>The shareholder-borrower conflict exposes banks to moral hazard by borrowers, who, like the shareholders of the bank itself hold a call option on the value of their assets with exercise price equal to the face value of the loan. This is also one of the sources of risk available to shareholders to raise profits. It can be expanded or limited by means of ex-ante risk level selection or monitoring activities. R&S constrains credit risk exposure allowed to a bank.</p>	<p>Absence of profit goal reduces the attractiveness of credit risk.</p> <p>May be regulated by traditional “banking regulation” methods.</p>	<p>The conflict is internalized in the CFI.</p> <p>May be regulated by traditional “banking regulation” methods.</p>
Shareholder-manager	<p>Its severity is positively related with ownership diffusion. Tends to neutralize the shareholder-depositor conflict. Investor-owned banks have access to efficient mechanisms to control the conflict (ownership shares, stock options).</p> <p>Banks regulators ignore this source of conflict.</p>	<p>Generally under good control through concentrated ownership by donors.</p>	<p>Significant conflict due to high ownership diffusion.</p> <p>Theoretical and empirical research suggests this is the main source of failure risk.</p> <p>Ignorance of conflict by “bank regulators” makes bank style regulation unsuitable for CFIs.</p>
Net borrower-net saver	<p>Not applicable.</p>	<p>Not applicable.</p>	<p>Significant conflict that can be made more severe by subsidized external financing, and lack of competition. In contrast to the shareholder-depositor conflict that can be exercised through all forms of risk, this conflict leads to credit risk only.</p>

the main criteria to analyze the institution, NGO and investor-owned banks are “closer to each other” than they are to CFIs. Some authors argue that CFI operations are concentrated in the micro and small enterprise segments of the market and that in most cases they fund their operations from community savings. Thus they compete for deposits with other types of financial intermediaries in the locality—especially licensed banking institutions. Consequently, according to this opinion, CFIs confront similar types of risks as investor-owned financial institutions and thus should be subject to a similar regulatory framework.¹⁵ However, even if the markets’ investor-owned banks and CFIs serve were identical, risk exposure would differ due to the nature of the agency conflicts *within* the institution.

15. An example is Gallardo (2001, p. 28).

The Macro-governance

Core Competences and the Search for Alliances

In most countries the CFI sector presents some level of macro (or inter-CFI) organization. It is common for CFIs to organize themselves as networks of some sort collaborating at least at an elementary level. Very few CFI movements present none.¹⁶ Often they organize into complex strategic alliances capable of producing and offering to its members a variety of financial products that compare favorably with those offered by universal banking conglomerates. These arrangements are as or more sophisticated in their organizational features, play a similar role to, and are as vital to the functioning of CFIs, as the well known airline industry alliances or the Japanese *keiretzu* (such as Toyota and its network of suppliers) are to those industries and enterprises. In these cases—and many more—the alliances are institutional devices designed to control market risk facing the enterprise members of the alliance. The prejudice that cooperatives are simple and unsophisticated institutions and that their network arrangements are just advocacy and money-peddling syndicates should be discarded if one wants to really understand systems of CFIs and exploit their potential to serve the poor.¹⁷ Doing this implies understanding their organizational dynamics, and creating legal and regulatory conditions that favor those mechanisms to enter into action while ensuring financial prudence.

16. The system of cooperative “rural banks” of Philippines—a specialized charter bank under the banking law, of which there are cooperative and investor-owned rural banks—is one example.

17. Even though some have been converted into just that deplorable state by government eagerness to exploit them for their political and social objectives, starting with the British Empire in the beginning of the 20th century. In a few cases, however, they have been able to overcome the externally-induced distortions to become powerhouses of popular finance (e.g., SANASA in Sri Lanka).

Inter-CFI alliances are so vital to the functioning of CFIs that we could confidently submit that a CFI movement *without* effective inter-CFI alliances may, if reasonably successful and depending upon the size of the economy, serve thousands, or tens of thousands or perhaps hundreds of thousands of people. *With* effective alliances, the same CFI movement may serve millions, with a surprisingly rich range of financial services. Many real-world examples illustrate that difference. There are several questions that appear to be relevant when considering these inter-CFI networks: why do they form? Is there a common pattern in the way they are organized? Do all the apparently different configurations serve a common purpose? What purpose do they serve? What are significant differences? There is also the vital question of the role of the legal and regulatory framework that will facilitate/obstruct the functioning of these inter-CFI alliances. The issue is very important for both (i) the performance one can expect in terms of outreach and sustainability, and (ii) the nature of the regulatory regime that should govern them. These are, of course, the central questions addressed in this paper. For this reason we present an abridged yet relatively elaborate exposition of the arguments presented in two recent papers, both based on principles of transactions costs economics.¹⁸

Principles of finance serve to explain why CFIs form and what are the internal conflicts that dominate their operations. However, they do not explain the universal trend to form inter-CFI alliances of varying levels of complexity. For this we must resort to principles borrowed from the organization theory and from the “new institutional economics” (NIE). The central idea we can extract from those approaches is that market risk exposure can be controlled through organizational tools in addition to those finance has to offer (such as asset-liability management, derivative products, portfolio diversification). In fact, the tools proposed in finance are of no use to control certain forms of risk. What financial instrument can, for example, be used to prevent opportunistic behavior of a supplier facing a small firm? Does it mean that supplier opportunism is not a form of risk? Clearly, when we speak of these forms of risk we are entering into the realm of contracts, and the instruments available to insure party compliance. Except in the case of classical spot contracts, the judiciary system rarely serves to ensure compliance. To make this clear we first identify the form of risk that CFI control through organizational tools, and then explain how they do it.

Cooperative financial institutions accomplish the intermediation process by allocating resources in the procurement of inputs such as materials, services and capital goods from outside suppliers, and labor. These inputs are transformed into outputs that consist of financial products and services for their members. We can divide inputs by their use in the intermediation process as production inputs, infrastructure inputs and pass-through inputs. The latter are products that are not transformed by the CFI and for which it acts as retailer or broker. These three types of inputs are used to produce on and off balance sheet products. Two key on-balance-sheet products are savings and credit instruments, outputs like any other whose production requires inputs (other than funds) that the CFI procures in the market.

The uncertainties associated with the input (upstream) and the output (downstream) sides of the intermediation process are radically different. On the output side, uncertainty with respect to type, quality, and quantity of products demanded by members is low.

18. They are Desrochers and Fischer (2005, 2003), Desrochers, Fischer, and Gueyie (2004).

Due to its close relationship to the members it serves, the CFI is uniquely positioned to correctly assess the demand for services of the community it serves—it is owned and governed by its clients. This relationship to its member/owners is the CFI’s “core business” in which no other institution can do better in the particular community in which it operates. In sharp contrast, on the input side, uncertainties associated with the conditions of supply are high. A CFI faces uncertainty about the technology, specifications, quality and costs in the procurement of these inputs and lack economies of scale in the procurement of the same. One of the main reasons for this uncertainty is the small scale of its demand for inputs, the low bargaining power with suppliers and the lack of specialized personnel available to make informed decisions about the procurement of a large set of complex inputs. The inputs acquired by CFIs in the open market include: capital goods such as land and buildings, computing equipment, technology (for example, debit and credit card management), furniture, service automation equipment (ATM, telephone-based transaction equipment, and so forth), financial products and process know-how; materials such as electricity and office supplies; financial products such as insurance (credit insurance, life insurance), financial derivatives for their own use or use of the customers; and a wide range of services including software and equipment maintenance and upgrading; clearing services for cheque, draft, debit card and credit card transactions, remittances, liquidity management, auditing, legal, personnel training and consulting. The situation is illustrated in Figure 3.

The technological complexities involved in many of the inputs, the lack of economies of scale in the procurement and the uncertainty associated with their supply conditions in a market often controlled by large enterprises are three of the most troubling aspects in the management of a CFI. Controlling this uncertainty is the key reason why CFIs—and other

Figure 3. The CFI as a Financial Services Production Unit

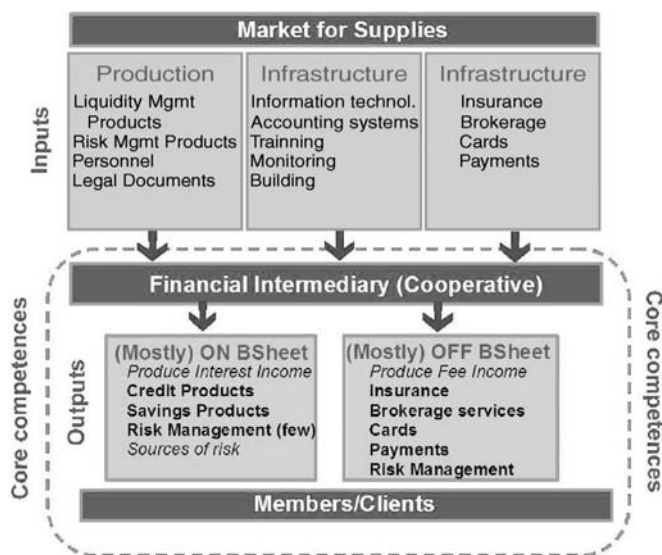
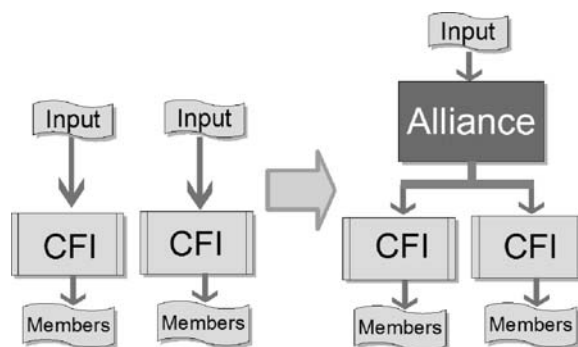


Figure 4. CFI Networks as Input Pooling Alliances

mutuals—engage in lateral contractual relations with peers to form collectives (known as federations, unions, leagues). They create what in organization theory is known as a “supply alliance” (Figure 4).¹⁹

These collectives take very specific organizational forms. They either merge, or form an alliance that establishes a long term contract between parties with an administrative structure that manages the partnership. In the choice between mergers and creating these networks, expense preferences (EP) play a central role. As EP increase with the size of the institution, mergers become less attractive giving way to hybrid arrangements that achieve the same input procurement pooling but avoid the creation of large bureaucratic institutions. In fact, to our knowledge, there are only four cases in which large scale (system wide) mergers have been the choice of organizational form to address the uncertainty in the procurement of inputs.²⁰ Thus, the cost-economizing organizational form of collective chosen by the vast majority of movements, at least for the system-wide collectives, has been the alliance rather than mergers. This suggests that the hybrid network structure (alliance) is superior to mergers as mechanism to control transaction costs including those of bureaucracy (governance). This does not preclude mergers at a more limited scale. Not every aspect of input procurement uncertainty can be addressed by alliances, to which we must add manager’s preferences to lead ever larger organizations.

19. It is useful to make a distinction between the cost effect and uncertainty effect of the small scale of the demand. Any independent supplier can achieve economies of scale in the production and delivery of the input to CFI. If the supplier would transfer at least a share of the gains of the economies of scale and not act opportunistically, no supply alliance would be needed.

20. The first case is Sweden where 350 credit cooperatives merged into a single banking corporation, Föreningsbanken, in 1992. This bank joined forces in 1997 with another 90 savings banks that had also merged in 1992 to form *Sparbanken Sverige*. The merged coop-savings banks conglomerate is known as *FöreningsSparbanken*, since de-mutualized. The other three cases are *Banco de Crédito Cooperativo* (BCC, Argentina), *Caja Popular Mexicana* (CPM, Mexico), COFAC (Uruguay). According to available information in the case of CPM the merger was the choice of the movement. In the case of BCC and COFAC they were, for any practical purpose, coaxed into it by supervisors through minimum capital standards. COFAC has since been intervened by banking authorities and its future as a CFI is in peril.

In the less common case where a large-scale merger is the choice—for cost economizing or EP reasons—a unified organizational structure evolves under a single management. In the more common cases of formation of an alliance, CFIs must now manage the contractual relations that develop within it. The alliance may consist of a few members (for example, United States Credit Union Service Organizations) or *thousands* of them (the German Raiffeisen system). There are few, if any, other industries in which supply alliances become so huge, covering such a wide range of inputs and so complex in their organizational structure as those setup by several CFIs—and mutual savings banks—systems around the world. The actual set of inputs included under the alliance is usually not enumerated explicitly. Instead, networks create planning mechanisms that will include/eliminate elements as needs in the collective evolve.

When CFIs join in an alliance the first-tier nodes entering into the arrangement give up control of the distribution of pay-off of the joint activity. In doing so they incur in what is known as appropriability hazards (AH) or hazard in the presence of weak property rights.²¹ The reference to weak property rights is related to the fact that when alliances are formed, protection of property rights through the courts is near impossible given the difficulties of third-party verification. That is, when CFIs enter into a collective the protection of the property rights to the subscribing parties falls out of the competence of the courts. This protection can only be achieved through control mechanisms built into the alliance governance called “private ordering mechanisms.” The loss of control over the distribution of pay-off increases with the intensity of the delegation of decision powers towards the alliance institutional structures. It reaches its highest point when a full merger of all activities is the choice of governance structure. In this case, the property rights of individual members are fully diluted into those of the new institution.

Usually, complexity of the institutional structure of the alliance increases with the technological sophistication of the products object of the alliance, the scope of products, the geographical range of the alliance and the number of members participating in the same. Over ranges of contractual hazard that are very small—that is, CFIs that are relatively small and unsophisticated in the services they provide to their members and do not wish to expand those services—one can expect to see institutions that remain independent or tied up in only very loose arrangement. This is the typical situation of many developing countries in which the CFI is an incipient sector offering only basic financial services. Over intermediate ranges of AH, usually associated with the procurement of more sophisticated inputs, CFIs will tend to create collectives that are organized as more complex alliances, with support on long-term contracts of the neoclassical type. These alliances may consist of networks of entire systems; partial networks of fractions of the system but with a uniform and relatively large span of pooled inputs; or smaller limited-purpose alliances/networks that may cover a limited set of inputs. Which schema evolves depends on a number of circumstances which in the model is subsumed by “shift parameters.” Only for very

21. It refers to situations where a party to a contract has only relatively low power enforcement mechanism available to enforce its rights. A majority shareholder has high-powered mechanisms . . . she may fire her manager at will. A member of a CFI will have low-powered mechanisms since she has to mobilize a general assembly to place a complaint about a manager’s behavior, and her chances of success are low. This illustrates the fact that a CFI itself is an alliance of individuals subject to appropriability hazard.

advanced levels of AH would CFIs tend to merge instead of creating alliances. Two types of networks are of particular interest:

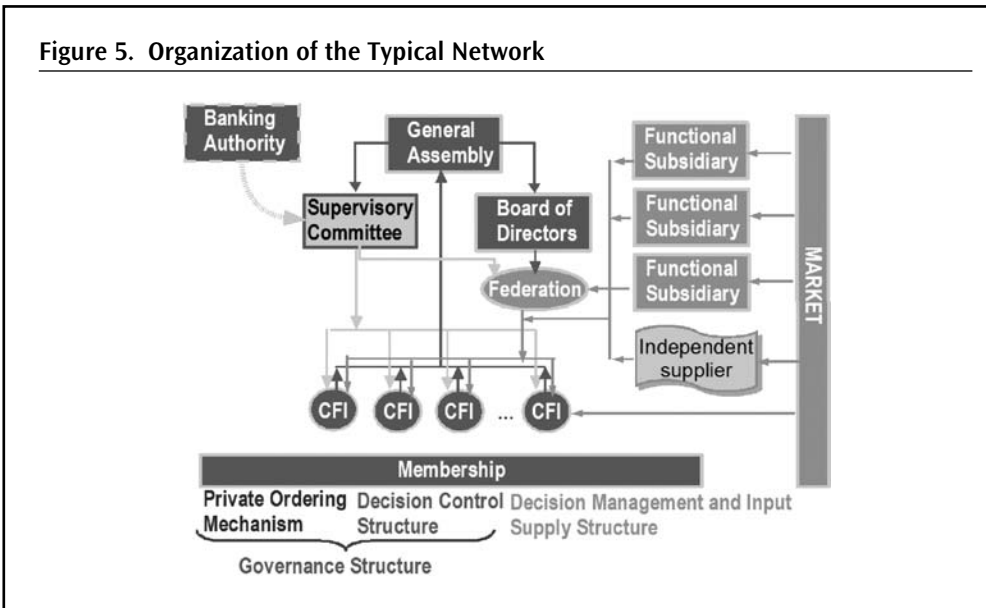
- *Consensual networks*, which consist predominantly of collections of multilateral agreements between first-tier nodes of relatively loose nature. They operate on the basis of continued consensus of all or a subset of participants of the collective. An “apex organization” usually exists but has mostly representation and some limited pooled resource management function. Strategic decision control and management for the network is explicitly excluded.
- *Strategic networks* are collections of multilateral agreements between first-tier in which decisions taken by the integration bodies of the alliance according to agreed upon governance mechanisms become binding—by law or convention—for the entire collective. The decision process is made operational through the cession by first-tier nodes to the apex of control over a relevant range of issues that affect the collective, that is, strategic aspects related to the network. The apex becomes a “hub node,” with meta-coordination functions.

Strategic networks are created to control higher levels of AH. As the number of products subject to joint production/contracting increases and the technology involved in their production becomes more sophisticated, and CFIs become increasingly tied up in mutual dependence. The resources that have been invested in developing the capacity to produce those services, and the risks of loss of investments, also multiply. That is, AH is positively related to the sophistication of the mix of financial services offered in the network. With AH increases the need to incorporate to the organizational structure cooperative adaptation mechanisms that consist of a range of hierarchical features. This implies giving up decision management and control to a hub, resulting in a separation of operational and (at least some) strategic decision making between first-tier and the apex.

The organizational structure of a typical network, specially the more advanced ones, regardless of cultural or economic context, replicates at a second level the governance features of a CFI, with its executive, governance (General Assembly and Board of Director) and regulatory (Supervisory Committee) functions. Thus the network presents three superposed institutional apparatuses used to govern the neoclassical inter-CFI contract: (i) an executive or decision management structure; (ii) a decision control (or representation governance) structure; and (iii) a private ordering structure. The executive structure is responsible for implementing decisions and manages the procurement and delivery of inputs to the members of the network. This structure will typically also fulfill a strategic planning function. The decision control or governance structure, composed of the General Assembly and the Board of Directors of the federation, with proportional representation and keeping the mutuality principle of one-delegate-one vote, is the organ where strategic negotiation and decision making and control are accomplished. The private ordering mechanisms, invariably present in highly integrated systems, assume regulatory functions for the entire system and are usually under the control of the General Assembly. Figure 5 presents the skeleton of a typical network with its three functions.

Often the state will find it useful to employ the private ordering mechanism created by these networks to accomplish its own obligation of protection of savers interest and control

Figure 5. Organization of the Typical Network



of monetary and systemic risk. In those cases the state will “delegate” some functions (for example, data collection and processing, implementation of correction plans and control of sanction) to the network’s ordering mechanism. This leads to the creation of a regulatory framework—analyzed in more depth later—known as “auxiliary” or “delegated” supervision. In some cases this function will have been completely taken over by the state (such as in Switzerland and the United States) and the network may find it superfluous to maintain its own ordering mechanism provided that the state ensures appropriate control for the level of contractual hazard present in the network.

This theoretical framework has empirical implications in terms of individual CFI performance that are of interest to regulators and supervisors whose role is to limit the likelihood of low performance events that may put savings by consumers at risk. By separating strategic from operational planning and decision making, strategic networks achieve two benefits: specialization in managerial decisions (economizing on bounded rationality) and limited managerial opportunism (sub goal pursuit).

- *Specialization in management:* As the complexity of the market and the diversity of financial products and services required by member-clients increases, bounded rationality by managers limits their capacity to make informed decisions at both strategic and operational levels. The relatively small size of (most) CFIs prevents establishing local capacity to perform the evaluation and planning function required to accomplish this competently. Thus, local managers of nodes find it useful to pool resources with other nodes and create the capacity in the apex to perform this complex function. Managers at the hub thus can focus on the network’s strategic issues while not being occupied by the operational aspect of CFI management which become the exclusive competence of local managers.

- *Attenuation of managerial opportunism:* Attenuation of sub-goal pursuit is perhaps even more important as sub-goal pursuit translates into the suboptimal allocation of resources. The separation of function of first-tier nodes managers (focus on operational decisions) and apex managers (focus on strategic goal planning and control) makes assessing and controlling sub-goal pursuit at both levels easier. Management at first-tier nodes is now supervised both by members-shareholders and the network's private ordering mechanism. Simultaneously, the decision control bodies (such as the network's General Assembly and Board of Directors) controls opportunism by management at the hub. A narrowly defined strategic responsibility for the hub facilitates performance control—compared to that of a large CFI where managers assume both strategic and operational management responsibilities.

Economizing in bounded rationality and limiting sub-goal pursuit has a double effect: (i) it reduces the variance of individual first-tier node performance; and (ii) it also reduces the cost of running the combined bureaucracy at the level of the individual CFI and the hub. The latter is one of the most surprising and controversial hypotheses that can be derived from this analysis and one worth of further analysis and testing. Yet, it is a direct consequence of the organizational features of strategic networks.

One more aspect in the analysis of networks is that exemplified by the United States Credit Union Service Organizations (CUSOs). The United States credit union system is a huge and diversified sector but with a low level of integration. Whatever the reason behind this phenomenon, there is casual but strong evidence that the current levels of integration and pooling of resources by existing regional and national apex structures are insufficient to exploit economies of scales and control uncertainties in the procurement of inputs. CUSOs are a substitute.²² The interest of CUSOs is their universality as mechanisms of addressing obstacles to the development of CFI movements in any corner of the world. CUSOs are indeed a smart configuration of an inter CFI-alliance that has the convenient support of a well established practice, demonstrating the type of collaborations in which they work best, and a well thought-out legal and regulatory framework to back it up. CUSOs are networks, as described above, in every sense, with one particularity: in contrast to many of the larger all-encompassing networks with root in the European tradition they are relatively small limited-membership limited-purpose networks. Their big advantage over the large all-encompassing networks is that they are much easier to set-up, precisely due to their limited scope and membership as a temporary or permanent solution to the input procurement problem. They are not the solution to every situation where the pooling of resources is necessary—indeed they have many limitations—but they are an arrangement worth considering under many circumstances. The arguments presented in this section lead us to formulate the following propositions:

Proposition 4: Inter-CFI alliances (federations, leagues, unions) are hybrid organizations that allow CFIs to exploit economies of scale and manage efficiently uncertainties in the procurement of intermediation inputs. Thus, the legal framework should facilitate the formation of such alliances and provide legal support to the inter-cooperative contracts that result.

22. CUSOs are also at times used to accomplish a relatively mild regulatory arbitrage: engage through CUSOs in transactions credit unions are not allowed to perform. These instances are of less interest to us.

Proposition 5: Inter-cooperative organizations that include private ordering mechanisms and separate strategy from operational decision making between the apex and the base units, contribute to the control of expense preference thus enhancing the resiliency of the system to failure and crisis.

Empirical Tests

A small but growing literature has started to compare measures of performance of CFIs under alternative governance and regulatory regime. One study covered 23 systems of CFIs in 17 countries (Desrochers and Fischer 2005). Systems were classified into four categories that are consistent with organization theory: atomized systems (no or very low integration); consensual networks (medium level of integration), strategic networks (high level of integration) and mergers into a single CFI or cooperative bank. The fourth category had no representation in the sample, thus it was ignored. The systems included in the study cover a large variety of economic conditions from the United States and Germany to Mali and Bolivia. In addition to the classification by level of integration, the sample was also classified by level of appropriability hazard (AH). Overall, results provide a weak support for the hypothesis that over ranges of low (high) AH low (high) integration will be related to higher CFI performance. The hypothesis that variability of CFI performance (and size) falls with integration found strong support. This is a result that is of interest to regulators. The data also provide weak support for the hypothesis that expense preferences (EP) increases with the size of the institution but less so in highly integrated networks. Another surprising but important result is that except for systems presenting low levels of AH, despite the higher costs of running a strategic network hub organization, the overall cost of running the network decreases with integration. This is consistent with the controversial notion that strategic networks economize in bounded rationality by transferring strategic planning and pooled asset management functions to the hub and reducing the competence scope of individual CFI members of the alliance.

Three other studies compare the performance of CFIs with different levels of integration (Desrochers and Fischer 2003; Desrochers, Fischer, and Gueyie 2004; and Fischer 2002). The first compares United States credit unions—low level of integration, which in the previous study was classified as consensual network—with a matched sample of French Canada (Quebec) *caisses populaires*, with a high level of integration, classified as strategic network. The second compares French Canada *caisses populaires* with Ontario credit unions. These two studies suggest that *caisses populaires* present overall higher efficiency than U.S. or Ontario credit unions. The difference in efficiency increases with the size of the institutions. Also, large U.S. credit unions present considerably higher EP than equally sized *caisses populaires*. These results are consistent with the propositions that strategic networks provide substitute, hierarchy based, control mechanisms, and enable specialization in managerial functions at nodes and hub (economizing on bounded rationality).

The third study analyses 16 cases of “mature” FC systems classified into two major groups—equivalent to the consensual and strategic networks reported above—comparing performance measures. The author used market penetration in terms of population (outreach) and financial assets, stability of the system, and level of services provided to members (innovation), among others. The data rejected the hypothesis of equal performance with strategic networks displaying either equal or superior (but not inferior) performance than

consensual networks. Two studies compared French and German CFIs with joint-stock banks, using a stochastic frontier approach, and found that financial cooperatives display *higher* levels of operational efficiency than their stock counterparts.²³ This is an unusual result when compared with studies performed on United States data. The authors attribute this performance to disciplining and control mechanisms provided by the network to which they belong.

Unfortunately there are no other studies that attempt to compare systems operating under different levels of integration. The studies reported come from the same (group of) author(s) and may be deemed non-independent. Whether future empirical research confirms these findings is an open question. However, the results obtained thus far are consistent with a theory of organizations that explains successful business behavior in joint ventures, strategic alliances, franchising and others, not only of CFIs.

The Design and Evolution of Networks of CFIs

Networks are subject to stresses and changes that respond to internal or external forces. Also, variations in economic, cultural, and legal environments have varying effects on the way the same mechanisms work in different contexts. These forces cause some networks to function more or less efficiently than others and cause them to change when the intensity of the stress is greater than the cost of undertaking the change. Among the forces that cause stress within networks and often bring them into motions that will cause significant changes in their configuration we highlight three examples:

- The size of member CFIs. When the differences in size are too big, particularly if the size of the large ones is such that the gains obtained from belonging to the alliance approach the cost of doing so, the network is likely to be subject to strong atomizing forces.²⁴ Differences in size of members can also be a complicating factor in the creation of new alliance/networks.
- The combination of Basle II standards and the increasingly powerful role played by rating agencies is putting considerable pressure on some networks to centralize functions and decisions, modifying the power relations between the member CFI and the apex's bureaucracy. Whether this is good for the movement is an open question. Rating agencies, perhaps myopically, think yes. Yet, giving power to bureaucracies, especially considering the poor record of bureaucracies in CFIs, can hardly be described as a road to safety.
- The increasing integration and openness of financial markets puts pressure on networks to adapt, seeking collaborations across the border and forcing them to abandon, at least partially, their traditional domestic focus and to think in international terms.

23. Jaeger, Gurtner, and Ory (2001) for French CFI systems, and Altunbas, Evans, and Molyneux (2001) for German CFI systems.

24. These forces are reported by Schediwy (2001). Schediwy assesses these forces to be strong enough to bring down CFI network structures as we know them and causing their conversion into a still unknown configuration.

Further, we are far from having a complete understanding of what is a good design of a CFI network. Many uncertainties remain, particularly in relation to the organization of networks in developing countries, despite the fact that several have been operating successfully. A badly designed network, if it fails, can do more harm than no network at all. UCONAL in Colombia and the failures in several enterprises at the apex of Costa Rica's CFI movement are two examples that provide a warning of how serious the damage can be. An illustrative list, by no means exhaustive, of aspects in the design of networks we do not fully understand is the following:

- Considering that most successful networks are structures resulting from a bottom-up development, how much can the state do to encourage their formation without distorting incentives? In particular, how much can a law and a supervisory authority do to assist in this development?
- What is the level of integration desired under different levels of development of the economy and financial markets? It is easy to say that with increasing appropriability hazard, integration should increase, but how much integration is too little or too much?
- In particular, at what point should an apex organization become a strategic hub? This step has definitive advantages in managerial efficiency for the entire network and control of managerial opportunism (sub goal pursuit) at the level of the individual CFI, but it also exposes the movement to a bureaucracy with its own agenda and considerable power, increasing the risk of system failure.
- More generally, what is the right balance between subsidiarity and centralization? This is a debate that is not only pertinent for developing countries but one that is continuously renewed in practically every network in industrialized countries.
- There is a trade-off between reduced volatility of failure risk associated with higher integration and the burden of financing an apex that increases with integration. Should integration be encouraged to reduce performance volatility, and if so, who pays the bill?
- To what extent will particular institutional designs that are known to work well in industrialized-country systems (CUSOs, auditing federations, multi-CFI business service centers) also work well in developing-country movements?
- Is there an optimal "sequencing"?

Many of these questions probably have a simpler answer than we may anticipate. Often it is not even a responsibility for policymakers to find that answer, but for leaders of the movement of the CFI itself, which is their inalienable right and responsibility as agents of the owners of the CFI. In fact, too much state or donor intervention can alienate the movement and discourage participation. The result will be atomization and reduced performance and not integration which defeat the very purpose of the intervention. Nonetheless, policymakers need to better understand what the dynamics of formation of these networks are and to assess how much they can influence it. This conceptualization must still be developed, but a few building blocks of understanding exist.²⁵

25. We understand, for example, the fundamental forces behind the process (controlling market risk); the functions and to some extent the variations in institutional design of key structural components of networks; how some key "main cases" work; and most of all, we know that there is a rich variation out there from which we can learn.

The Legal Environment

The Roots of Cooperative Laws

The current legal environment of CFIs in developing countries is strongly influenced by the particular path of introduction and posterior evolution over time of cooperative laws in the region. One particularly influential law is the Cooperative Society Act of 1904 enacted in India by the British Colonial Government. While the Indian Law has been object of critics and admiration (and emulation by many) there are two observations that are particularly pertinent to assess the influence it had on the way cooperatives were understood in India and elsewhere:

1. The Law reflects an interpretation of a British Colonial Officer of a German institution that presented organizational characteristics that were strange even to British business (hybrid business alliances build on neoclassical contract designs). When the law was written the German CFI system had already achieved a high level of integration, a level of integration the British credit unions system has never been able to achieve.
2. The Law changed the nature of the CFI movement. The German model on which it was based was a self-help grass roots movement that grew out of specific local circumstances, building a sophisticated business structure that survives today. The German cooperative laws were written to provide legitimacy not only to the individual CFIs but to the entire self-governance structure that was built to provide the necessary conditions for growth and expansion. The Indian law, by contrast, was designed to create CFIs that would be instruments of development policies for the then British government. A regulatory law was converted into a promotional law.

This vision of the CFI survived the British Empire and decisively influenced the evolution of cooperative laws in Asia, English-speaking Africa and eventually Latin America through the United States. Starting in the 1960, carbon-copy cooperative laws were passed in one Central and South American country after another, to create the legal framework that allowed social workers and volunteers to go out and create small legions of CFIs to channel state and donor funds to farmers all over Latin America, in an emulation of the policies of the British and independent Indian governments. Thus again, an organizational instrument designed to allow adversely selected agents to generate alternative contractual arrangements and govern their contractual relations, was converted into an instrument of governments to spread promotional credit around the country. Unfortunately, the top down philosophy of governments with respect to the CFI movement is not just a fact of history. The 1998 United Nations Report of the General Secretary (pp. 13–14) reports cases, particularly in transition and developing countries, where drafting and passing cooperative legislation is often undertaken without consultation of the sector itself. While these are extreme cases, they still reflect a philosophy of CFIs and cooperatives in general as instruments of the state and not of its members.²⁶ Another critic of the phenomenon notes:

by letting the original state sponsorship of cooperatives degenerate into state involvement, and hence control, this legislation (the Indian law) was disfigured . . . failing to further the stated goal of creating “autonomous, self-reliant co-operatives of the Raiffeisen or Rochdale Pioneer type.”²⁷

This “degeneration” was copied along with the Law and happened many times elsewhere.

While we can now, in hindsight, be critical and forgiving about the legal frameworks that were introduced in the past, there are errors that should not be repeated today. Ignoring either what has been learned from those historical experiences or the insight provided by New Institutional Economics, particularly when they are supported by ample empirical evidence, is unacceptable today. Any proposal of legal framework for CFIs must thus take into consideration the following fundamental facts about their nature as:

- An endogenous institutional arrangement that solves the problems of market failure through risk sharing and self governance of contractual relations, and *not* an instrument of government political goals, however benign they may be. The switch from a self-help organization to an instrument of government political goals modifies fundamentally the character of the contract between the stakeholders driving its functioning.²⁸ The consequences are that stakeholders will behave in unexpected, and often undesirable, manners.
- An institutional mechanism with a fragile governance structure in which certain agency conflicts—the net borrower *versus* net saver and the member-manager conflict—can overwhelm the equilibrium, leading to failure.

26. A particularly elucidating analysis of the 1904 Indian Cooperative Law and other cooperative law developments in the developing world is provided by Münkner (1989, 2005). Münkner (2005) carries the suggestive title of “100 Years Cooperative Credit Societies Act India 1904: a worldwide applied model of co-operative legislation” leaving little room to doubt about the influence of this piece of legislation.

27. Quote from Henry (2005).

28. This includes influencing the composition of governance bodies, channel government subsidized funding or isolating the institution from market competition.

- An institution that naturally seeks to create alliances with peers that facilitate mitigating market related risks, improve managerial efficiency and help control key agency conflicts.

This has more often than not been ignored in the legislation that exists today in developing countries even if it was initiated by cooperative-minded and well-intentioned individuals. In hindsight, the consequences were unsurprising: numerous CFI systems that are chronically dependent on state subsidized financing, prone to corruption by individual seeking to appropriate available rents, subject to manipulation by politicians, borrower-bias in its governance structure and high exposure to credit risk. If one does not understand the root of these distortions, it is difficult *not* to arrive to the conclusion that CFIs are a questionable instrument to provide financial services to the poor. This was indeed the state of affairs towards the end of the 1970s. It is worth noting the following observation made in the “Report of the Task Force on Revival of Cooperative Credit Institutions” of India (Vaidyanathan 2004):

The State has used co-operatives to channel its development schemes, particularly subsidy-based programmes for the poor. As these institutions have a wide reach in the rural areas and also deal with finances, the choice was natural. The trend, however, also made cooperatives a conduit for distributing political patronage. This and the sheer magnitude of resources and benefits channelled through the societies, makes control of decisionmaking and management attractive to parties in power, for accommodating their members, to influence decisions through directives, and for individual politicians to be on the management boards of the cooperatives.

The NGO Movement Makes Its Appearance

Following the massive failures of CFIs created under the top-down approach, the 1980 and 1990 saw a loss of interest in CFIs among donor and international development organizations. There was thus, in the mind of many, an effacement of the CFI as an institutional tool to provide access to financial services to the poor. In parallel, another development that had a significant and negative impact on the legal framework under which some CFI movements operate today is the appearance of the NGO movement in the 1970s. Starting around that time, in the eyes of many donors and the public, the word *microfinance*, finance for the poor, and NGO were associated as being the same. The spotlight had moved from CFIs, despite a history by then of 130 years of serving the poor in most corners of the world, to NGOs—not least because the latter is an industry that has performed remarkable public relations work and frequently expresses publicly concerns for, and appears as spokesperson of, the poor and developing countries. This is not surprising, as some NGOs are international organizations with presence in several continents led by well educated individuals able to articulate a cogent message. In the modern media-driven world, this reflects positively on the entire industry. With this shift in attention came new preoccupations. What should be the legal, regulatory, and supervisory framework for *microfinance*, that is, NGO-microfinance? The preoccupation was legitimate, after all NGOs were appearing by the hundreds. The problem is that CFIs were often included under the NGO category and thus the notion of a legal, regulatory and supervisory framework for NGO and CFI was intermingled,

or, to be more exact, confused. It is common for authors working in the NGO camp focusing on the legal and regulatory aspects of microfinance to acknowledge the existence of the CFI as an institutional form, completely different in nature from an NGO, that provides access to diversified financial services to much larger numbers of the poor than the NGO sector does. Yet the proposed formulas intended to apply to every microfinance institution, including CFIs, overlook their strikingly different institutional features.²⁹

There is perhaps scope for creating legal and regulatory frameworks that cover both types of institutions, CFIs and NGOs under one Law. However, the proposals tabled by the NGO establishment often do not address the specific legal and regulatory needs of a mutual financial intermediary. This vision is just as myopic as saying the investor-owned commercial bank regulatory framework should apply verbatim to CFIs . . . or NGOs. Ignoring the special characteristics of CFIs, in terms of the particular agency conflicts that affect them most and their natural inclination to create alliances, will likely diminish their capacity to provide financial services to vast sectors of the population. Thus, there is a generalized feeling within the international CFI movement that the current proposals put forward by the NGO industry are, for the most part, unacceptable. However, positive experiences exist where legal frameworks were created to meet needs of both institutions under one law. Mexico's "Ley de Ahorro y Crédito Popular" of 2001 is one example where up-to-date understanding of both CFIs and NGOs were taken into consideration in its design—although it might actually be biased in favor of CFIs. Whether the particular approach adopted in this law for CFI supervision, the indirect type, is the appropriate or not is an entirely different question. The importance of the law is that it explicitly recognizes the different nature of both and makes an attempt to accommodate these differences.

The Forces of Change

In the late 1990s and beginning of the 2000 decade things started to change. Important milestones in regulatory and supervisory frameworks were introduced in several countries. As a result of these reforms we arrive to the present with a variety of legal frameworks. A brief overview of the current situation suggests the existence of three distinct legal frameworks for CFIs:

- i. A CFI specialized law,
- ii. A cooperative societies law, and
- iii. A financial institution (banking) law, or a combination thereof. The most common combination is a cooperative society's law and a banking law. Within this combination there are two variants:
 - a. Articles of the two laws apply to all CFIs;
 - b. Articles of one or the other law apply to different groups of CFIs based on some classification criteria (dual regime).

Variant a, that is, that *all* CFIs are under both laws is common in Europe and is the result of the banking authorities taking an interest in the sector and choosing to undertake the supervision of the entire system. The last approach, the dual regime, in which CFIs are

29. Well-known examples are Arun (2005), and Christen, Lyman, and Rosenberg (2003).

under the cooperative law but *some*, based on some criteria are also under the banking law—and thus under banking authority supervision—is a new trend that is emerging in developing countries, particularly Latin America.³⁰ When legislators choose to write a special law for CFIs, often this law overrides provisions of the cooperative law. It is however possible, albeit less common, that CFIs are subject to articles of the specialized CFI law and the banking law.

Overall, our assessment of the situation is the following:

1. Either the strength of the growth of the CFI sector or the existence of an important crisis in it has put pressure on governments in many countries to update the legal framework and to move away from keeping CFIs exclusively under the cooperative law.
2. The direction the reforms have taken, however, vary considerably. The list presented above with combinations illustrates the point. In some cases supervision is direct, in others it is delegated/auxiliary and still in others, the sector is left to take care of supervision by itself through what is known as an auto-control regime. This lack of unified approach contrast with that of investor-owned banking for which the Basel Committee of Bank Supervision (BCBS) has precise and unique guidelines of what constitutes a good legal and supervisory framework for the institution, and forcefully advocates its vision upon developing and industrialized countries' governments.
3. In almost every case where the system of CFIs had reached an advanced level of integration, the alternative chosen by the authorities has been to include the entire system under a unified regime. In countries with low integration the trend has been to adopt the dual regime, leaving smaller, closed and rural CFIs under the traditional cooperative law and cooperative authority supervision.

All choices are not equally good and results will not be the same in terms of supporting the development of the CFI sector.³¹ Some innovations are outright catastrophic when they ignore key features of the institutions they intend to regulate. Yet this, unfortunately, happens to be an area in which opinions are set and exchanges among actors tend to be somewhat acrimonious. Developing a better understanding of the pros and cons of each of the regimes is perhaps one of the most important goals of any open debate.

In particular, the wisdom of the dual regime is the subject of intense debate. To this we must add the debate about the quality of the regimes applied to either of the two portions. Those in favor of the dual regime argue that:

- The dual legal and supervision regime solves rapidly and efficiently the problem of quality R&S for at least a significant portion of the CFI sector at a relatively low cost. This argument is based on the fact that usually a few large CFI cover a significant portion of the total membership.

30. The latter arrangement has become relatively common in Latin America following the lead of Bolivia. Under this regime the CFI sector is split into two groups—larger and/or “open” (that accept deposits from non-members) supervised by the banking authorities, and smaller and/or “closed” CFI supervised by cooperative authorities. An open CFI accepts deposits from non-members and a close doesn't. The distinction is largely artificial because management can easily switch forth or back through a resolution in a general assembly and shifting moneys between accounts. Thus the distinction is an invitation to regulatory arbitrage.

31. In fact, some legal frameworks were designed to suppress the scope of the sector or of its integration structures. One example is Argentina's in the 1970s.

- The dual regime is seen as a transition towards a unified regime that covers the entire sector. It solves the problem of adequate supervision for key institutions while preparing the terrain (and training supervisors) for eventual unified supervision under the banking authority.
- Larger CFIs are more like commercial banks and thus should be subject to banking laws and banking authority supervision. The arguments are similar to those presented earlier (Chapter 2) that investor-owned banks and larger CFIs have a similar customer base and offer similar financial products.

Those that oppose the dual regime argue that:

- There are fundamental differences in governance between a large CFI and an investor-owned bank resulting from the difference in ownership. The agency conflicts behind failure risks and the performance measures used to assess it, and thus the mechanisms used to bring them under control are also different.
- It is nearly impossible to integrate two groups of different CFIs that are under different regulatory regimes. Differences that develop in the two groups prevent the setup of a workable alliance. Creating multiple alliances may be equally unattractive, as the group of smaller CFIs will be unable to finance the overhead required to run integration structures and the investments required to expand services to members. Thus a dual supervision regime is at least a major stumbling block for the already difficult process of creating a successful alliance that may produce the benefits that integrated systems of CFIs have to promise. Unfortunately experience is showing that “temporary dual regimes” have a very long life.
- A system with two different supervision regimes may potentially solve the problem of low quality supervision under cooperative authorities by placing the large (usually urban) CFI under supervision by the banking authority. However it leaves the most vulnerable portion of the population, the smaller and rural communities, in the predicament that their CFIs are poorly supervised or not supervised at all. That is, a dual system which favors urban and less marginalized populations and leaves rural and more marginalized people unprotected.
- Finally, a dual system encourages regulatory arbitrage creating incentives for some to avoid the regulation or the costs of regulation. It also may create confusion among consumers if the distinction between regulated and non-regulated CFIs is not made clear to the public.

CFI Laws and Banking Laws

Including CFIs under banking authority regulation, although desirable, brings along a whole set of new problems. Banking authorities in developing countries that face the responsibility of supervising CFIs will often tend to impose on them standards and practices of supervision identical to those applied to investor-owned banks. It is not just that the standards may be fully inapplicable—because it is a specialized regulatory response to the particular features of an investor-owned organization—to the CFI, but they may be ineffective when applied to the CFI. Take a capital standard. While it may be relevant in a

context of a CFI that makes intensive use of deposits, it is totally irrelevant in a CFI system where most sources of funding are share contributions.³² Clearly, the goal of seeking banking authority regulation of CFIs is *not* to end up under a regime that applies investor-owned bank regulatory standards to CFIs, but a regime that applies standards adapted to CFIs with the same rigor and technical expertise—largely unachievable under cooperative authority regulation—as the one applied to banks.

Practitioners of CFI development have argued at length that the particularities of the mutual institution require an adapted legal framework and that general cooperative laws ignored many of the specialized aspects that result from the financial function of the CFI. This intuitive position is finding support in new theoretical developments that propose that the mutual contract is a “natural solution” to the contracting problems under condition of information asymmetry, flexible (endogenous) institutional design, no ex-ante full specifiability of contracts and transaction costs. Significantly, this literature insists on the relevance of *specialized* legal and regulatory framework for each type of contract to validate and make the contracts enforceable.

There is a certain tendency for legal frameworks to move towards the writing of specialized laws for CFIs. This has been the case in industrialized countries and is happening with increasing frequency in developing countries; in some cases—such as the PARMEC law that applies to members of the West African Economic and Monetary Union—it has been in place for sometime now. More recently (2004), the Central Africa Economic and Monetary Union passed a “microfinance law”—for a sector dominated by CFIs, as in West Africa—which avoids most of the pitfalls of the PARMEC law. Thus, a considerable experience is accumulating. On the other hand, there are some quite ancient cases where CFIs operate under a combination of cooperative and banking laws (such as Brazil) with considerable success. Both regimes appear to be, in principle, acceptable to a wide range of stakeholders, except for the differences on dual or unified regime. The only alternative that is definitively not acceptable is that CFIs remain under a cooperative law regime.

Guidelines for and Models of CFI Laws

The 1998 United Nations Report of the General Secretary, while focusing on cooperatives in general, supports such guidelines.³³ Moreover, “several respondents (of Africa, Asia, and Latin America) further specified that they considered guidelines aimed at creating a supportive environment for the development of cooperatives elaborated by the United Nations would be of great value in re-forming and updating their national legislation.” Against this opinion, there are three arguments in favor of a common guideline for specific CFI legislation. First it is unlikely that, if asked, respondents would differentiate between CFIs and non-financial cooperatives, the distinction between financial and non-financial cooperatives would need to be made clear in any kind of global guidelines. Second, the legal frameworks for the commercial banking sectors—overwhelmingly dominated by investor-owned type

32. Provided, of course, that the shares satisfy the definition of “permanent capital” as modern accounting standards require. We address this issue in more detail in Chapter 5.

33. United Nations (1998), pp 14–15.

of organizations—resemble each other, particularly in developing countries, as the influence of the international standards of bank R&S formulated and advanced by the Basel Committee of Bank Supervision (BCBS) take hold. Thus, these standards are *de-facto* guidelines for bank legislation in developing countries. Their application to developing countries is spelled out in detail in the *Core Principles of Effective Bank Supervisions*. The notion of a common standard is perfectly applicable to the CFI. Third, as the present paper demonstrates, designing an adequate legal and regulatory framework for CFIs is not a simple task. Designing such a framework entails consideration of principles of institutional economics, regulation theory, empirical research and an evaluation of historical experiences. The expertise required is not widely available in developing countries. Thus, it makes sense to employ those resources wisely by providing well documented principles for a CFIs' legal and regulatory framework, which countries may then adapt to the particular context they face.

The caveat is that the BCBS has been working on standards of bank supervision for over 20 years now. As a result, the level of convergence about what constitutes a good regulatory and supervisory (R&S) framework for commercial banks is high and counts with a substantial support of theoretical and empirical research. Thus the consensus is sufficiently high to issue and provide guidelines to countries about how to create legal frameworks that will facilitate efficient regulation of the banking system. This consensus is lacking in the CFI sector, and reaching more or less rapidly a reasonable level of technical and political agreement is desirable if the sector is going to converge towards generally accepted international guidelines and principles.

In practice, organizations such as the World Council of Credit Unions have gone beyond guidelines and produced a "Model Law for Credit Unions" (WOCCU 2005). This model incorporates many elements we argue for in this document and is the result of a careful reflection about WOCCU's experience in developing countries. Thus it is clearly a step in the right direction. However, there are problems with the model at hand.

In some aspects it reflects the United States, or perhaps more generally the Anglo-Saxon, credit union experience rather than that of financial cooperatives under a more diversified cultural context.³⁴ This makes the model unsuitable for other systems that respond to a different cultural tradition or present organizational features that are in conflict with this law. While the WOCCU document is careful to insist that the model is just a guideline, it is nonetheless very detailed in presenting a particular type of organization and regulatory

34. In fact, development law theorists warn against exporting "Western laws" as vehicle for development (e.g. Henry 2005). This is why we prefer to use the concept of principles. Analyzing in detail WOCCU's model law would divert from the objectives of the document. However, just as examples: the articles on dividends (Art. 6.20) appear to support the notion of dividends as a percentage of share ownership—common in the United States—over alternative schemes such as those based on intensity of participation in the operations of CFI—uncommon in the United States, but common elsewhere. The model law bars the use of shares as collateral (Art 6.10), while this is a common practice elsewhere and a useful mechanism to implement joint-liability of members. The whole section on supervision and the use of deposit insurance schemes reflects the United States experience which is rather unique, and makes one question how to reconcile with this model law the operation of many successful supervision schemes currently in operation which do not rely upon the existence of a Superintendent of Credit Unions. There are, however, many more concepts that have been included in the model law that represent a definitive advance over existing legal frameworks than there are points of contention.

regime. Almost every other “model” that attempts to propose laws across countries, continents and cultures is likely to be subject to similar critique. It is worth noting that the BCBS has not issued any model of banking law. However, implementing the *Core Principles* implies adapting the legal framework to make them possible, which suggests that a model law is not the only means of influencing legal reform.

Marry the Legal Framework of CFI and NGOs?

The Consultative Group to Assist the Poor (CGAP)³⁵ argues rather strongly for creating a unified regulatory framework that covers the entire microfinance sector. Their argument is based on an evolutionary thinking in terms of regulation spearheaded by Nobel Prize winner Robert Merton (1992, 1995), called the “functional regulation” approach, which proposes regulating activities (functions) rather than institutions. The application of the concept to microfinance is somewhat odd. In the functional regulation approach, “functions” are products such as: deposits and deposit like instruments, insurance and insurance like instruments, means of payments, independent of the institutions that offer the service. According to this approach, regulation should focus less on institutions and more on functions. Microfinance is a market segment not a “function,” hence the extension of the functional regulation approach to microfinance is not clearly warranted.

Nonetheless, the argument that there is an advantage to consolidate a regulatory authority that is capable of focusing on financial services to the poor and rural areas has its merits. A condition for this to be acceptable is that the differences in institutional forms are respected and the special needs of each institutional form are met. Further, a common regulatory framework would have to reconcile the fact that systems of CFIs, although they perform the function of microfinance efficiently, they are not limited to do just that. When systems of CFIs are organized into advanced networks, they develop into full-fledged community banking institutions offering a wide range of financial services, unlike microfinance NGOs. Thus, regulatory needs can diverge rapidly from those of an NGO. As noted, the law passed in Mexico in 2001 is an example of a legislation that covers both types of institutions and respects the particularities of each. It is a good starting point for a debate on a consolidated regulatory framework. Regrettably, the series of “Special Prudential Standards for Microfinance” proposed in the CGAP Guidelines look very much like a list of regulatory issues that are of special concern to NGOs but only few to CFIs, while those of importance to CFIs are absent altogether (Christen, Lyman, and Rosenberg 2003). Perhaps one should not forget the point made in the 2003 United Nations report: “. . . *equal treatment does not mean uniform treatment but non-discriminatory treatment* which recognizes the distinct character of cooperatives” (emphasis added).

Common and Other Laws

We close this chapter with a phenomenon about which we can do relatively little but that has explanatory power to interpret some observable phenomena. There is a remarkable pattern in the way different legal environments appear to influence CFI integration. While in countries

35. For example, Christen, Lyman, and Rosenberg (2003).

with a Civil (French) or Germanic law tradition advanced integration is common, with few exceptions the opposite is true in Common Law countries. Even in countries with Common Law tradition where CFI systems have reached an advanced degree of integration (Ireland, Australia), the phenomenon is recent and the resulting structures are under considerable stress. Take the United States, English Canada, the United Kingdom (the various leagues) and many of the Commonwealth countries. In practically all cases (except the two mentioned) available information suggests that they have not gone beyond a consensual network. In contrast, in all of continental Europe—with the exception of Spain—and the Scandinavian countries, and in many French colonies, the level of integration is often that of a strategic network.

The phenomenon just described is not limited to CFIs. Other mutual financial intermediaries—the savings banks movement—present the same pattern. In the United States and other Common law countries the saving banks movement presents practically no integration at all. In contrast, in Continental Europe and Scandinavian countries the savings banks movements have reached advanced levels of integration presenting all the features of a strategic network. In fact, in the majority of those countries the networks taken together represent the largest financial intermediary in the country (for example, the German Sparkassen network controls 30 percent of the country's financial assets, the largest share of the market of any institution, including the CFI network).³⁶ Further, in several of those same countries the majority of the population enjoys health and social insurance coverage offered by tightly knit networks of mutual health insurance associations, a phenomenon unheard of in Common law countries such as the United States and Canada despite their strong cooperative tradition.

The literature on business alliances in general reveals a similar pattern. In Continental Europe and Scandinavia—and of course Japan and other Far East countries with similar legal tradition—business display a much higher disposition to engage in business alliances and the alliances created involve a much higher engagement by the counterparties than those observable in the United Kingdom and the United States. Detailed interview studies of businesses operating in Germany and the U.K. reveal that in the latter the fundamental disposition of managers towards alliances is one of suspicion and a certain inclination to engage in opportunism towards partners (Bachmann and Lane 1997). In contrast, German managers enter into the relation with an *a priori* attitude of confidence that the counterparties will not engage in opportunism and that if they do they will be able to rectify the situation by legal action. This difference of attitude is deeply rooted in the legal system of both countries. One key difference is the existence in the Common law tradition of the *ultra vires* clause (Latin for “beyond the power”) which in the UK was derogated only after it became member of the EEC.

We can conclude Chapter 4 with the following proposition:

Proposition 6: Mutual financial intermediaries require a “specialized” regulatory environment that supports the special nature of the contracts and the institution. There are sufficient institutional features that warrant a legal, R&S framework different from that of commercial banks and NGOs.

36. In Europe the savings banks movement is represented by 24 networks representing over 1,000 individual savings banks. Assets in 2003 stood at almost €4 355 billion with around 67,000 branches and nearly 757,000 employees.

The Regulatory Framework

A Review of the Main Issues

Governments monitor and regulate the solvency of financial intermediaries to protect depositors and foster financial system stability. Given the option-like nature of limited liability stock³⁷ it follows that owners of stock banks are motivated to invest in high-risk assets and to speculate on risky positions (interest rate, foreign exchange, off-balance sheet). The likelihood of repayment to those small investors is thus not assured. The central agency conflict that drives failure risk in an investor-owned bank is this conflict between depositors who prefer safe assets, and shareholders who prefer risky assets. It is this understanding of the banking industry that motivates the dominant regulatory structure worldwide: government intervention through licensing, require minimum capital and solvency ratios, control amount of risky assets and other risk position on and off balance sheet, and through (deposit) insurance schemes aimed at increasing the likelihood that depositor's funds will be available as promised.

When the focus shifts from the joint stock banking firm to the mutual financial intermediary, a realignment of agency conflicts occurs. In contrast to investor-owned banks shareholders, members of a CFI have no incentive to expose the mutual to risk or to speculate on risky positions (interest rate, foreign exchange, off-balance sheet) for the sake of

37. This was formally shown by Merton (1977). It demonstrates that the stock is in reality an option on the assets of the bank with exercise price equal to the face value of liabilities. Of the five variables that influence the value of this option, volatility (risk) of the underlying assets is quantitatively the most important. The value of an option is positively related to volatility, hence the incentive for shareholders to take on more risk than is desirable from the point of view of depositors.

increasing the volatility of assets. The question then arises, is an R&S framework, as the one for joint stock banks that focuses on the risky shareholder-depositor agency conflict, still applicable when the subject of monitoring is a mutual institution? Are the criteria, instruments and tools employed for joint stock banks still applicable for a mutual institution? The question is not only whether there is the need for an adapted legal framework but also one of R&S.

The historical review of the German case, and many other similar for other countries suggest that the regulatory framework for CFIs in countries with advanced systems have evolved together with the systems themselves, adapting to the evolution of the system and always encouraging its development while ensuring its stability. In all countries where the CFI sector is a significant player, the regulator has not attempted to put the institution into a straitjacket designed for another institutional form as has increasingly been the case in developing countries. Given that those systems of CFIs have very rapidly organized themselves into alliances with complex structures of governance, business management and private ordering mechanisms, the regulatory framework that evolved took this into consideration, supporting the integration into alliances and did not just focus on the individual CFI as if it would have been an investor-owned bank.

In consequence, and to recapitulate from Chapter 2, a specialized R&S framework must take three fundamental factors into consideration:

- The agency conflicts that render the CFI most vulnerable are not those that render an investor-owned bank vulnerable. In the latter it is the shareholder-depositor conflict (and in the presence of a deposit insurance scheme, the shareholder-insurance fund conflict) that encourages shareholders to exploit various risk taking opportunities offered by a bank such as credit, interest rate, and off-balance sheet exposure. In the CFI it is the members-manager conflict that encourages managers to engage in expenses that debilitate the institution.
- The fact that CFIs tend and need to improve their competitiveness to organize themselves into alliances designed to limit risk in the procurement of inputs and exploit economies of scale, thus resulting in the layered structure of a typical integrated CFI system.
- The fact that CFIs operate in a special market segment—where other market-based institutions are not able to perform transactions due to information asymmetry and transaction costs and market failure—but must do so by adapting ownership structure, transaction cost structure, and business practices to the limited possibilities of the communities they serve. It is, for example, highly unlikely that a CFI that serves a poor rural community will be able to support the costs of meeting commercial bank like reporting standards.

There are thus several aspects of a financial intermediary that are typically subject to control by banking authorities that need to be re-evaluated when focusing on the CFI. Key aspects are:

- The need to use simplified reporting standards that are both adapted to the nature of the conflicts and risks that make the CFI vulnerable and ignore aspects that are crucial to control risks in an investor-owned commercial bank but are irrelevant—or

of limited interest—in a mutual intermediary (for example, simplified asset and liabilities structure, simplified measures of interest rate risk; off-balance sheet, derivatives). Complex reporting standards are expensive to run, for both the supervisor and the supervised, and may not be affordable given the precarious margin available in the market segment served by the CFI. Keeping transaction costs low is *one* of the very reasons why CFI can accomplish transactions where other intermediaries cannot.³⁸

- The shift from a fixed and unredeemable capital to one of variable and redeemable capital that results from the fact that members of the CFI can cancel membership at any time only subject to restrictions established in the charter of the institution (for example, authorization by board of directors, restrictions of withdrawal under critical conditions).³⁹ There are also questions of minimum capital, how capital is defined and the conditions required to obtain a CFI license.
- The preference of CFIs to create alliances designed to control risk in the procurement of inputs required to perform the intermediation process. These alliances cannot be viewed as oligopolistic tactics to limit competition and appropriate consumer surplus (market failure) but as organizational tools to enhance their competitive power to serve the market segment in which they operate that depends on the intensive use of “soft information” to make transactions possible (market completion).
- As part of the alliance, systems of CFIs also have the predisposition to create within the structure of the alliance private ordering mechanisms. These mechanisms serve to insure that the members of the alliance respect the terms of the alliance and avoid deviant behavior that endangers the stability of the same. These mechanisms have often been used by bank supervisory authorities as a tool to execute their own duty of monitoring the financial sector.
- The natural disposition of CFIs to create private mechanisms to protect savings of members not in the form of deposit insurance but “institutional insurance.” This institutional insurance is aimed at providing funds to perform salvage operation (mergers, closures, restructuring) of failing institutions insuring that members are not affected rather than to reimburse fixed-debt liabilities only. This is in contrast to an investor-owned bank, where only depositors are compensated and shareholders absorb the loss of asset and receive the residual value if any. Instead, institutional insurance is associated with the particularity of mutual financial intermediaries where users of the service (savers and borrowers) are also the shareholders and the need of the alliance to prevent failures that may provoke a panic or reduce in some way the franchise value of the alliance.

38. The other two are that they are capable of making decisions based on lower-cost to gather “soft information” (see item below) and that it limits exposure of the economically vulnerable members of the institution to opportunistic behavior by profit maximizing oriented investors.

39. The International Accounting Standards Board has recently (November 2004) emitted the IAS 32 indicates that under certain conditions shares in cooperatives are considered liabilities, not equity. The standard states that members’ shares are equity if the CFI has an unconditional right to refuse redemption of the members’ shares. An unconditional prohibition may be absolute, in that all redemptions are prohibited, or it may be partial, in that it prohibits redemption of members’ shares if redemption would cause the number of shares or amount of paid-in capital from members’ shares to fall below a specified level. Members’ shares in excess of the prohibition against redemption are liabilities.

We now proceed to discuss the more controversial of these issues, the one related with the use of the private ordering mechanisms by supervisors to implement what is known as delegated/auxiliary supervision.

The Debate over Delegated and Auxiliary Supervision

Delegated monitoring (or a translation of a Spanish expression that expresses the idea more exactly, “auxiliary supervision”) is probably the hottest point of the debate and disagreements on R&S of CFIs. It has been consistently supported as a viable concept by some and sharply rejected by others.⁴⁰ If *delegated/auxiliary monitoring* (or simply indirect supervision) is the subject of public debate, then the concept of *auto-control* has been dismissed as a recipe for disaster. Unfortunately very little exchange has occurred on the strength and shortcoming of both concepts. Such a debate is due, for at least two reasons:

- Supervisors, international agencies, donors and consultants often face the decision of whether to insist on adopting a direct supervision approach—which sometimes is near impossible for a variety of circumstances—or to consider an auxiliary/delegated monitoring approach or even auto-control. Even the most fervent opponents have on occasions had to adopt, forced by circumstances, the least desirable of the option, auto-control, and may be pushed into accepting some kind of indirect supervision approach as a second best.
- An agreement over the true value of the approach would likely pave the way for a much larger convergence of points of view about what is an appropriate regulatory framework for CFIs. A unified voice would, in turn, have definitive beneficial impact in convincing many governments and banking supervisors to move swiftly in the direction of the consensus. Governments are confused about the direction to take, sometimes they will cede to the one that offers the best financing package, or stay out of the debate altogether, to the cost of the CFI sector and the under-served segments of the population who could benefit from a more vigorous CFI sector.

This is a relatively difficult topic. There is no theoretical or empirical work from which we can draw clear guidelines. The little theoretical work that touches tangentially on the subject provides only arguments why these kinds of arrangements *might* work. On the empirical side, although there is vast experience out there of the successes and failures of systems that work with and without delegated/auxiliary monitoring, this information has not been processed in an orderly fashion allowing drawing inference. We are reduced to the fact that there are systems of CFIs that employ the approach and work well. The same can be said of systems operating under direct supervision. Everyone in the industry can tell a horror or a success story of either indirect or direct supervision that is consistent with prejudice.

40. Supporters and detractors tend to be aligned, respectively, with the continental European and Anglo-Saxon (credit union) backgrounds of cooperative systems. However, indirect supervision is practiced in a wide range of countries including some squarely aligned in the credit-union tradition (for example, British Columbia, Canada, and Ireland).

Box 2: Delegated/Auxiliary Supervision

Indirect supervision is a regulatory regime that is unique to CFIs. In this regime 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 CFI, 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 later to make it work.

Some make a distinction between delegated and auxiliary supervision. In the former case, in addition to the execution of function of data collection, processing and information/recommendation production, the delegated supervisor is endowed with powers to enforce corrective actions, cease and desist, or, rarely, intervention and or liquidation orders.

Historically this regime grows from the experiences in Germany (and then Europe), starting in the second half of the XIX century, throughout modern times, where it is still the dominant supervision regime.

None is valid as evidence. To complicate matters auxiliary/delegated monitoring seems to be an arrangement that is unique to *mutual* (not only cooperative) organizations.⁴¹ A few cases have appeared recently of networks (other than mutuals) that employ similar mechanisms in other fields: the International Swap Dealers Association (ISDA) and the International Bond Dealers Association (IBDA) have taken upon themselves to regulate their members (in both prudential and market practices), while authorities are watching over their shoulders, apparently relatively satisfied. However, even these experiences have been subject to little inquiry.⁴²

The way to settle this debate, we submit, is through more rigorous research that systematically tests the hypotheses that exist. Whether positions will converge is another question altogether. It may not be obvious to translate into practice, a complex process with which one has only limited or no experience. However, the theoretical and econometric instruments (see Chapter 2) to assess performance under alternative regulatory environments and with differing levels of integration exist, are credible and their application do not represent a challenge. What is a challenge is collecting reliable data for a sufficiently large cross sectional and time-series sample to make results as credible as possible. This sample should include as many countries/systems as possible covering both industrialized and developing countries with sufficient variation in the regulatory and macroeconomic environments to control for different possible effects on performance.

41. Auxiliary/delegated monitoring is also employed in other networks such as those of savings and loans banks (German, Scandinavian countries, and Spain for many years before switching to a direct supervision schema), insurance (Quebec) and health insurance (France, Belgium). It is likely that there are many more systems out there employing the approach of which we do not know.

42. Finally, to complicate matters, rating agencies are increasingly providing information about financial institutions to the market and to supervisors. In the case of CFI systems the rating of PAMECAS (Senegal) and Kafo Jiginew (Mali) are good examples. What is the role played by these rating agencies in the process of supervision?

Why Auxiliary/Delegated Monitoring Might Work

There are two arguments why indirect supervision might work. One is based on the transaction costs economics (TCE) argument and the other on the analysis of the dominating agency conflicts within a CFI. First, the TCE argument. As in any alliance of business enterprises private ordering mechanisms are necessary to prevent opportunism and insure minimum standards of performance by all parties. The types of ordering mechanisms vary. Reciprocity, hostage taking, outright regulation are all known and regularly reported mechanisms in the literature on joint venture and alliances. The more complex the alliance, the more advanced and effective must the private ordering mechanisms be. CFI movements, starting with Raiffeisen's, have chosen an ordering mechanism that over time proved to serve the movement well: private regulation. Investor-owned banks do not engage in such alliances or in private ordering arrangements. Their solution to the problems of economies of scale and scope and control of uncertainty in input procurement is mergers—with all the built-in disciplining tools that the relational contract provides—not alliances. There is no need in the banking sector for an ordering mechanism that controls participants in the industry. However, such a mechanism is essential whenever inter-CFI alliances exist, unless the State takes over and the public ordering mechanism is adequate to support the alliance.

While there is agreement in the literature of organizations research that alliances require private ordering mechanisms, stretching the use of these mechanisms to serve the regulatory objectives of the State is an unusual innovation, except the relatively new cases of the ISDA and the IBDA noted above. It is thus not surprising that many regulators are sceptical about its functioning. However, in many countries, helped by a favourable historical experience, authorities have come to trust those mechanisms, modifying them just to suit their own special demands for information and control. The CFI movements have found it convenient to accommodate this arrangement. The higher the level of integration the more often authorities appear to rely on the movement's own monitoring arrangements.

Regulators face the challenge of creating a regulatory framework that minimizes costs to all parties of both, the administrative costs (to taxpayers) of performing the function and social costs (to users of the system) that may result from failures. Unfortunately, despite some advances in using principles of transaction costs economics to analyse regulation, no attempt has been made to quantify these two costs and produce a table with options and price tags attached to them. In fact, this is an obvious but strongly discouraged approach. The high uncertainty in estimating these costs makes results unreliable. Rather, the recommended approach is to focus on transactions (in our case the contracts behind the main agency conflicts that beset the CFI); consider the possible institutional structures that are able to govern the relationship (hazard mitigation) and their capacity to adapt to changing environments; and then assess those alternatives that have the potential to reduce total costs of performing the regulation function.⁴³ Consideration should be given to alternatives such as private ordering mechanisms (created for the purpose of managing the alliance) and public mechanisms. Once the institutional alternatives have been identified,

43. This is also the approach advocated by Kane (1997).

the researcher seeks to identify observed frequency of the different institutional arrangement. Were the social costs associated with the inefficiency in preventing failures more important than the administrative cost gained from adopting an indirect regime, there should have been a gradual reduction in the use of the regulator approach. Observations, however, suggest the contrary. Thus, if we assume that governments have been acting as transaction costs economizers (both social and administrative)—an assumption that may or may not be valid—then we would be forced to conclude that more governments assess indirect supervision as likely to minimize the transaction costs of the regulation function. While this short argument cannot be considered a proof, it is indicative of the results that might be obtained from an in-depth analysis of the problem using TCE tools.

Second, the agency conflict argument. In contrast to the investor-owned bank, in a CFI sector there is no fundamental conflict of interests between member-shareholders and regulators, a fact with significant consequences to our problem. In the case of the investor-owned banks, regulators protect the interests of depositors against the incentives of shareholders to expropriate them. Thus, regulators are continuously confronting shareholders seeking to control their incentives to take risks beyond prudence through ever new risk-taking strategies. Shareholders thus have built-in incentive to deceive regulators. Incentive aligning compensation schemes insure that the managers' incentives are aligned with those of shareholders. The shareholder-depositor agency conflict vanishes in CFIs because they are one and the same. By extension there is no conflict of interest between regulators and shareholders. Regulators do not need to protect depositors from shareholders. In fact, from the perspective of CFI members, the regulator is the best allied in its own effort to control managers expense preferences, the primary source of CFI failures. If there is a conflict of interest between stakeholders of a CFI and regulators, it is between managers and regulators and not between shareholders and regulators. The result is that CFI shareholders, by definition, have a built-in incentive to cooperate with regulators. If (and only if) governance and private ordering mechanisms built into a network are designed to protect the interest of members and not those of managers—that is, members have not lost control of the organization to management's expense preferences—one should expect that the presence of regulators is welcome. Even managers of the better-run CFI will see in the regulator an ally to control aberrant behaviour by opportunistic partners in the alliance.

It is likely that whether a delegated/auxiliary monitoring system is successful or not may depend on a set of characteristics that are inherent in the configuration of the network. Other things equal, the higher the level of integration achieved and the higher the dependence of member CFIs from services and products provided by the alliance, the higher will be the chance that a delegated/auxiliary monitoring schema will work correctly. This is so because the private ordering mechanisms the alliance will have put in place are likely to be more efficient. Similarly, it is unconceivable that a delegated/auxiliary monitoring system will work efficiently without a strong commitment of the supervisory authority to make it work.

Why Auxiliary/Delegated Monitoring Might NOT Work

The main arguments stacked against indirect supervision are strongly influenced by the investor-owned bank supervision tradition. As noted, in investor-owned banks shareholders have a vested interest to deceive the regulator. This vision of regulation is transposed to

the context of the CFI. Under this perspective the lack of independence of a regulatory body that is under control of the governance bodies representing those that are being supervised cannot be a reliable mechanism. For the same reasons presented above, this risk will be particularly serious in networks with weak governance and where managers have gained discretionary power that allows them to operate without much regard for shareholder interests. In networks where the weakest CFI, from the point of view of solvency is also the largest CFI in the network or one of the largest, there is considerable risk that the private ordering mechanism may simply lack the power to discipline the aberrant behavior of the oversize member of the alliance. These are also the CFI which, for reasons that were presented early in this paper, display the highest failure risk. To complicate matters, the federations typically also have the role of advocacy and promotion. These activities are inconsistent with that of supervision. There is a fundamental contradiction between promoting a rapid expansion of the sector and, at the same time, ensuring that the expansion is achieved under the strictest standards of safety and prudence.

Auto-control is the extreme case where supervision is performed and controlled by the integration bodies (typically federation) without any intervention by banking authorities. The absence of any independent party to control the quality of the process makes it completely unreliable. This is a plausible argument, particularly when the system is facing a system-wide crisis.

Does It Work?

The debate is made difficult by the absence of documented evidence. Thus, the next best thing is to observe the extent to which the schema is employed in the world and to which extent we have clear evidence of failure in those countries in which it is being employed. Even the strongest critic is likely to admit that there are more than just a few systems of CFI—in both industrialized and developing countries, but mostly in the first group—that function under a system of auxiliary/delegated monitoring. In fact, in Germany it has already been in place for nearly 130 years. Interestingly, between 1889 and the late 1920s two schemes of indirect supervision existed in parallel: (i) for CFIs affiliated to a federation, the federation performed the supervision of the member CFI; and (ii) those not belonging to a federation were supervised by an independent “freelance” auditing firm. After a wave of failures in the group of CFIs subject to “freelance” auditing the German government reformed the law forcing all CFIs to become members of a federation and eliminated the second schema.⁴⁴

Table 2 later presents the most common R&S arrangements in the world with examples for each. While the table provides a richer set of information than we need in this discussion, our focus is on the use of either direct or indirect supervision. The reader may recall that there are also non-CFI networks of mutuals that also employ indirect supervision. A rapid perusal of the last column shows that of the systems under banking authority supervision there are more CFI systems under indirect than under direct supervision.

44. The process was described by Seibel (2003). Guinnane (2001) provides an interesting analysis of the factors that played a role in those years and what can be learned from that experience. This particular experience contradicts the often argued intuition that, if indirect supervision will be used, the delegated monitor should be an independent party.

Table 2. Classification of Regulation and Supervision Approaches

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

Notes:

IC: industrialized countries; DC: developing countries.

1. Countries that are mentioned twice are under a split regime under which some CFIs are under banking authority supervision and others (smaller or “close”) are under cooperative authority supervision. This is the case of Argentina, Bolivia, Colombia, etc.

2. Empty cells are those in which information available does not allow to pinpoint examples unambiguously. They tend to be the odd cases

* Argentina and Uruguay can be considered under direct banking authority supervision if one considers the BCC and COFAC as consolidated structure. If they are regarded as networks that were forced to merger by the regulators, then they would fall under the “delegated” category. Directives of both institutions often insist that in reality they are federations with a consolidated balance sheet.

§ The Deposit Insurance Corporation performs the supervision on behalf of the state.

☼ The “authority” is the registrar of credit unions. Insufficient information to assert whether it can be considered a specialized CFI supervisory authority in the sense of the United States’ NCUA.

Source: Authors’ compilation. While we are confident in the correctness of the classification, there might be small errors in it. Many other countries were not listed due to difficulties in inferring the regulatory regime from the patchy documentation available.

Of the developing countries under direct supervision, some are actually networks that have officially merged but keep an internal network structure with local “branches” having their own governance structures (Argentina, Uruguay) and thus, for any practical purpose, they employ indirect supervision. To our best understanding none of the systems listed in the row of indirect supervision (delegated or auxiliary) suffered a crisis during the period in which the system was in use. While several did suffer crises, these happened before the system was introduced. Further, several of the systems under direct supervision (Argentina, Colombia, and Peru) underwent serious crises under this supervision regime. In the case of

Peru this happened before the introduction of the indirect supervision regime. In Colombia and Peru, the worst failures happened precisely in the institutions that were under banking authority supervision (BankCoop and UCONAL in Colombia and BCC in Peru).⁴⁵

Synthesis of Pros and Cons

The concept has problems that cannot be ignored or glossed over. The main critiques note the following:

1. There is a fundamental lack of independence in a regulatory body that is under control of the governance bodies representing those that are being supervised.
2. The federations typically have also the role of advocacy and promotion, activities that are inconsistent with that of supervision.
3. A mechanism of auto-control is the extreme case where supervision is performed and controlled by the integration bodies (typically federation) without any intervention by banking authorities. The absence of any independent party to control the quality of the process makes it completely unreliable.

However, the concept is much less far-fetched than its critics argue for the following reasons:

1. It is a logical extension—and likely a transactions-cost minimizing one—of a private ordering mechanism, a natural arrangement that exists in every inter-organizational alliance.
2. Both auto-control and delegated monitoring have an illustrious history of over a century of achieving stability and reduced performance variances in CFI systems in many places in the world, starting with the Raiffeisen's auditing federations. The indirect mechanism has historically been and is currently widely used by CFI movements in many countries.
3. The active intervention of regulators is in the best interest of member-shareholders who see in the regulators a means to reinforce the control of management—constraining their expense preferences—and of potentially aberrant members of the alliance.

We conclude this chapter with the following two propositions:

Proposition 7: Indirect supervision (auxiliary/delegated) is a powerful tool to: (i) adapt supervision to specific needs of the CFI; (ii) facilitate integration of CFIs to a supervision environment with financial sector standards; and (iii) encourage integration.

Proposition 8: Tiering (splitting) the CFI sector into two groups: one of large/open CFIs under banking authority supervision and another of smaller/closed CFI is (is not) a reasonable strategy to address the problem of creating an appropriate R&S environment for CFIs.

45. In all cases mentioned, they were apex organizations that operated as primary banks, partly encouraged by the banking authority. Their failure led to massive crisis in the networks to which they belonged. This experience in itself represents a strong warning against apex organizations that abandon the subsidiarity principle and engage in retail banking.

Cost of Supervision: Who Should Bear It?

With the institutional separation of the bank supervision function (bank superintendent) from the money management and lender of last resort function (central bank), it is increasingly common, that the supervised institutions pay for the supervision function. A policy must be developed about how these costs will be covered in the case of CFIs. While it is reasonable to expect that in the long run the supervision costs will be covered increasingly by the system itself, in the development stages a substantial subsidy may be needed. It could be argued that CFIs provide a public good, thus full cost-recovery from individual financial institutions may not be appropriate. CFIs are providing a service to the poor population that is as efficient if not more—in diversity of financial services provided—than most schemes of financing the poor through government sponsored and financed programs. Thus, it is not just the public good of deposit protection against the risk taking incentives of shareholder, but the public good of providing access to savings, credit, insurance and other services to populations that would otherwise not have that access. From a transaction-cost economics point of view, what matters is which is the lowest cost setup: whether to provide subsidized and often unrecoverable funding to the poor through directed credit programs, or to subsidize the R&S of a system that provides the service using private contracting mechanisms.⁴⁶ This, without counting the added benefit of introducing market discipline in the financing function, eliminating distortions and creating the basis for a sustainable community based financial system. In effect, what is being proposed is that governments shift the costs of subsidized financing to target sectors to provide the adequate regulatory environment (plus training, advisory services, help in promotional work and other services that strengthen the institutions . . . except subsidized financing) that encourages the development of the sector in areas of interest.

In several countries supervision of CFIs is funded by internationally financed projects. In Mali it is funded by a World Bank project; in Niger it was funded by an IFAD project grouping several donors. When projects end, however, supervision may fall apart for lack of funding. This happened recently in Niger where the IFAD project was stopped and the microfinance supervision cell at the Ministry of Finance was no longer able to operate for lack of funding. It is useless to have the best legal, regulatory and supervisory design if the funding of the same is not secured. As we noted above, it is generally agreed that microfinance plays an important role in the fight against poverty and promoting equitable growth. Only sustainable micro-finance institutions (including CFIs) can contribute to poverty alleviation, and sustainability can only be assured through adequate supervision. Thus, this supervision is an important element in the fight against poverty and in contributing to equitable growth. This should justify, at least for some 10 to 20 years, subsidized funding from governments. In countries where public finances are unable to cover the funding (such as sub-Saharan countries), government budgets should be supplemented with donor funding in a sustainable fashion.⁴⁷ By extension, if the supervision

46. Note that the public good argument does not apply solely to CFI, except perhaps as regards the diversity of services. A similar case could be made for limited-service microfinance institutions.

47. The last paragraph draws almost *verbatim* from a written comment made by our colleague André Ryba on an earlier draft of this paper. Any further paraphrasing risked obscuring the ideas he put forth.

design adopted is one of indirect supervision, because it is providing a social service, this subsidy could be extended to the delegated/auxiliary supervision body.

Some proponents of indirect supervision have argued that delegation can help reduce the costs of supervision. They point to the widespread use of the approach as evidence in this direction. However, others argue against this notion questioning whether a specialized supervisory agency (like a body attached to a second tier organization or an independent rating agency) can really carry supervision in a less costly way than specialized state agencies could. There is a danger of duplication. Centralized supervision may be able to exploit economies of scale. The cost of supervision under alternative schemes (direct vs. auxiliary/delegated) should be verified and compared against the efficiency of the schemes in performing the supervisory function.⁴⁸

Toward a Set of “Core Principles” of CFI Regulation and Supervision

Ideally, the debate should be taken to the point where we may be able to speak, as in the case of commercial banks, of “core principles” of CFI R&S. Whether this is possible depends on the crucial process of finding a consensus. The following factors influence, positively and negatively, the likelihood of arriving and successfully pushing forward a set of principles of CFI R&S.

On the plus side we count:

1. Banking authorities, after many years of exchanges and debates have converged to a set of principles that apply, with some specializations, to a large set of contexts. The application of those principles to developing countries led to the preparation of the *Core Principles of Effective Bank Supervision*.⁴⁹
2. In the past there have been at least three “successful” models (if we ignore the bias incorporated into the concept) of cooperative development applied to a variety of situations (Münkner 1989): i) the British Colonial Pattern of Cooperative Legislation (applied to Asia and parts of Africa); ii) the French Colonial Pattern of Cooperative Legislation (applied to Africa mostly) and iii) what we could call the United States Pattern of Foreign Cooperative Legislation (applied mostly to Latin America starting in the 1960s). This suggests that a new “pattern” of a well-designed model is possible.

48. Throughout this text, we assume that auditing and prudential supervision are two distinctive activities with separate purposes, and both are necessary. This distinction is not always clear in the CFI sectors due to the historical fact that in Germany auditing performed by the “auditing federations” encompasses prudential supervision.

49. The BCBS after having completed the *Basel II* standards, will now proceed to revise the *Core Principles*. It is a good moment to undertake discussions with the BCBS about specificities of CFI. The leadership of the World Council of Credit Unions (WOCCU) has taken steps in this direction. Some of the *Basel Core Principles* are in outright conflict with the very essence of a mutual institution. This is, for example, the case of Principle 10: On lending to related parties. By definition all members of a CFI are related parties. The focus should rather be on lending to directors and managers. A number of comments have also been made by WOCCU about the applicability of Principles 2, 3, 6, 14, 22 and 24 to credit unions (letter to BCBS of January 17, 2005).

On the minus side one should consider:

1. The world CFI movement does not count with a body like the BCBS (with the powerful support of the Bretton Woods institutions) to obtain the commitment of individual countries engaging in a reform that aligns the local legal, R&S framework to the BCBS “Core Principles.”
2. Under those circumstances the local political pressure of cooperative leaders who prefer the status-quo may outweigh the external pressure that may be possible to apply on governments and regulatory authorities.
3. Regardless, producing a set of “principles”—whether to call them “core” is a question we wish not to solve here—would be a giant step that would give the international CFI movement a new jolt. The experiences and errors of the past, aided by the sharp insights that modern economic and finance theories and research methods provide, should allow us to arrive at a consensus that will set the foundations to make that jolt sustainable and less exposed to crises than in the past.

As an exploratory exercise of items that could eventually find a place in a list of “Principles of Effective CFI Supervision,” we propose some below. This list is based in arguments presented throughout this document. The areas touched are inspired by the list proposed by the BCBS but expanded to include issues that are specific to CFIs. They are:

- Licensing standards: What type of license/charter should be given to a CFI?. Should it be a uniform license or should there be tiers? What activities should be included in this license/charter?
- Capital standards: Should absolute minimum capital be established or should minimum capital be based on membership? Should there be solvency ratios similar to those employed for banks?
- Control of management expense preferences: A clear emphasis should be given to devising mechanisms (rules) that aim at controlling expense preferences, as a key issue in preventing CFI failure.
- Supervisory authority: Who should the supervisory authority be and under what conditions should one employ a dual system with different portions of the CFI sector under different supervisory authority?
- Networking: Define the activities allowed to networks and their affiliated companies. Should there also be a tiered system by which the charter for the network is expanded with the maturity of the system? The emphasis should be less on limiting activities (although far-fetched activities should be prevented) than to make regulators aware of the role of these networks as an essential part of a CFI system.
- Delegated/Auxiliary supervision: Should delegated/auxiliary supervision be employed, encouraged or discouraged and under what conditions should this happen?

Cooperative Financial Institutions: Background

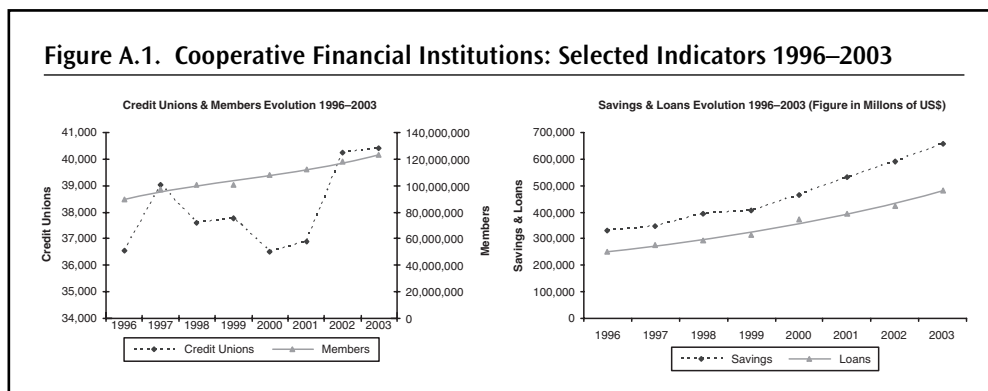
Cooperative financial institutions include diverse member-owned financial intermediaries, referred to as credit unions, savings and credit cooperatives, cooperative banks, and other terms that usually differ across regions of the world. Their institutional structure and governance, legal and regulatory status and framework, scale and services portfolio also vary widely across regions and especially between developed-country CFI systems and their developing country counterparts. A most basic common denominator is that they collect deposits and do business often solely with members, although in some cases they also serve non-member users.

Specific features of CFIs in different countries are to some extent associated with their historical roots, that is, the continental European (Raiffeissen) model, or the so called Anglo-Saxon (credit union) model, and the mechanisms through which they were introduced in developing countries. A common means of dissemination was associated with missionary work, before international networks based in Canada, the United States, and Europe began CFI promotion as part of development assistance.⁵⁰ This study will cover institutions that fit the common denominator indicated above and that have resulted from either the “European” or the “Anglo-Saxon” model, or from a combination of or variation from them.

Global Overview

To give an overview of the evolution of the sector we provide statistics of the World Council of Credit Unions (WOCCU) which include members and affiliated and other credit-union

50. For example, in Quebec, Canada, in the early 1900s there was one financial cooperative attached to each parish.

Figure A.1. Cooperative Financial Institutions: Selected Indicators 1996–2003

Source: World Council of Credit Unions, 2005, see Annex 1.

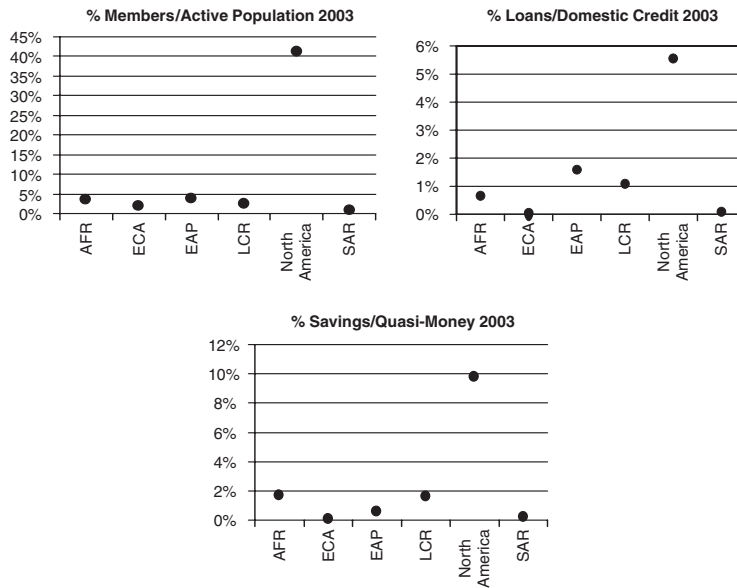
countries operating in 84 countries, encompassing about 40,000 institutions with 123 million members. Available data indicate that while the number of institutions has increased by about 10 percent between 1996 and 2003, membership has grown by 40 percent, and savings, loans and total assets have roughly doubled in that same period (see Figure A.1).⁵¹

Market coverage (penetration ratios) of CFIs in different regions of the world in 2003 using WOCCU's statistics are estimated to range between 1 percent (South Asia) and 41 percent (North America) for the ratio of members to active population,⁵² between 0.04 percent (Europe) and 5.5 percent (North America) for the ratio of CFI loans to domestic private sector credit, and between 0.07 percent (Europe) and 10 percent (North America) for the ratio of CFI deposits to quasi-money (see Figure A.2). Underlying these composite regional ratios there is a wide diversity of market coverage across countries. Ireland and Dominica for example, show membership over active population above 100 percent due to widespread "senior citizen" participation, whereas CFI presence and relevance in some Asian countries is negligible.

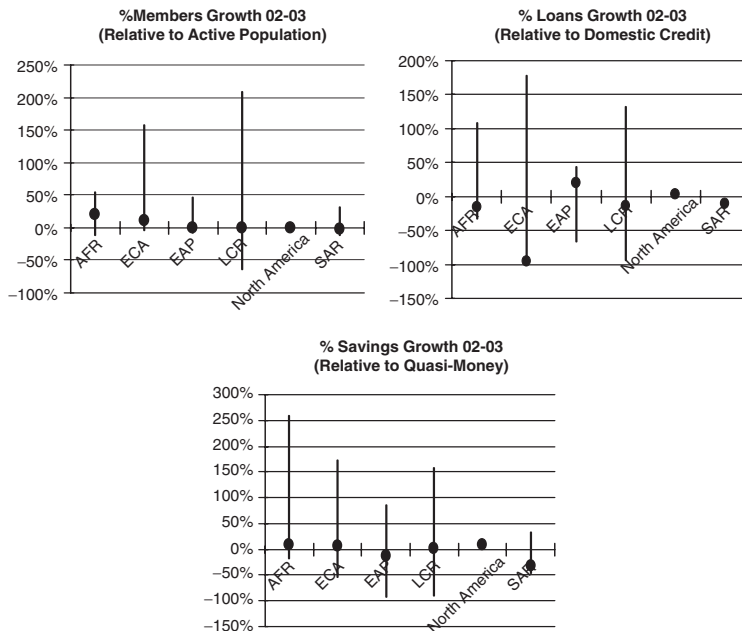
Cross-country heterogeneity is even more apparent when the 2002–2003 growth rates of the three market coverage ratios are considered (Figure A.3). The dispersion of individual country growth rates around the regional average, shown by the vertical lines in Figure 3, is substantial for all regions excepting North America. While the penetration ratio in terms of membership over active population and in terms of savings over quasi-money remained for

51. WOCCU data include affiliates and non-affiliates in "credit-union countries." Among non-credit union countries (hence not in WOCCU's data) there are some with large CFI membership such as Austria, Finland, France, Germany, Italy, Japan (the Shinkin system), the Netherlands, the Quebec province (Canada), Spain and Switzerland. Another important caveat about these and other figures is that the basic data are reported statistics from country or regional CFI associations which may be inaccurate, a matter the on-going study intends to address. Data from other sources will be compiled to complement WOCCU's figures.

52. North America includes the USA and Canada. Mexico is included in the Latin America region. See footnote 64 for excluded countries in the data.

Figure A.2. Market Penetration Ratios: Clients, Loans, Savings

Source: Authors' estimates based on data from World Council of Credit Unions, 2005, Annex 1.

Figure A.3. Growth in Penetration Ratios, 2002–2003 (Average per Region)

Source: Authors' estimates based on data from World Council of Credit Unions, 2005, Annex 1.

the most part stable in this sample period, the market coverage measured by CFI loans over domestic private sector credit decreased in three of the regions, most drastically in Europe.

Major Developed Country Systems and International Networks

Cooperative financial institutions comprise an important part of the financial system in several developed countries, notably Canada, France, Germany and the United States, among others.⁵³ Linked to each of these major national systems, there are international networks and service providers with affiliates and/or development projects throughout most regions of the world: Développement international Desjardins (DID) in Canada; Deutsche Genossenschafts und Raiffaisenverband e. V. (DGRV) in Germany; and World Council of Credit Unions (WOCCU) in the United States.

Two elements of these developed systems are worth noting at this initial stage. First, the fairly sophisticated national systems are likely to provide models and experiences useful to developing countries; and second, the international networks anchored in those national systems serve as mechanisms for knowledge generation and dissemination, as well as services provision. While the current state of developed-country national systems may be too sophisticated for replication elsewhere, their experiences and the historical factors that contributed to their development may provide useful lessons and, combined with modern technology, allow for “leap-frogging” stages in developing countries.

Cooperative Financial Institutions and Outreach to the Poor

While researching this aspect is precisely within the scope of the OPD study, existing literature already supports the notion that CFIs serve many poor people, even though middle-income clients are also among their membership, a feature that in fact allows CFIs to reach poor segments of the population without necessarily compromising their sustainability. “Mixed outreach” as some practitioners have labeled the diversity of CFI clientele, translates into the fact that in many cases CFIs serve larger numbers of poor people than specialized (“targeted-to-the-poor”) microfinance institutions, without relying on donor support as the latter do (Cuevas 2000). Yet, the perception that CFIs are associated with “middle-class” customers has kept them for the most part outside the radar screen of government and donor development resources.

The imbalance in technical assistance support to microfinance institutions versus CFIs, for example, has been criticized recently, by others including Westley (2001) for the case of Latin America, in light of the facts that: (a) CFIs are the dominant suppliers of microenterprise credit in the region; (b) they provide savings services, which microfinance institutions usually do not; (c) they provide a broader range of credit products including housing and consumer loans; and (d) CFIs have a relatively larger presence in rural areas

53. Other developed countries such as Austria, Holland and Spain also have fairly well developed CFI systems. The extent to which they “export” their know how, however, is less than that of the three countries included here.

in Latin America. Westley attributes this imbalance in donor support to the (mistaken) perception that CFIs do not serve the poor in spite of evidence to the contrary, as indicated above. One may add to this explanation the apparent success of specialized microfinance institutions (mostly donor-funded non-governmental organizations) in capturing donor support under the banner of poverty alleviation, and the dearth of knowledge among donor staff about the CFI sector.

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Cooperative financial institutions (CFIs) are among the poorly understood entities in financial markets. They include diverse member-owned financial intermediaries referred to as credit unions, savings and credit cooperatives, cooperative banks, and other terms that differ across regions of the world. Their institutional structure and governance, legal and regulatory status, and scale and services portfolio also vary widely across regions and especially between industrialized countries and developing economies. A most basic common denominator is that they collect deposits and do business often solely with members. Existing literature already supports the notion that CFIs serve many poor people.

This paper addresses topics on which an agreement is necessary to arrive at consensus guidelines or "principles" of regulation and supervision of cooperative financial institutions (CFIs) in developing countries. Three main topics covered are: (i) the fundamental structure of the sector in terms of its internal (micro) and inter-CFI (macro) organization, with a focus on the agency conflicts inherent in the mutual structure, the extent to which they contribute to failure risk, and whether and how these conflicts are controlled by existing governance mechanisms; (ii) the existing legal frameworks in an international context, their origins, and the implications for the functioning of CFIs; and (iii) the regulatory frameworks under which CFIs operate and the different propositions by stakeholders about what should be an appropriate regulatory framework and an effective supervision mechanism.

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