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A Newsletter Published by the Financial Sector Vice Presidency

Access to Finance Thematic Group

Regulation and Supervision of Cooperative Financial Institutions – The Debate over Delegated and Auxiliary Supervision

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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.

Lack of knowledge of CFI governance, regulation and supervision has been a recurrent obstacle in development finance, resulting in widespread neglect of the CFI sector in spite of its pervasiveness and potential. In addition, 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 refer to 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. Of these many issues, this note focuses solely on the debate associated with indirect supervision, i.e., delegated and auxiliary supervision mechanisms.³

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 regulation and supervision (R&S) of CFIs. It has been consistently supported as a viable concept by some and sharply rejected by others.⁴ 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.

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.

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. To complicate matters auxiliary/delegated monitoring seems to be an arrangement that is unique to *mutual* (not only cooperative) organizations.⁵

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.

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. Networks of CFI (federations, leagues, unions, etc.) are in fact input pooling alliances designed to consolidate across CFI the procurement of inputs required to perform the intermediation function. The purpose of the alliances is to limit risk and exploit economies of scale in the procurement of inputs. The pertinence and complexity of the pooling alliance increases with the range of financial products CFIs offer.⁶ As in any alliance of business enterprises control mechanisms that insure contracting parties' compliance with the terms of the agreement (often called "private ordering mechanisms") are necessary to prevent opportunism and insure minimum standards of performance by all parties. The types of ordering mechanisms vary. The more complex the alliance, the more advanced and effective must the private ordering mechanisms be. CFI movements – starting with W. Raiffeisen--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. But 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 respect of the terms of 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. 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 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 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 TCE to analyze regulation, the tremendous difficulty of estimating these costs makes results unreliable. Rather, the recommended approach in the literature 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.⁷ Consideration should be given to alternatives such as private ordering mechanisms –created for the purpose of managing the alliance—and public mechanisms. 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 perceive indirect supervision as likely to minimize the transaction costs of the regulation function.

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 (or member-manager agency conflict), a 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. Thus, private ordering mechanisms built into CFI networks will favour collaboration with regulators. This mechanism is, of course, weakened if the CFI network is corrupt and controlled by entrenched bureaucrats. This is likely to be the case in CFI systems that have been manipulated by governments for social or political reasons or built in a top-down approach.

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 reasons presented above, this risk will be particularly serious in networks with weak governance and entrenched management or a strong borrower-bias induced by intense subsidized government financing.⁸ 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 oversized member of the alliance. These are also the CFIs that 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.⁹ In fact, in Germany it has already been in place for nearly 130 years. Interestingly, between 1889 and the late 1920's two schemes of indirect supervision existed in parallel: (i) for CFIs affiliated to a federation, the federation performed the supervision of the member CFI (auto-control); 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 leaving auto-control as the only allowed schema but increasing the power of the auditing federations. That was changed later into “delegated supervision” when banking authorities expanded the banking powers of the CFI and put them under their indirect control.¹⁰

Table 1 below 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 use here, 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. And 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).¹¹

Table1: Classification of regulation and supervision approaches

		<i>Cooperative</i>	<i>CFI Specialized</i>	<i>Banking</i>
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), Finland, France, Germany, Ireland, Italy (BCC), Netherlands, DC: Albania, 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		

IC: industrialized countries; DC: developing countries.

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.

Notes:

- (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.

Synthesis of pros and cons

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.

References

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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. Interested readers are encouraged to see the Working Paper for a comprehensive review of the other issues.
 4. 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 (e.g., British Columbia, Canada and Ireland).
 5. 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.
 6. This aspect of CFI systems is explored in more detail in the Working Paper.
 7. This is also the approach advocated by Kane (1997).
 8. Borrower-bias is a term used in situations where the equilibrium between borrowers and savers (suppliers and demanders of funds) becomes distorted by (usually) external factors, such as excessive external financing, particularly if this is subsidized, and controlled rates that depress both savings and lending rates.
 9. See *AccessFinance* Issue 7 (September 2005) for a description of a World Bank supported program in Albania.
 10. 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.
 11. 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.