Cooperative Financial Institutions in Rural Development: Promise and Challenges

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REGULATION AND SUPERVISION FOR SMALL, RURAL CFIS

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Executive Summary

This panel examines opportunities to improve current models of regulation and supervision of cooperative financial institutions (CFIs) in rural areas so that they maximize the protection of members' savings while increasing financial inclusion in their markets. The discussion will consider the challenges supervisors face in monitoring many small and geographically dispersed financial institutions with limited resources, while also addressing the compliance costs borne by the supervised CFIs themselves. High compliance costs can reduce the financial viability of small CFIs and compromise their legal status as financial service providers, ultimately impacting rural financial inclusion. This panel will also include discussion on proportionality, integration, and digitization in respect to small rural CFIs and the role of the supervisor in encouraging an efficient rural financial cooperative sector.

OBJECTIVE

The objective of this panel is to generate discussion on efficient, adequate, and proportionate mechanisms of regulation and supervision of small CFIs in rural contexts that achieve effective protection of member savings and foster financial inclusion in their markets.

BACKGROUND

Financial sector crises in the 80s and 90s led financial authorities to adopt international codes and standards, such as the Basel Accords on Minimum Capital Requirements ("Basel I" of 1988) and on the Control of Market Risks (1996). These standards were later followed by the 29 Core Principles of Effective Banking Supervision (2012), the introduction of the International Financial Reporting Standards (IFRS) together with the International Standards on Auditing (ISA), Anti-Money Laundering standards (FATF-GAFI Recommendations) and the Anti-Terrorist Financing Recommendations.

The costs of complying with regulatory and supervisory requirements impact the competitiveness of CFIs. Fulfilling requirements such as liquidity and capital provisions, risk management, auditing, internal control, anti-money laundering and terrorist financing, consumer protection rules, deposit insurance, as well as supervision and reporting, all carry a cost and directly affect the extent to which CFIs can allocate resources to member service and product development.

In addition to regulatory requirements, rural financial cooperatives may face challenges associated with their business model, such as governance issues, outdated management information systems, and risk management and internal controls, for which skilled resources are scarce in rural areas. Moreover, CFIs face new competitors in financing rural activities such as microfinance institutions, non-profit organizations, niche banks, development banks, and increasingly new digital competitors, such as Fintech platforms.

Despite these challenges, CFIs are often the only local financial intermediaries contributing to financial inclusion in many rural areas. To expand financial access for a greater proportion of rural populations, while reducing the cost of access to financial systems, the state devotes time and resources to the supervision and regulation of non-bank financial intermediaries, including savings and credit cooperatives (CFIs).

Session Discussion

- What are examples and elements of proportional regulations and supervision for CFIs?
- How can regulatory incentives encourage the integration of CFIs to facilitate their supervision?
- How have supervisors been successful in lowering the regulatory compliance barriers for CFIs while still ensuring they keep depositors' money safe?
- What has been the success of placing supervisors in rural areas closer to CFIs instead of sitting in the capital city?

THE ROLE OF SUPERVISOR

The supervisor's primary role is to maintain a stable financial system and protect the safety of savers' deposits, while creating regulatory and supervisory frameworks conducive to sound market behavior by financial actors. For small CFIs, supervisors also have the potential to apply principles of proportionality to regulatory and supervisory frameworks, balancing the costs of supervision with the efficient protection of savers in rural areas. Requirements that should be considered under the principle of proportionality for small CFIs include:

- Longer compliance deadlines in relation to their capitalization indices
- Simplified methodology for the creation of loan loss allowance
- Risk-based approaches to customer due diligence under AML/CFT;
- Proportionately differentiated deadlines and organizational structure requirements
- Proportionate contributions, if any, to the savings/deposit protection fund and to supervision

Supervisors can also incentivize the consolidation or integration of rural CFIs in the legal and regulatory framework. Small rural CFIs may be indirectly encouraged to seek integration alternatives (e.g., standardized technology systems) through prudential regulations, compliance challenges, and increased competition. While the regulatory framework could incentivize this process (e.g., by explicitly contemplating and regulating the integration of CFIs), it should not require integration through inappropriate prudential requirements.

LIMITATIONS AND CHALLENGES

1) Modality of supervision:

The high geographic dispersion and sheer number of small rural CFIs present a challenge to supervisors. Direct supervision by the central bank or bank supervisor requires a large staff and brings an associated high cost that is difficult to cover through contributions from the supervised CFIs. These logistical and budgetary challenges have led supervisors, first in Europe and North America (Germany, Canada) and then in Latin America, to evaluate and implement auxiliary schemes. Currently, in the trade-off between "intensity of direct supervision" and "control coverage," high-income countries seem to be leaning towards more direct supervision, albeit auxiliary systems remain in place for small CFIs. For CFI systems in developing countries however, the pros and cons of direct versus indirect oversight, and the advisability and feasibility of mixed systems remain important topics for discussion and research.

Delegation of certain supervisory functions in an auxiliary supervision model presents numerous challenges. When the auxiliary entity is a federation or apex cooperative entity, conflicts of interest can arise between the entity's interests of representation and its supervisory duties. Large CFIs within the entity can create governance problems and may limit the effectiveness of the entity's auxiliary supervision function. The situation worsens if the CFI can choose which entity will be its supervisory authority and there is no restriction on moving to another (a form of supervision arbitrage). In general, this model lends itself to application in Latin America only under appropriate conditions due to the presence of conflicts of interest, weak technical structures in the sector, and the associated risk ("political" and legal) for the official supervisor.

2) CFI size and incentives to merge or be absorbed into larger entities

Larger CFIs may be better able to absorb regulatory and supervisory requirements, affording them a competitive advantage in some contexts. For example, in Germany, a study by the federation of cooperative banks BVR identified that for cooperative banks with a balance sheet total of less than EUR 50 million, regulatory costs exceed revenues from the securities business by more than 33%[i]. Simply staffing cooperative banks with the right specialized personnel is a challenge for small cooperatives. For example, cooperative banks in Germany with a balance sheet total of less than €50 million had an average of only 3.6 full-time and 3.8 part-time employees in 2014. Moreover, the workload for the implementation of regulatory provisions in the reporting system was between 51 and 100 or more man-days. From this, we can say that as the size of a bank decreases, the relative share of regulatory costs in gross income increases. Therefore, the size of a cooperative bank can contribute to its competitiveness "in addition to its business model, the quality of its management and the efficiency of its internal processes." In this sense, mergers, absorption, or transfer of assets and liabilities become relevant in the sector.

3) Methodologies, tools and best practices for supervision of cooperatives

Risk-based supervision is crucial when monitoring the risks of small cooperatives. The sheer number and geographic dispersion of CFIs in rural areas with fewer financial institutions makes off-site supervision paramount. Because the board members of small CFIs generally have less of their wealth tied up in the entity compared to the board members of small commercial banks, they may be less inclined and skilled to monitor and police credit (and other) risks in the firm. As such, the importance of the supervisor in monitoring risks in CFIs is especially relevant. In this sense, the primary challenge is the quality and consistency of information that supervisors receive. SupTech systems can help supervisors spot data problems and standardize what CFIs need to provide and the channel to do so. Supervisors can create incentives (such as less frequent on-site exams and lower annual supervisory fees) if they can directly extract information on CFIs from a database or standardized core banking to prepare regulatory reports.

One question to consider is if it is ever necessary for supervisors to conduct on-site inspections of the small rural CFIs. From a purely risk-based perspective (defined as the allocation of scarce supervisory resources), the answer could be no. From a political and equity standpoint (i.e., small deposits of lower-income rural member should have just as much oversight as those of urban salary workers), on-site inspections may still be important in markets lacking a deposit protection scheme. To truly protect deposits in large numbers of small rural CFIs, deposit protection and reliable digital reporting to the supervisors are essential (i.e., from federations, atomized CFIs and/or direct access to their databases). For rural areas, the infrastructure-related issues regarding connectivity (signal, internet access) to enable digital reporting must be recognized and addressed. Both deposit protection and digitization of CFIs require public investments or subsidization by larger CFIs.

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