Regulation and Legislation of Cooperative Banks and Credit Unions

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Introduction

Credit unions/cooperative banks collectively represent generally a small percentage of the financial sector's total assets in most countries, in part because they focus on providing retail financial services to poor, low and middle income individuals. Although their assets may be low by comparison, of commercial banks credit unions/cooperative banks serve large numbers of small depositors and, as such, should be regulated and supervised. This paper addresses three key areas that will be discussed at the Expert Group Meeting on Cooperatives panel discussion on regulation and supervision of credit unions and cooperative banks. These are include: 1) challenges for governments and central banks in regulating credit unions and cooperative banks; 2) strategies for finding the right balance in regulatory approach; and 3) important legislative measures necessary to strengthen credit unions/cooperative banks.

The regulation of credit unions around the world is a reflection of their diversity in size, scope and complexity. Nonetheless, their regulation has been largely effective as is evidenced by the fact that no credit union movement in any country has required any direct recapitalization from government to address its safety and soundness.

1. Challenges for Governments and Central Banks in Regulating Credit Unions and Cooperative Banks.

The primary challenge facing many governments and central banks in this regard is how to best deploy scarce supervisory resources to regulate a relatively large number of small community-based financial institutions that mobilize deposits from the public. While a number of different models of credit union supervision have emerged, there is general consensus that the ministry or agency that regulates financial institutions should supervise credit unions through a specialized unit trained in their nature, risks and methodologies.

Development of Supervisory Approaches

The evolution of supervisory approaches for credit unions is largely dependent on the phase of development of the credit union movement in each country. In the early years of development, credit union regulation tends to focus on basic functions such as licensing and registration. As these movements mature, standards for prudential behavior tend to emerge – for example capital, liquidity and other risk management requirements. Following the establishment of prudential standards typically a risk assessment process is established by the supervisor to ensure compliance with legislated requirements. These processes would normally include financial and regulatory reporting and on-site field examinations. Once these mechanisms are in place, a risk-based supervisory framework is introduced to measure and assess risk on an institution by institution basis. These frameworks also begin to introduce enforcement measures to mitigate risk to the depositors through required prompt corrective action. Finally, in a mature system, a deposit guarantee system is introduced in order to provide explicit comfort to depositors that their funds are partly or fully protected.

Models of Supervision

Different models of credit union supervision have evolved around the world Each model has strengths and weaknesses, depending on the perspective of the supervising agency, the credit union and the depositor. Confidence is one of the most important ingredients for successful financial intermediation in any country. Selecting a supervisory framework that provides the highest degree of consumer confidence will ensure that individual depositors and national economies alike can reap the long-term benefits offered by credit unions. Predominant models of supervision are as follows.

Direct Supervision of All Credit Unions

Direct supervision of all credit unions by a prudential government regulator with the statutory responsibility of regulating credit unions ensures uniform standards of competition in the market, eliminates the chance for regulatory arbitrage and promotes greater consumer confidence.

The greatest deterrent to implementing this framework is the actual and perceived cost in countries that have hundreds or thousands of credit unions to supervise with scarce public resources. Supervisors need to be able to recover their costs of these services, leverage technology, utilize a risk-based supervisory structure and, most importantly, use alternative methodologies for conducting examinations, especially in small-to-mid-size and low-risk institutions. In some jurisdictions, the credit union movement has not been supportive of a cost recovery program which in turn, has inadvertently led to less than optimal supervisory oversight. Some jurisdictions that use this approach include Canada, Australia, Ireland, UK, United States, Ukraine, South Africa and Kenya are transition to this model and India (for its urban cooperative banks),

Direct Supervision of the Largest Credit Unions

In some countries, the financial sector regulator directly supervises only the country's largest credit unions, based on asset size or deposit base. This model emerged in Latin America in the mid-1990s and is now utilized in Bolivia, Chile, Colombia, Ecuador and El Salvador. In some instances (e.g., Bolivia, Ecuador and El Salvador) smaller

institutions that the regulator does not oversee receive limited non-prudential oversight from another government agency not responsible for banking matters. In other cases (e.g., Chile and Uruguay) a ministry responsible for other non-bank institutions, such as mortgage brokers, insurance and money transfer firms, supervises the smaller institutions.

This type of direct supervision extends the technical expertise in central banks to credit unions and focuses resources on the largest institutions, which could present systemic problems if they failed. This framework requires fewer resources from the supervising agency but may create regulatory arbitrage. It also divides the credit union sector into two, with differing compliance, service offerings and interests. The effect of this bifurcated supervisory framework is confusion among depositors about which credit unions are supervised (and sound) and which are not. The confusion can lead to a lack of confidence in all credit unions. This confusion is further complicated if the deposit guarantee system is not equally applied to all credit unions.

Delegated Supervision

Delegated supervision occurs when the government formally assigns supervisory enforcement power via law or regulation to a third party, most often the credit unions' national association or an arm of the association. This model is typical of credit union movements in the early stages of development and may extend to more mature systems if managed well. If delegated to the national association, this model can help ensure closer feedback between the credit union and its supervisor compared to direct supervision by the government agency regulator.

This model benefits the government in the short run by allowing it to avoid the financial cost of supervision. It also benefits the national association by providing an income stream. In addition, credit unions benefit from the more collegial relationship with a supervisor whose responsibility is to ensure the sector's growth and promotion.

However, successful delegated supervision requires 1) strong management of the conflict of interest where the supervisor is the primary advocate for credit unions and governed by the organizations it supervises and 2) the development of strong technical capacity in the delegated entity. Some jurisdictions that use this approach include in Korea, Mexico, Peru and Poland.

Supervision by Restructured Ministries of Cooperatives

As governments recognize the need for prudential, credit union-specific supervision, some have restructured the ministry of cooperatives to become the prudential credit union supervisor. Based on experiences in many jurisdictions over the past fifty years, there are several financial and technical weaknesses in this approach. Most ministries of cooperatives are focused on promoting cooperatives of many types and purposes (e.g., agricultural, housing, production and others) rather than solely on financial cooperatives. They are typically under-funded, especially compared to central banks and/or superintendencies of banks. A lack of funding and focus makes it difficult to attract and retain individuals with the necessary financial and technical expertise. And finally, through international training and exchanges, banking sector supervisors generally have

greater access to newer supervision techniques and technologies. This is the predominate form of supervision in Africa and many part of Asia and Central America.

Core Principles Underlying Credit Union Supervision

- Credit unions are private sector organizations and should operate free of government interference with management.
- The appropriate role of government vis-à-vis credit unions is that of legislator, regulator and prudential supervisor.
- Credit unions should be supervised by a government agency responsible for the financial sector with specific knowledge and training related to the sector.

Enforcing Standards

The government agency responsible for supervising the financial sector should supervise all credit unions in a country to ensure the safety of member deposits. The financial sector supervisor should create a specialized unit trained in the nature, risks and methodologies of credit unions and other non-bank institutions. Credit unions, for example, have higher transaction costs relative to a bank that serves big business and wealthy individuals because credit unions focus on the retail market, offering small savings and providing both secured and unsecured loans.

Credit union supervisors need to be well-trained and have at their disposal the tools and power to be effective enforcement authorities. They must have a reporting and monitoring system that gives them the ability to complete off-site examinations and identify problems that warrant an on-site field examination.

Regulations must clearly describe the actions examiners may take to resolve problems in weak institutions. Prompt corrective action includes administrative actions, sanctions, de-licensing, removal of management/officers and liquidation. Outlining progressive disciplinary steps in the regulation ensures that all parties are aware of the consequences of poor financial and/or fiduciary management.

Challenges in Regulating in the Current Economic Environment

Given the current state of the economic environment, credit union regulators are carefully monitoring the overall trends in the regulation of financial institutions to determine what, if any, the legislators' responses will be to the current market turbulence. In this type of situation, the natural reaction of regulators is to "tighten up" within the limits of their supervisory powers.

Despite the current market conditions, credit unions around the world remain financially and operationally sound. There has been no requirement in any jurisdiction for the types of massive bail-outs required for large international financial institutions. This is largely based on two factors. First, credit unions are locally owned and operated. As such, they are more likely to be impacted by local market conditions rather than international events.

Second, typically they are smaller and less complex than larger financial institutions and thus, less likely to be caught up in the "too big to fail" syndrome which require large capital and liquidity injections. In theory, a large number of smaller institutions is more stable financial system than one comprised of a smaller number of larger ones.

Looking forward, the current environment may in fact create a tremendous opportunity for credit unions in many countries to demonstrate that they are a sound, stable and economically viable alternative to large commercial financial institutions. Regulators have a responsibility to ensure that while credit unions exploit this opportunity, they do so in a safe and sound manner.

2. Finding the Right Balance in Regulatory Approach

Setting the Rules

Credit unions are financial intermediaries that enjoy the privilege of taking deposits from the public and thus must be subject to prudential standards. Regulations set forth the application and enforcement of a law. More detailed than legislation, regulations address specific operational, financial and administrative issues.

Regulations establish minimum prudential, operational, administrative, governance, accounting and audit requirements. As in the case of legislation, one set of requirements does not fit all financial institutions. Credit union regulations are likely to differ from those of other financial institutions in the areas of:

- Establishing minimum start-up capital
- Defining what constitutes capital and determining capital adequacy
- Servicing small accounts and loans
- Allowing the use of non-traditional collateral
- Governance structure

Minimum Start-up Capital

Credit union regulatory standards include lower initial start-up capital requirements because credit unions are established at the community level to provide a means for low- and moderate-income members to access small savings accounts and loan services. Member shares provide the initial funding base. Credit unions do not have private joint stock capital investors, but instead build their capital from retained earnings over time as well as other sources of member contributed capital. The issue of necessary start-up capital to establish a credit union is one area that significantly diverges from banking regulations. Banks need start-up capital to secure the investors' stake in the venture and to ensure sufficient funds for operating costs. Community and member interest, as opposed to investor interest, drives the formation of credit unions.

Capital Adequacy

The mandatory purchase of shares by credit union members creates a membership stake in the institution. Credit union shares are fully withdrawable by the member at par value upon leaving the membership. When crises occur in credit unions and their surrounding

economies, members might withdraw their shares and savings to protect their own assets. It is during such crises that credit unions most need to rely on their institutional capital to cover losses. Because shares cannot be counted on to absorb losses at such times, they are not considered credit union capital, rather a liability. Shares should be considered capital only if the national law or regulation defines all member shares as "permanent and non-withdrawable." Where this is the case, members should be advised upon joining the credit union that shares are non-withdrawable. While not part of institutional capital, supervisors in some developed countries allow credit unions to raise subordinated debt from or sell preferred shares to members and/or non-members with special restrictions on the voting and ownership rights of the debt. The subordinated debt or preferred share issue is often long-term with regular payments due to the investor(s) or shareholders.

Small Accounts and Non-traditional Collateral

Credit unions typically serve individuals of low- and moderate income groups by collecting large numbers of small savings and making small loans to many borrowers. As such, credit union regulation and supervisory practices usually allow non-traditional collateral and alternative guarantees for small loans. Equally as important, reporting and compliance requirements should take into account the high relative costs of serving large numbers of small depositors.

Governance

Governance matters in all financial institutions. In credit unions however, governance can be their greatest strength or their greatest weakness. Good governance is an essential component of success as the boards of directors are democratically elected from within the membership on a one-member one-vote basis. Rules of governance establish systems for internal control and oversight to address problems before external supervision is required. They include role and fiscal responsibility guidelines for the general assembly, board of directors, internal auditor and management. Regulations can also identify proper criteria for board members. These requirements may include a specified level of education or management experience in a financial institution. Alternatively, regulation may require that board members complete formal training in financial institution management and supervision to maintain their board seats.

As credit unions grow larger and more sophisticated in their financial offerings to members, the level of member involvement tends to wane unless there is a concerted effort by the credit union to promote member involvement. Large credit unions in more developed countries can have hundreds of thousands of members which makes the governance process more complex. New and innovative governance strategies are being developed to address this challenge through greater use of technology (e.g., online voting) and decentralized governance processes. In addition, there is a trend towards establishing basic qualifications for election to a board including requirements such as skills, experience and independence in order to ensure that directors are able to oversee the operations of larger, more complex institutions.

3. Important Legislative Measures Necessary to Strengthen Credit Unions.

Establishing a Secure Legal Foundation

A strong supervisory framework is built upon a secure legislative foundation that is prudential, proportional and predictable.

• Prudential legislation establishes financial standards to which a credit union must adhere to protect the financial health of the institution and safeguard member deposits.

• Proportional legislation recognizes the risks a credit union presents to depositors and the financial system as a whole and establishes appropriate rules to mitigate those risks.

• Predictable legislation provides a credit union the clarity and certainty it needs to plan and invest for the future.

As recognized in the UN Blue Book on Building Inclusive Financial Sectors for Development that emanative out of the UN Year of Micocredit, a diversity of legislative structures often produces the best results enabling competition and innovation. Legislation that seeks to address the needs of credit unions within a body of law for banks, cooperatives or microfinance institutions (MFI) often neglects to recognize the cooperative governance structure, deposit-taking function and/or scale and scope of credit union operations. Conversely, credit union-specific legislation ensures an appropriate set of financial management disciplines, creates avenues for building and distributing capital, establishes governance controls and sets up a prudential supervisory framework for a large number of small institutions.

Different from Banking Legislation

While there may be similarities in the area of establishing prudential standards, legislation intended for commercial banks is generally inappropriate for credit unions whose purpose is to provide cooperative financial services to members who are the depositors, borrowers and owners. Unlike commercial banks:

1. Credit unions are often formed by individuals who lack(ed) access to affordable financial services and have banded together to overcome the market failure. As a result, they have limited ability to raise initial start-up capital.
2. Credit unions do not have the same access to capital markets.
3. As not-for-profit institutions, credit unions should not have external shareholders, rather members who own the institution and receive the financial services provided.
4. Credit unions are governed by a board of directors that is democratically elected from within the membership through a one-member, one-vote process.
5. Credit unions share back-office operations, policies and procedures and cross-guarantee systems with other credit unions to a much greater degree. Legislation should

recognize this not as a violation of anti-trust principles, but as credit union cooperation within a non-competitive framework.
6. In best practice, credit unions generally do not “negotiate” mergers in which one party attempts to bid up or receive any price beyond the book value of its outstanding ownership shares.
7. It is best practice for credit unions that voluntarily liquidate to not compensate members beyond the value of their initial shares.

Different from Cooperative Legislation

Most legislation for cooperative societies is limited in scope to addressing the governance, registration and promotion of cooperatives. Cooperative acts generically encompass agricultural, consumer, marketing and production cooperatives. They are inadequate for credit unions because unlike other cooperatives:

1. Credit unions mobilize voluntary public deposits from their members.
2. Credit unions maintain a capital base that is comprised principally of accumulated reserves and retained earnings from operations.
3. Credit unions specialize in financial intermediation, which necessitates adherence to prudential financial standards and supervisory oversight.
4. Credit unions require access to central bank liquidity mechanisms as well as to payment, settlement and clearing networks.

Different from Microfinance Legislation

As interest in microfinance has increased in the last decade as demonstrated in the UN Year of Microcredit, governments have enacted legislation for microfinance institutions (MFI). Because credit unions and other MFIs serve the same market—the working poor and others who are traditionally excluded from the financial sector— policymakers often mistakenly assume that microfinance legislation will cover credit union needs as well. While credit unions are a type of microfinance institution, they differ from other MFIs in that:

1. Credit unions intermediate a broad array of financial services beyond credit.
2. Credit unions mobilize voluntary public deposits from their members on a much greater scale.
3. Credit unions have boards of directors elected from within the local membership on a one-member, one-vote basis.
4. Credit unions are community-owned by individuals with equal ownership.
5. Credit unions share back-office operations, policies and procedures and cross-guarantee systems with other credit unions to a much greater degree. Legislation should recognize this not as a violation of anti-trust principles, but as credit union cooperation within a non-competitive framework.
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Conclusion

While not unscathed, credit unions in most markets have performed reasonably well in this current crisis in comparison to other financial institutions. This is due in part to relatively straight-forward operations of most credit unions, their ability to focus on member service as opposed to short-term profit maximization and the conservative nature of credit union executives and their regulators.

In summary, to enable credit unions/cooperative banks to continue to grow in sustainable and prudent manner they should 1) be supervised by a well-resourced government agency responsible for the financial sector, 2) have regulatory systems that seek to achieve balance by recognizing the unique nature of credit unions in the areas of minimum start-up capital, capital structure, servicing small accounts and loans, allowing the use of non-traditional collateral and their governance structure, and 3) operate under credit union/cooperative bank-specific legislative.

Together these actions can ensure a vibrant and resilient credit union system that actively contributes to the attainment of the Millennium Development Goals.