REGULATION AND SUSTAINABILITY OF COOPERATIVE BANKS: A CROSS COUNTRY STUDY

INTERNATIONAL COOPERATIVE BANKING ASSOCIATION

INTERNATIONAL COOPERATIVE ALLIANCE

BRUSSELS

REGULATION AND SUSTAINABILITY OF COOPERATIVE BANKS: A CROSS COUNTRY STUDY

CONTENTS

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FOREWORD

The present cross-country comparison of the regulations and sustainability of cooperative banks provides a comprehensive overview of the features, strengths and weaknesses of these member-based social organizations and of applicable regulations and supervisory arrangements. It was prepared by the International Cooperative Banking Association (ICBA), which encompasses over 40 cooperatives banks from around the globe. While building on a thorough review of relevant literature, the study clearly draws from the rich experience of ICBA and its members, who operate in very diverse environments.

The document emphasizes the nature of cooperative banks as stakeholder banks, which have some advantages if compared with shareholder banks in terms of their orientation to serve households, farms and small firms. It describes in detail the different models that these institutions have pursued to overcome the challenges that arise from their origins as local self-help organizations, considering their advantages and disadvantages. In addition, it looks at the specific characteristics of their governance structure, which -similarly to the governance of private of private commercial banks- can fail without adequate internal controls and external oversight. When looking at the regulatory and supervisory environment as well as at the access of cooperative banks to financial safety nets, the note highlights the need for a proportionate and adequate approach that considers the risk profile and characteristics of the cooperative banks. It stresses that especially smaller institutions should not be over-burdened with regulatory and reporting requirements, which are oftentimes designed to deal with the risks of large systemic institutions. In general, cooperative banks should be overseen in a way that ensures their sound operation. Furthermore, cooperative banks should have access to the financial safety nets that are available to commercial banks such as deposit guarantees or emergency liquidity arrangements, which can be very valuable to deal with crises such as the on-going situation in consequence of the COVID-19 pandemic.

To conclude, this is a very valuable text for international organizations, financial sector authorities as well as for practitioners engaged with cooperative banks. I would like to commend the authors for drafting a rich document that provides valuable insights, lessons and considerations to be taken into account by local financial sector authorities when drafting or revising the laws and regulations that govern these important member-based providers of financial services.

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International
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Bruno Roelants
ICA Director General **31 July, 2020**

PREFACE

Cooperatives are people’s organisations that respond to different socio-economic needs and aspirations (which are a type of need) of its members and customers more particularly needs concerned with their work, business, agricultural production, consumption of essential goods, housing, credit etc.

Among these, the need for funds for carrying on an economic activity (production) and meeting consumption expenses has been predominant since the industrial revolution, as it is today. Cooperative banks appeared in the 19th Century in the then mainly rural Germany, to meet the financial needs of poor farmers/artisans, and in the process helping them out of the usurers’ grip, out of the informal or semi-formal economy, thus creating strong bases to Germany’s eventual industrialization.

Cooperatives are organised for many purposes/objectives. However, because of their ability to meet the most fundamental socio-economic need for credit and other financial services among ordinary people, cooperative banks / financial cooperatives have become one of the main types of cooperatives existing in the world, and simultaneously financial institutions with the highest level of capillarity. The fact that they lend mainly to individuals and SMEs, and thus remain deeply rooted in to the “real economy”, is nothing more than the consequence of their responding to this fundamental need of human beings for credit and other financial services.

As associations of persons (and not of capital) that are need-based (with the members being the same ones as the ones meeting their needs), cooperatives necessarily rely on a type of governance which is specific and has to be implemented through developed governance skills and tools. The paper “*Regulation and sustainability of cooperative banks: a cross country study*” shows very clearly that, in cooperative banks like in other types of cooperatives, governance is not only based on an “assembly” type of democracy, but also on checks and balances, where the general assembly, the board and the executive function in unison like the three arms of any republic. The most successful cooperative banks are also those who have managed to develop best of these checks and balances.

Further, , as the paper shows in a very convincing fashion, successful cooperative banks are usually also those that have managed to create horizontal groupings among themselves, with links among them having different modalities and levels of intensity, but always applying the 6th cooperative principle of cooperation among cooperatives in a very operational and entrepreneurial fashion. This has been key to withstand competition with other banks and financial institutions at a time, like today, of large mergers and acquisitions in the banking sector. This networking among cooperatives has enabled them to maintain their local and regional presence. In spite of certain mergers among local banks due to financial reasons and in spite of electronic banking, this local character has maintained itself largely, and the presence of cooperative banks in many villages around the world bears witness to the fact that members-clients still need some form of physical presence of local branches.

Local presence is also important to ensure a certain level of participation to general assemblies. Although the percentage of members who attend the general assemblies of cooperative banks is generally low in relative terms, the absolute numbers are often impressive and are part of one of the most conspicuous types of gathering in the world: it remains a matter of wonder that tens of thousands of citizens in a given country care to attend a general assembly of a cooperative bank. These members are usually representative of the different components of society and can thus also provide a strong feedback regarding ordinary people's financial needs in a given community, as well as their aspirations as to how the financial services should be delivered. This provides cooperative banks with a strong competitive advantage, but it also provides the financial system with a strong element of stability.

In this regard, the argument or proportionality advocated in this paper is a fundamental one, and it is the responsibility of regulators to ensure appropriate differentiated regulation for cooperative banks in order to preserve the stability of the whole financial system, considering that, in the countries considered in this paper, financial cooperatives make up 5% to 40% of the financial market: these countries can ill afford to lose them, particularly as these banks are more involved in financing farmers and SMEs

In its approach to cooperative banks, the regulator often tends to make a confusion between the concepts of "level playing field", which means providing different types of actors with the same access to markets, and "one size fits all", which, in reality, means the uniformization of different economic actors around one which is perceived as being a dominant one, independently of the characteristics of the other ones. Cooperative banks need a genuine "level-playing field", not "one-size-fits-all" regulation.

The 2008 financial crisis has revealed in all its depth, for the first time in history, a new world which is finite and interdependent, crisis-prone and unstable, and where speculation speeded by computers/technology can create financial earthquakes in a fraction of a second. In sharp contrast the cooperative banks and other financial cooperatives are not exposed to high risk speculation, except when the people in charge deviate from the cooperative principles. The report cautions on too much dependence on company form of organisation and argues strongly that there should be different organisation and differential regulation. It would be interesting to ponder on what would be, to the stability of the global financial system, and to the economy and society, the cost of not having cooperative banks / financial cooperatives in the world.

I congratulate International cooperative Banking Association (ICBA) , of International Cooperative Alliance (ICA),under the Presidentship of Bhima Subrahmanyam, did a commendable exercise in the overall interests of Cooperative Banks/Cooperative Financial Institutions.

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PRELUDE/ACKNOWLEDGEMENTS

International Cooperative Banking Association (ICBA) is one of the eight sectoral associations of International Cooperative Alliance (ICA). ICBA has been rightly conceived to perform as representative of Co-operative Financial Institutions(CFIs) and Cooperative Banks, affiliated, directly or indirectly to ICA. The main objectives of ICBA are a) to facilitate the promotion at the international and regional levels of the distinctive cooperative values of cooperative banks and of the advantages of using them over other banks b) and to facilitate and encourage the exchange of information amongst members on key cooperative banking issues and foster inter-cooperation in the finding of solutions.

ICA took decision to revive & activate ICBA in October 2019.During the meeting of the Board of Directors of ICBA, held on 14 October 2019 at Kigali, Rwanda, in my capacity as elected President of ICBA, I emphasized the need to concentrate more on replication of best practices in cooperative banking sector at the international level. I have also advised the need to address more on the important issues such as Regulation, Supervision, Monitoring, Lobbying etc. aimed to ensure financial stability of Cooperative Banks and CFIs. This includes Technology Adoption, Payment Platform, Credit delivery channels, Digitalization, Financial structures, Accounting Standards, Cyber security measures, Fraud Monitoring systems etc. The need to focus attention on preparation of Articles, occasional papers, carrying out research studies etc. on cooperative banks and CFIs has been further impressed upon by me.

In order to work out a specific action plan & strategy, it becomes essential to commission a systematic study of Cooperative Banks & CFIs to begin with, on at least few important aspects. Therefore, a search began, for a talent as consultants who can take over the responsibility of undertaking a study on Cooperative Banks/CFIs with a main focus on Regulation & sustainability. After a long search, I came in contact with two consultants, retired from formal service as Chief /Senior most executives in India, who had an excellent exposure in the areas of our look out. A brief profile of these two consultants is given in the next paragraph. Discussions on proceeding with the commencement of study have been initiated in April 2020. It has been mutually agreed to carry out the study based on the available secondary sources. It has been also decided to elicit the information by establishing contacts with the members of ICBA. The consultants have agreed to carry out the study based on the information available from the Cooperative Banks/CFIs in countries namely France, Netherlands and Poland in Europe, Kenya and Nigeria in Africa , Bangladesh, India and South Korea in Asia, and USA. The web resources of European Association of Cooperative Banks (EACB),ICA,ILO, Bank for International Settlements (BIS), etc. have been thoroughly searched for relevant data & information. Member institutions of ICA/ICBA have been consulted on certain important matters more particularly on Principle of Proportionality in Regulation. The tremendous task of finalising this kind of study has been made possible because these consultations.

The prime consultant to the entire assignment is Dr. R. Bhaskaran. The tasks of Collecting, collating, compiling the information, continuously browsing innumerable number of websites in search of most relevant data, analysing the data, drafting the report, sharing the same and editing the report to finalise have been very well executed by him. He was CGM in National Bank for Agriculture and rural Development (NABARD) and later served as CEO Indian Institute of Banking and Finance. Prior to this, he was Chief General Manager in NABARD. Dr Bhaskaran was a member Board of Supervision for cooperatives with NABARD for 4 years. Author of a few books on Banking and Risk Management and he has prepared risk management and investment policy for many State Cooperative Banks in India. Last year, he has undertaken research commissioned by NABARD on the legal and regulatory aspects of rural cooperatives and also written a book on “Governance Practices in Rural Cooperative banks” for Bankers Institute of Rural Development (BIRD) to be used as study material for capacity building of Directors of Cooperative banks. He has also developed India’s country profile covering the entire gamut of Cooperative banks/Cooperative financial institutions. The entire report has been prepared and edited by him. We are very much pleased to acknowledge and record our appreciation towards his contribution to complete the current study assignment.

S Padmanabhan, was Ex. Chief General Manager, NABARD. He worked both in the Reserve Bank of India (RBI) in 1982 and later in NABARD . His areas of specialization included IT services, Corporate Planning, Training systems. He prepared the status of cooperative banks in eight countries in the form of country reports. which have been published separately. All these country reports have been edited by Dr. Bhaskaran. The words “Cooperative banks’ used in this article cover all forms of financial cooperatives including credit unions.

There are many others who have been associated with the study in terms of providing information and offering suggestions /comments/Feedback. They are listed as follows:

1. Ms. Ferrand Isabelle, CEO deputy of the Crédit Mutuel Central body, France 2. Mr. George Magutu Mwangi, Chairman, KUSCCO, Kenya 3.Dr. Eng Mieczyslaw Grodzki , President, Board of National Cooperative Council(NCC),Poland 4.Dr. Adam Piechowski, NCC, Poland 5. Dr. Andreas Kappes, Director General, DGRV & Secretary General, IRU. 6.Mr.Bjorn Schrijver, Senior project Manager, Rabo Partnerships, Rabobank, Netherland, 7.Dr. Ahmed Mohiuddin, Bangladesh Samabaya Bank Limited .

8.Mr.Hong Gwangseog, NACF, Deputy Secretary General, ICAO, South Korea, 9.Mr. Santosh Kumar, Legislation Coordinator, ICA and Dr. J. S. Hanamashetti, Secretary, ICBA.

The ICBA shall initiate and encourage worldwide discussion and constructive resolution of the crucial issues that emerges out of the conclusions of the present study and also shall disseminate best practices amongst members and encourage co-operation between them.

31August 2020

Bhima Subrahmanyam

President
International Cooperative Banking Association

Regulation and Sustainability of Cooperative Bank: A Cross country Study

ABSTRACT

This report about the constitution, regulation, role, market share, contribution and importance of cooperative banks in USA, Europe (Germany, France, Netherland, Poland), Kenya, Sri Lanka, Bangladesh, USA, India and other countries is based on information, data, press coverage, articles/essays available about them in the portals of Regulators, Banks, Cooperative Departments and Cooperative Bank Associations. Cooperative banks/financial cooperatives play an important role in the banking sectors of these countries and their market share in banking ranges from 5% to 40%. Generally cooperative banks are registered under cooperative law of the country and regulated by the banking regulator.

Though not explicitly stated and shared, there is some proportionality in regulation of these banks. Apparently Cooperative banks are more closely regulated than Cooperative Unions. Within this, regulation varies from country to country and ranges between Basel I and Basel III norms with some customisation and modifications in each country. IPS and similar structures have an impact on regulation and supervision. It appears that proportional regulation is derived (i.e. (+) or (-)) from the regulations applicable for commercial banks and systemically important banks. It appears that, generally, regulators are more comfortable with "Company/Corporate' form of organisation. As such there is no evidence of any work being done on understanding risks posed by cooperative banks particularly from stability angle for arriving at appropriate norms for cooperative banks. Almost all regulators seem to nudge the cooperative banks towards consolidation and move towards a "too big to fail" model. In this regard more the capital more the strength seems to be the approach. The term 'too many to fail' is in vogue but not how they should be regulated. This has resulted in demutualisation of big cooperatives and distancing the member from the cooperatives. Cooperative banks in many countries are feeling strained on account of lack of level playing field in regulations. The margins of the cooperative banks are under pressure and compliance cost is on the increase. The study has shown that barring GSIB/DSIB banks the rest of the cooperatives (most of them) are less systemically important and pose no threat to financial stability. At the same time cooperative banks are important for financial inclusion because, though their overall market share is around 10% and 20% their contribution to financial inclusion is high due to higher share in the in the credit flow for agriculture, SME and small business. This aspect is very important for the growth of the countries. Further, as these banks do not pursue profit maximisation goal the quality of Governance, with reference to financial stability, has been much better than commercial banks. Occasional governance failure is more due to the board teams at a given place or point of time than any sector specific issue or shortcoming. In view of this, the sector's demand for appropriate proportional regulation should be heeded to. As per Basel methodology, regulatory norms are applied with reference to balance sheet data. Compliance is also linked to a specified date. Since a bank is a going concern, it is recommended that instead of 'one size fit all', "norms" could be linked to market share, business mix, deposit insurance, bank size, contribution to financial inclusion, performance in some key area of risk management and future plans. Also banks which are very small may be kept outside the ambit of regulation till they reach a threshold level of business. Strong cooperative banks are needed for financial stability.

1.1: Cooperative Banks/Financial Cooperatives

Introduction

Cooperatives have a long history. Cooperatives, as business organisations are/were formed through spontaneous efforts by people to help themselves in carrying on economic activities. These are institutions are established and run by their members for a mutual and common purpose, including banking. Cooperatives as business organisations, be it farmers' cooperatives, milk producers' cooperatives, home owners' cooperatives, cooperative banks/financial cooperatives[1] etc., are well recognised by Governments of almost all countries by enacting cooperative laws that enable them to own property, trade, borrow and lend money. Cooperative law is common for all types of cooperatives. However in view of licensing norms and regulations that banks have to comply and/or adhere, cooperative law in some countries have some special/exclusive provisions for cooperative banks.

Cooperative Banks are important players in the financial market/system of almost all countries around the world. They offer savings, credit, remittance and other financial and non-financial products and services to members and other customers. The basic activity that distinguishes a bank from other societies/businesses is 'accepting deposits' from 'non-members'. There are at the same time, cooperatives which accept deposit from non-members as well and deal in credit but are not named as banks. As per International Association of Deposit Insurers[2], financial/deposit-taking credit institutions include (a) Credit Unions aka "Caisses", (b) Mutuals, (c) Cooperative Banks, (d) Savings Banks/Savings and Credit Associations-Organisations, and (e) Rural Banks/Community Banks. These are all called as financial cooperatives. There were, as of December 2018[3] more than 18500 financial cooperatives in the world serving nearly 272 Million members/customers.

Banking business can be carried on by licensed cooperatives or companies[4]. In common parlance, banks which are organised in company format are called as commercial banks. Though they offer similar products and services like commercial banks, cooperatives carrying on banking business are called cooperative banks mainly based on the type of organisation. The expression cooperative banking includes all banking institutions promoted as cooperatives and regulated by the country's banking authorities. In many countries cooperative unions/societies and cooperative banks have federated themselves and formed networks with a central organisation. In some countries village level credit societies may not be regulated[5] nor allowed to seek public deposits. Also there could be employees thrift and credit cooperatives (similar to SACCOs but with no retail and SME lending) which are not banks and not regulated.

Financial cooperatives were formed, long back out of necessity to finance agriculture and SME. Over the years, finding it difficult to meet all the credit needs of their members, some of them started accepting non-member savings and also sought borrowings. In the asset side their focus was primarily on loans to members and very few of them ventured to investments. In most cases, their bye laws limited their activities to credit for activities carried on by their members and therefore they did not undertake all banking activities. (This continues till date with most of the cooperative banks). Eventually, as banking industry got organised, acceptance of deposit from public brought them under banking regulation. Over the years on account of growth and periodical changes in the rules and regulations some of the cooperative banks, today, function almost like big commercial banks and undertake all banking business. Some of them are even classified as globally/domestically systemically important institutions.

In terms of number of products offered there could be some- though not much- distinction between cooperative banks and commercial banks. But in terms of business style and orientation a clear distinction between them is that cooperatives are "Stake Holder Banks" while commercial Banks are "share holder banks". This is because;

a. Cooperatives are 'for profit' organisations but 'not for profit maximisation'. It is well recognised that no business can survive without profit but profit maximisation is not a precondition for business sustainability. In view of this and being member oriented profit maximisation is not an objective of cooperative banks. In this they are supported by the fact that the main reason for a person to take membership in cooperative banks/unions is not return on investment in shares of the cooperative but getting credit and other banking services. As such profit maximisation is not the main objective.

b. Cooperatives offer credit and other financial services on reasonable terms to meet the needs of their members/customers. This ideology is derived from the point above. As profit maximisation is not a goal these banks are able to offer rates viable for them and their members.

c. Unlike commercial banks which may not have a regional, product or activity bias cooperative banks could have specific regional (limited area of operation) or customers (say farmers or SMEs or retail customers) or activity (housing finance, Insurance, SME finance) focus.

In terms of vision and mission, these banks are conservative, confined to limited products and business. They are close to their members and are important providers of financial services in the villages. Their importance has increased after the Global Financial Crisis because they did not fail or suffer as much as the commercial banks[6] though they deal with more vulnerable section of population and have high co variance risk. It has been well documented that they were not severely impacted by the GFC because, majority of them did not indulge in originate to distribute model of banking. As such, most of the cooperative banks withstood the financial crises[7] more efficiently than other banks. In this regard RABO bank has observed that "All large co-operative banks suffered substantial losses on more risky investments. But by comparison with private banks they appear to have been dealt only a glancing blow by the immediate effects of the crisis. These co-operative banks escaped relatively unscathed from the crisis thanks to their unique characteristics, not least in terms of their corporate governance". However, being part of the financial system contagion did impact some of the cooperative banks. It is a matter of record that most of them[8] could manage whatever impact they faced on account of contagion because their members came to their rescue. Thus they did not need the government bailout which was the case with commercial banks in many countries. An ILO report[9] on European and other cooperative banks points out that cooperative bank performed better than commercial banks during the financial crisis of 2007-2008. It observes that "The cooperative banking sector had 20% market share of the European banking sector, but accounted for only 7% of all the write-downs and losses between the third quarter of 2007 and first quarter of 2011". The report points out that, in the 10 countries covered by its report, cooperative banks had a higher share in lending to small and medium-sized businesses.

Till the GFC, cooperative banks in many countries were not regulated as closely and rigorously as commercial banks; the focus of regulation being limited to Deposit Insurance and Minimum Capital. For that matter, till recently, even the regulation of commercial banks was also not fully risk oriented. Prior to GFC the most talked about regulation was prudential guidelines on income recognition and asset classification norms, more popularly known as NPL/NPA norms and exposure limits. Post GFC there is a discernible resurgence of cooperative banks on account many customers of commercial banks shifting to cooperatives and increased cooperation among cooperative banks/financial cooperatives. Cooperative banks are also involved in extending retail credit and remittance services. This has led to certain increased regulation and institutional development programmes for the segment. As a result, cooperative banks in Europe have a market share (2018) in deposits of around 10% in Poland to 33% in Netherlands and more than 40% in France. Further, cooperative banks, world over, are playing a very useful role in lending to SMEs[10]. It has been reported that credit unions in the US had five times lower failure rate than other banks during the crisis but more than doubled lending, from $30 billion to $60 billion to small businesses between 2008 and 2016, whereas overall lending to small businesses during the period declined by around $100 billion. Public trust (study of 2016) in credit unions stood at 60%, compared to 30% for big banks.

Characteristics of Cooperative banks/financial cooperatives

Cooperative banks are owned by their members and follow the unique principle of 'one member-one vote'. These banks are registered under cooperative law with an intention to offer financial services (deposit, credit and transactions) to their members and others. As they have to transact banking business these are also licensed and regulated by banking regulator of the country. Cooperative banks are also covered by deposit insurance organisations which could be common for all banks or exclusive for cooperative banks/unions.

Box.1: Cooperative banks/Financial Cooperatives. Distinct principles

Ownership:
Co-operative banks are institutions owned by their members/shareholders. These are private initiatives[11]. Most of the members of the society/bank are its customers as well. In fact they become members of the cooperatives, mainly for the purpose of obtaining banking services, most importantly credit, rather than seeking a share in the profit of the bank. They avail savings, credit and remittance products from the cooperative Bank.
In serving its members a cooperative bank will follow a consensus-driven approach. This prevents focus on any 'one or more stakeholders' which could happen in proportionate voting system. This member cum customer centric aspect is a special feature of co-operative banks. It is hard to replicate this outside the cooperative model.

Democratic Governance - One member – One vote.
Cooperatives practice 'one member one vote' rule which means that irrespective of the number of shares held by a member he/she will have only one vote, i.e. all members have equal rights. They have the right to elect the leaders (BOD in the case of companies) or get elected as a leader and have a say in the decisions and policies of their banks. This will ensure that the common interest of the members is the top priority of the banks. In contrast to a company form of management prevalent in commercial banks where governance is mostly by promoters and outsiders, customers and members of a cooperative bank can be a part of its governance structures such as Board, Committees and General Assemblies.

Members' benefit/surplus and long term relationship:
Compared to investor or shareholder owned commercial banks, which are primarily focused on maximising shareholder profit, co-operative banks are focused on maximising the value for their members' i.e. provision of financial services to members, customer satisfaction, earnings stability, etc., in a non-speculative, long-term strategic way.

Sustainability and Resilience:
Co-operative banks are stake holder banks and pursue a policy of low risk appetite than shareholder-based banks. Due to their long-term vision and orientation, they also maintain, on average, higher capital reserves. Their local roots and deep involvement in local economies help co-operative banks to anticipate and quickly adapt to local circumstances. In their history of more than 2 Centuries, co-operative institutions have demonstrated their ability to adapt to changing circumstances and reinvent themselves much faster and more easily than other banks.

Social Commitment:
Co-operative banks have a definite commitment to social values and solidarity. Their aim is to improve their clients' economic status/environment. From 19th century when they were originally created in Europe/UK to solve the problem of financial exclusion of social groups and alleviate the plight of rural populations, till date when cooperatives are spread all over the world, co-operative banks are part of the economic and social environment of their customers. In this connection it is noteworthy that majority of the cooperatives/banks set aside a portion of their earnings to invest in local economic initiatives that would benefit their members as also the local community

Customer connect:
Co-operative banks are committed to creating value for their customers, members and society at large. In these days of changing client behaviour, disruptive technology and a complex economic environment, value can be created only through enduring relationships with all stakeholders and efficiently responding to client needs. In this milieu, co-operative banks are

involved in sustaining the real economy by creating and fostering local jobs and giving local communities the means for their own social and economic development.

Among the financial cooperatives, systems and procedures of cooperative banks are well developed and more integrated than credit unions/societies. Co-operative banks select their own boards of directors and manage their own operations. Cooperative banks could be of varied sizes starting from a stand-alone bank to a regional village and a central institution in a networked system. The network offers liquidity and other support to the local stand alone or regional banks. The central units operate like a commercial bank and participate as lenders and investors in money, bond and equity markets. However, if these banks are part of a network or federation then strategic decisions could require approval from their central office. Depending on the depth of the networked/integrated system and understanding, standalone banks/credit unions may also take strategic decisions at a local level. Generally board of directors of the bank are chosen from the members. Some banks induct outside experts as independent professional directors. In some countries regulators stipulate that Board of Directors of cooperative banks should be independent and professional.

A shareholder of a company cannot redeem shares with the company but can access the stock market to sell or buy his/her shares. Unlike this, shares of cooperatives are redeemed on request but not traded in the market. (However there are a few instances where shares of some demutualised cooperative banks are traded on public stock markets[12]. In such cases member control is diluted by these outside stakes). In view of this a member can only seek redemption of the shares. This could reduce the capital funds of the concerned bank though new members could be inducted. In order to augment capital some cooperatives have two types of members namely member with voting power and nominal members who may not have voting powers or become a managing committee member.[13]

Box.2: Types of Financial Cooperatives:

There are many varieties of financial cooperatives. Not all of them use the word "bank" in their name. Also whereas all banks are regulated some of the FC's who do not use the word "Bank" in their name could also be regulated as they do banking activities. The following are the varieties of Financial Cooperatives.

a. Credit unions/Credit Societies[14]: Credit unions/Societies[15] are established with the objective of promoting thrift, providing credit as also other financial services, to members locally at reasonable rates. These cooperatives could be promoted by persons who are from a given locality, employer[16], religion or economic activity. Heart of England Co-operative Society (UK), Primary Agriculture Credit Societies of India (not allowed to accept public deposits) and SACCO of Kenya are examples of credit societies. Members of credit societies contribute to the share capital, save money with it, take credit or loan and also do financial transactions.
   Credit Unions are typically (though not exclusively) a smaller and localised version of cooperative banking institution. Generally they lend to members for identified purposes such as agriculture, SME and home loans and at times personal loans. Most of these loans are unsecured barring home loans which could be based on mortgages.
b. Cooperative Banks: Credit Unions grow to become a cooperative bank due to increased demand for funds. Credit unions, which are allowed to accept deposit from public, are called cooperative banks.
c. Cooperative land development banks: These are special cooperative credit institutions-providing Long Term Loans called Agriculture and rural development banks (ARDB)[17]. The objective of these banks is to finance farmers for investment (long term loans) in agriculture equipment, land development etc. Though named banks, these societies cannot accept deposit from public and cannot offer transaction banking.
d. Building societies: Building societies function in Britain, Ireland and several Commonwealth countries. These are formed by members whose primary requirement

is credit for constructing or buying a home. These societies extend credit on home mortgages. They also provide certain retail banking services, such as current accounts, credit cards and personal loans. UK regulations permit these societies to access market funds (debt) to extend credit on mortgages.

A cooperative bank, which accepts deposit from public (non-members), has to be licensed by the banking regulator of the concerned country. Cooperative Credit Structure/models are not uniform across the countries and various types/forms of financial cooperatives namely cooperative unions, banks etc., as mentioned above (box.2) exist in various countries. Brief[18] note on cooperatives in some countries is given below.

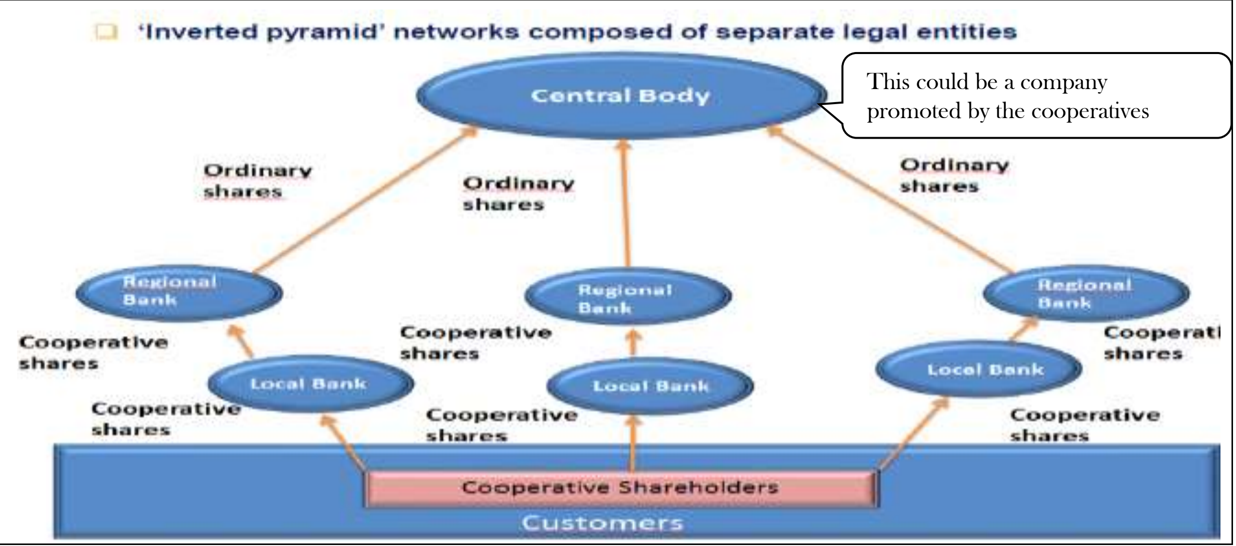
Canada[19]: Cooperative banking in Canada is provided by credit unions. These are structurally similar to banks. Nearly half the economically-active population of Canada are members of these credit unions (caisse populaire[20]) one of the highest penetration rates in the world. There are around 700 credit unions across Canada, with the highest membership in Quebec and the western provinces. These credit unions operate in large number of Canadian communities and are governed by cooperative members and volunteer directors. As at the end of 2018 these unions had more than 10 million members, held more than $320 billion in assets and employed more than 60,000 people. Most of these credit unions are covered by provincial laws which stipulate as to how they can lend, borrow, and invest. Insurance for deposits is offered by provincial corporations or non-government insurers.

United Kingdom: In Britain, building societies which were formed for extending loans for houses (construction or purchase) eventually developed into general-purpose savings and banking institutions with 'one member, one vote' principle. Many of these have been demutualised into conventionally owned banks in the 80's and 90's. The well known 'Co-operative Group of UK' includes, 'the cooperative bank' which despite its name, is a commercial bank partly owned by a holding company which is a co-operative. Northern Rock is a well-known cooperative institution which started as a building society and later demutualised itself into a bank. It failed during global financial crisis due to the 'originate to distribute'[21] model. Credit unions in UK are loan and savings co-operatives. These are regulated by the Financial Services Authority (FSA). FSA sets certain standards and approve the people who hold important positions within a credit union. All credit unions must have the words 'credit union' in the title.

Europe: Cooperative banking in Europe is well entrenched. Leading cooperative banks of Europe are (a) 'Credit Agricole' 'Credit Mutual' 'Banque Populaire' and 'Caisse d'epargne' in France, (b) 'Rabobank' in Netherlands, (c) 'BVR/DZ' bank in Germany', (d) 'Banco Popolare' and 'UBI bank' in Italy, and (e) 'Migros' and 'Coop Bank' in Switzerland. All of these are based on Raiffeisen model/system of cooperative banking. As on December 2018[22] there were 2816 cooperative banks in Europe with 53282 branches. These banks with € 7 trillion in assets and € 3.7 trillion in deposits served 209 million customers and 83 million members. They had 20% market share in deposits and 30% share in financing SMEs and (Coop banks in France had more than 40% share in the market) and employed about 0.7 million people. It is noteworthy that some of the banks in Euro area are globally and domestically systemically important and come under Basel III norms. It is seen that standalone Cooperative Banks in Europe do not deal with all products offered by universal (commercial) banks, whereas some of the bigger cooperative banks offer almost all products offered by bigger commercial (universal) banks. It should be mentioned here that, in Europe, systemically important cooperative banks are supervised by BAFIN (European Regulatory Authority) while other banks are supervised by National Regulators like Deutsche Bundesbank in Germany. It is noteworthy that Germany and for that matter Euro countries consider Cooperative banks as an important pillar of the financial system. It is indeed recognition of the role played by cooperative banks in their countries.

One of the important components of cooperative banking system in Europe is the Institutional Protection System where in the central bank or higher tiers of banks help and monitor the smaller, regional and local coop banks. IPS structure ensures liquidity and/or solvency support to affiliated cooperative banks, in case of need. IPS is recognised by the regulator.

Figure.1: Illustration about the cooperative Banking Structure in Europe/France[23]



<u>Poland:</u>[24]

In Poland, there are two broad categories of banks. (i) those with capital above € 5 million and comply with the standards applied to commercial banks to operate nationally as independent entities; and (ii) (a) those with minimum capital between € 1 and € 5 million euro and operate, only regionally and (b) those with capital above € 5 million but do not comply with all applicable standards to be treated as independent entities.

The share of cooperative banks and credit unions in the country is less than 8 per cent of depositors but about 18 per cent of the population. Most cooperative banks and credit unions in Poland are stable. The supervisory arrangement for cooperative banks is evolving to a "supplementary" supervision model. The FSAP is broadly supportive of the policy direction for cooperatives. Yet it is not comfortable that credit union could be "standalone". Banks and Credit Unions have different Regulatory Capital Ratio. Banking authorities in Poland are encouraging cooperative banks be part of an Institutional Protection Scheme (IPS) that includes an affiliating joint stock bank. Two cooperatives are the exception to integration into an IPS, as both have achieved independent status. The IPSs is complementary to Polish Financial Supervision Authority (PFSA).

Singapore: There were 27 credit co-operative unions in Singapore (2013). They had 142,000 members, SGD $756.5m in members' deposits and SGD $14.6m in members' share capital. The net assets of credit unions also reached SGD $153m, while total loans given out by credit co-ops amounted to SGD $185.5m. Credit co-ops form just one of three co-op categories in Singapore. These are regulated by the Cooperative Department.

United States of America

In US cooperative banking is offered by cooperative banks and credit unions that are owned and managed by its members. All members have accounts in the union/bank. Credit Unions USA could be chartered under state or federal law. There were[25], as of December 2018, 5684 credit unions in USA with 112 million members, deposits of US$ 1.17 trillion, Credit of US $0.97 trillion, and total assets of US$ 1.39 trillion. It is reported that this sector had 1/5th failure rate during the GFC in comparison to commercial banks. As indicated earlier, this sector has more than doubled lending to small businesses (from $30 billion to $60 billion) between 2008 and 2016, while overall lending to small businesses, during the same period declined by around $100 billion. Public trust (2016) in credit unions stands at 60%, compared to 30% for big banks and small businesses are five times less likely to be dissatisfied with a credit union than with a big bank. Credit unions of USA commonly network with two types of second tier facility. The first is the 'corporate credit union' (CCU) a type of cooperative union network, which helps their member societies and unions associates to enhance their efficiency through economies of scale. The second network is known as "credit union service organisations" (CUSO) which can have inter-institution transactions and offer support.

<u>Africa</u>[26]

Africa has both cooperative banks and unions. Common form of credit union is "Savings & Credit Cooperatives (SACCO) or SACCOL where L stands for League". SACCOs are popular in Kenya, Uganda, South Africa and Malawi. SACCOs in Kenya have 14 million[3] members with Ksh 600 billion in deposits and Ksh 800 billion in assets. In Uganda, over half million adults were SACCO members (2013). As per AMFIU's (Association of Microfinance Institutions of Uganda) report[4], there were 2,000 MFIs and SACCOs in Uganda. Fin Access survey (2016) conducted in Kenya, showed that 66.4% adults use savings/deposit instruments. This includes MFIs, SACCOs and bank accounts. Sacco's are not very successful in Uganda and face many challenges. In the West African region (8 member countries, and some 80 million inhabitants) cooperative society is the dominant legal form of MFIs. It is reported that they cover about 10% of the population. South Africa has three cooperative banks which are regulated by a separate division of South African Reserve Bank. The need for cooperatives to play an active role in financial sector is very much felt in Africa.[27]

The Co-operative Bank of Kenya Limited (Co-op Bank), founded in 1965, is the second largest local bank in the country by volume of customers. It is a demutualised cooperative bank. The bank offers value-added financial services, with special emphasis on Savings and Credit Cooperatives (SACCOs) through a growing and effective network of service points, excellent customer service and a highly motivated team of qualified personnel

Box.3: Cooperative Bank and Microfinance Institutions
Microfinance institutions could be organised on cooperative basis. A Thrift and Credit Society (T&CS) is an example of microfinance carried out in cooperative method though the concept of T&CS is much older than the concept of a Micro Finance Institution (MFI). Cooperative banking differs from modern microfinance. In case of MFI there is no concept of membership and therefore no role for the members in managing the institution. MFI members are not entitled for a share in the profit. In most countries, unlike cooperative unions, MFIs cannot accept deposits. Deposit taking MFIs are regulated. Even if MFIs are allowed to accept deposits, given that most of its members/borrowers come from the same economic strata, it will be hardly sufficient to meet the needs of the MFI. Also MFIs are generally for profit organisations they charge a very high rate of interest. <u>Although group lending may seemingly share some similarities with cooperative concepts, in terms of joint liability practiced in MFI, the distinctions are much larger. In issues such as autonomy, mobilization and control over resources, legal and organizational identity, and decision-making cooperatives are substantially different from MFI.</u>

Bangladesh[28]: Most cooperative banks in Bangladesh are those which were formed before partition of India. In Bangladesh there were (2019) 119 cooperative banks, of which 64 are central cooperative banks, 48 are land mortgage banks and the rest seven are other cooperative banks. The maximum share of total assets, namely, 90%, deposits (85%) and advances (90%) are handled by central cooperatives. Credit cooperatives of Bangladesh come under the supervision of the Cooperative society's ordinance under the ministry of Law[29].

India

There are two types of cooperative banks in India, Rural Cooperative Banks and Urban Cooperative banks. Further, Rural Cooperative Banks are of two types namely Short Term Cooperative banks and Long Term Cooperative banks. The short-term credit structure which takes care of the short term (1 to 5 years) credit needs of the farmers, rural artisans, handloom weavers etc., could be (a) a three-tier structure in most of the States viz., Primary Agricultural Cooperative Societies (PACS) for a group villages (cannot accept public deposit), District Central Cooperative Banks at the District level and State Cooperative Bank at the State level or (b) a two-tier in some States namely State Cooperative Banks and PACS. The long term credit structure caters to the investment/term credit needs of the farmers (up to 20 years). Urban Cooperative Banks are for rendering banking services to members. Most urban cooperatives banks are registered under the State Law and offer banking service to their members in a specified area. They are not focused on any particular economic activity. Rural Cooperative Banks are registered under State Law whereas UCB could be registered under State law or Multi State (central) cooperative law. They are licensed and regulated by RBI regarding banking business.

As at the end of March 2019[30] there were 1,544 urban co-operative banks (UCBs) 54 of which were scheduled banks and 1490 Unscheduled. In the rural cooperatives the short term structure had 33 State Cooperative Banks (one State Coop Bank for each State/Province), 363 District Central Cooperative Banks and 95238 Primary Agricultural Credit Society (PACS). There were 13 SCARDBs and 601 PCARDBs. The SCBs and DCCBs being banks can accept deposit from members and non-members. PACS are not regulated and cannot accept deposit from non-members. RBI in its Report Trends and Progress of Banking (2019) observes that "The growth of these co-operative institutions has not been commensurate with that of other constituents of the banking sector in India. At the end of March 2018, the combined assets of urban and rural co-operatives were 10.6 per cent of the total assets of scheduled commercial banks (SCBs), down from 19.4 per cent in 2004-05[31]. Several operational and governance-based impediments have operated as drags on their performance, stunting their growth"

1.2. Models of Cooperative Banks

Right from the time they stated, some two hundred years ago, the focus of cooperatives and credit unions has been on pooling of member resources, and sharing it with others to help continue their economic activities. But with the passage of time and as they started accepting deposit from non-members and borrowing from financial institutions/others to meet the growing needs of their members, these institutions have been subject to regulatory norms and conditions as applicable to banks at that point of time. On account of these and to meet the emerging needs, these banks started changing and evolving into new designs/models. From a spontaneous association of persons to regulated banks it has been a long journey for the cooperatives. Let's understand them closely.

It was earlier said that cooperative banks undertake most of the basic banking functions like commercial banks but are organised in the form of cooperatives. It was also stated that that some cooperative banks in Europe are bigger than commercial banks and some of them international as well. As such, prima facie, other than the form of organisation there is no major distinction between cooperative and commercial banks. But due to organisation and governance style and member focus there are certain differences between cooperative banks and commercial banks. Some of the distinctive features are;

a. Cooperative member has only one vote irrespective of the number of shares held.
b. Whereas a commercial banks shareholder may not be a depositor or borrower, in the case of cooperative banks, members could have multiple relationships with the bank such as depositors, borrowers and some of them may also play a role in governing the cooperative.
c. At the ground level the governing body or management committee is more closely involved in operations than the boards of bigger cooperative banks which may be confined to policy making. The level of involvement is seen, normally to decrease with the increase in size of the bank.
d. In the case of cooperative banks profitability is not the main objective. Rather offering affordable financial services to members is the main focus. This does not mean that they are 'not for profit organisations'. Profitability is important to sustain their activities and be viable, important to comply with regulatory capital norms. Given this it can be said that maximising profit to distribute to members is not their sole or primary aim.
e. Most cooperatives practice narrow banking and there are certain limitations in the products they offer. Within this, in some countries a clear distinction exists between cooperative banks and credit union/society due to which cooperative banks are allowed to offer financial services not only to members but also to other customers who are not members whereas most of credit unions/societies can offer financial services only to member/owners.
f. Members of cooperatives generally share some kind of common bond among themselves such as a specific profession, activity, employer or geographical location.

Today there are a four or five models of cooperative banks. These models have evolved over the years due to market conditions and regulatory expectations. Early in their journey, cooperative unions/societies realised that they will not be able to meet the full credit demand of its members/customers exclusively from members' savings (member deposits). They needed funds from outside. The first step in this direction was accepting non-member deposits. The next step was market borrowing. To enable these products/services, cooperatives were licensed as banks and brought under banking regulation. As they accepted public deposits these societies/unions were brought under deposit insurance. In some jurisdictions, for their borrowing programme they had to comply with credit rating requirements. In some countries governments/regulators created dedicated funds to finance the members of rural cooperatives[32]. As such the <u>first reason</u> for evolution of different models of cooperative banking is licensing conditions. The <u>second reason</u> is the market share and size. Today the market presence of cooperative banks/financial cooperatives varies significantly across jurisdictions and on an average the market share could be 10% across the world. It is seen that, measured by market share, the relative importance of cooperative banks in various countries ranges from marginal to dominant. For example the share of cooperatives was less than 1% of the financial system's total assets in South Africa, whereas in France it was nearly half the country's financial assets, deposits, and loans. It is noteworthy that, in France, two out of the three cooperative banking groups have been declared as globally systemically important banks (GSIB) and the third one as a domestically systemically important bank (DSIB). The share of cooperative institutions in Australia, Brazil, China and Ireland can be placed at 5% of total banking assets. In Germany, Kenya and the United States, cooperative banks, collectively contribute 8–15% of the respective financial systems' assets. In India during 2018 cooperative banks, as % of business of commercial banks had 8.9% in Deposits, 10.7% in loans and 10.6% in total asset.[33] It should however be recognised that, seen from number of people financed or financially included cooperatives will have a much higher market share. Also in Europe, USA and Japan Cooperative banks/FCs compete directly with other types of financial institutions, be it commercial or savings banks, in providing financial services to retail customers and to small and medium-sized enterprises (SMEs). Cooperative banks of some countries have impressive international foot print and business. Cooperatives will not be able to do all these unless they are regulated, have access to resources and other support.

Table below gives a feel of the differences in size of cooperative banks on some parameters such as total assets, total loans and total deposits etc.

Table.1: Cooperative Bank/FCs in different countries[34] &US $ /€ Billion and # in Million

SN	Country	Number of FCs	Assets&	Loans&	Deposits&	Members#	Customers#
1	Australia	76	83	67	71		
2	Brazil	1006	54	29	32	9.6	9.6
3	China	1173	1200	568	868		
4	France	82	3897	2701	2413	27	65
5	Germany	918	1052	734	929	19	>30
6	Ireland	272	20	5.3	16	3.3	3.3
7	Kenya	174	4.3	3.2	2.9	3.6	3.6
8	South Africa	26	0.03	0.02	0.02	0.027	0.027
9	United States	5646	1416	972	1204	113	113
10	Europe[35] (including 4 and 5 above	2816	€ 7423	€ 4311	€ 3864	83	209
11[36]	India	2548[37]	799	404	645		

The <u>third reason</u> is governance and management structure. One of the fallouts of the growth of these banks is that member involvement has decreased substantially. This is more visible in medium to big size banks where professionals have joined the Boards and top management. The composition of the boards has also changed as governance expectations and guidelines issued by regulators do not distinguish a cooperative bank from a commercial bank. In many countries what the Cooperative Law says about the composition of the Board is at variance with the regulatory expectation. It is obvious that regulators are inclined towards company form of regulation. They do not agree that the cooperative advantage of 'one-member one-vote" that enables good member participation will automatically ensure professional management of the banks. Their concern is that some of the elected members may not be competent to manage a bank!

Increasing complexity of regulation, recent emphasis on capital adequacy ratios, and the need to comply with these norms necessitate changes in the structure of cooperative banks (<u>fourth reason</u>). That many small sized banks could not comply with these norms and found cost of compliance bit high for them, led the way for merger or networking among banks resulting in the way banks were governed and managed. The insistence on networking and IPS by some regulators, as they pursue "too big to fail" model of regulation has resulted in the development of net worked cooperatives and some demutualisation resulting in concentration of more powers with the central offices of networked cooperatives and reduced the autonomy and discretion of local members in management of banks. Even otherwise boards of cooperative banks would have found it difficult to keep pace with ever increasing regulations and compliance.

In some jurisdictions banks have created subsidiaries in company format (exclusively owned by cooperatives or partly owned by cooperatives) as a way of managing the increasing complexity in rendering financial services and use of technology. The underlying strategy is that the subsidiary will take care of the compliance with regulations, managing specialised products, managing international activities; investment banking etc., areas that call for professional management, which a co-op member, if elected to board, may not be able to provide. Evidently, wherever cooperatives had developed federal structure the management of the federation will not be as much member driven as the base level cooperative bank or stand alone cooperatives. All these could increase the distance between the management of co-operative banks and their members. In a sense these developments seem to suggest that only company form of organisation is suitable for banking and as such question the appropriateness of cooperative form of organisation for banking!

Member of a cooperative bank is not bound to bank with it. They can access commercial banks and other sources of finance. In the past such access was difficult due to distance and other issues. Technology has bridged the distance issue and therefore accessing commercial banks for doing business is easy. Technology has changed the banking processes and the face of the banking. In view of this, banks are able to reach rural customers with products delivered through technology and cash less banking. More importantly commercial banks and financial institutions have been able to reach the SMEs and farmers through technology driven banking products like mobile pay, credit cards, prefilled wallets etc structured to suit the needs of the clients and offer 24*7 transaction access. In the past banking was focused on Deposits and Credit (loans and advances) now a 3rd vertical has been added in terms of "Transaction Banking" which is exploding in volumes and is a good source of fee income. There has been an explosion of new products in banking. In the meantime credit and transaction requirements of the members have grown manifold which the cooperatives have not been able to meet fully. Availability of remittance and transaction facilities has become a criterion for the choice of a bank.

Given the above the comparative advantages that co-operative banks had in servicing small farmers and small businesses is no more unique. Cooperatives need to catch up. As such product innovations in the banking space and increasing use of banking technology and the need to match the services offered by commercial banks are compelling reasons for change and development of new models of cooperative banks.

Cooperative banks/Financial cooperatives can no more function as standalone organisations in the original style, model and size in which they were formed. If a cooperative bank has to succeed on a standalone basis it needs good financial strength which is a function of

a. Competitive and reasonable pricing
b. Physical proximity to customers.
c. Ability to offer all products that commercial banks give to its clients

Competitive and reasonable pricing will have to be the cornerstone of cooperative banking on account of the objective of extending affordable financial services to members though market forces will dictate the cost of funds. Historically, cooperatives have been able to do this by leveraging lower cost of capital and funds. That profit maximisation is not an objective, helped in fulfilling this objective.

In many countries cooperative banks have network of branches (brick and mortar structures) that ensure physical presence in remote and sparsely populated areas. Proximity to customers is an USP for standalone cooperative bank or its branches which are mainly situated in villages, semi urban centres and small towns. This 'proximity advantage' is being challenged by digital banking channels. Cooperative banks will have to quickly evaluate the digital products that their customers need and use proximity advantage to offer appropriate products such that operational costs come down.

Cooperative banks are aware of the above issues. They have been continuously evolving and making their shape and size appropriate to market needs. As such today there is, at one end, banks (standalone) that are small autonomous unions/societies which deal only with their members. Woven around a common bond which could be a profession, an entrepreneurial interest or simply their location[38] these institutions may not grow beyond a level. At the other end it is a complex network of standalone banks, regional banks/setups and a national level organisation with or without holding companies making them function in a way no different from commercial banks. These different types of organisations or business models of cooperative banks are depicted below.

(i) Standalone cooperative banks/FCs: This is the traditional business model of cooperatives. This could be a credit union or a village bank or a regional bank with branches, promoted by members, and funded by members and non-member deposits. Its operations will be in a limited geographical area primarily for the benefit of a class of members who could be, say artisans, SME or farmers. It is locally focused and characterised by the existence of a common bond among its members. Given the limitation of funds and management skills the range of financial products and services offered are also limited. These banks/FCs are known to charge reasonable rates of interest and depend on interest margins for their viability. They may not pay dividend as the fee or ROI could be concessional a member being borrower as well. They charge one price for the product including service and other charges.

(ii) Banks/FCs associated through cooperation agreements: When a standalone bank wants to grow it has the option to partner with other cooperative banks/societies/unions for pooling their resources. This typically involves setting up one or more entities, owned by the co-operating banks/FCs. This common unit or institution will provide some predetermined or identified services such as back office activities, IT services, preparing financial settlement and transactions, insurance, development of common products and brands, capacity building etc., to all the partnering institutions. An example of this is the two varieties of second-tier facility created by US credit unions namely (a) corporate credit unions (CCUs) owned by credit unions and set up in order to realise economies of scale and (b) Credit union service organisations (CUSOs) which provide products and services (e.g. payment services) to multiple CUs or to the actual members of these CUs. There were, in the year 2018, some 11 CCUs and 946 CUSOs operating in the United States. In the case of Urban Cooperative banks in India, currently efforts are being made to create an umbrella organisation for rendering such services[39].

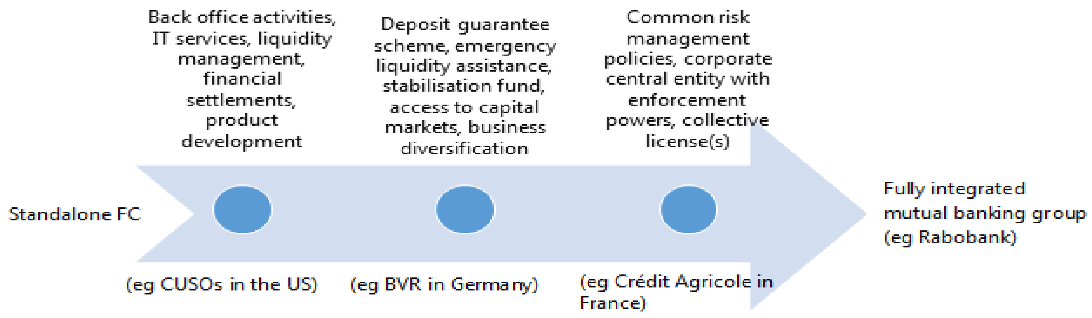
(iii) Network of federated cooperative banks: A third business model is a federation of cooperative banks or networks of banks/FCs, with a central entity providing common services to the whole network. This is a complex model and calls for deeper levels of cooperation. In this model banks that remain otherwise autonomous are brought under an umbrella association which offers a wide range of common services, including risk management through an institutional protection scheme. A well-known example of this is the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), which represents the interests of about 900 cooperative banks in Germany. The BVR oversees a joint strategy and also manages Germany's oldest deposit protection scheme for cooperative credit institutions. The association includes a number of cooperative technology companies providing specialised solutions to members and a central financial entity, DZ Bank, which offers investment banking and large corporate lending, as well as market based funding and clearing bank services for the cooperative banks that are both its customers and its shareholders. Brazil also has four such federations, which bring together more than 750 FCs.

The rural cooperatives in India are in a federated structure sans IPS and other aspects mentioned above. The Primary credit societies be it Agricultural or Weavers or Artisans or Fishermen are federated in to District Central Coop bank. DCCBs are federated into State Cooperative bank. DCCBs and SCBs can have other cooperatives as members from whom they can accept deposits and extend credit. Primary societies are not regulated by Reserve Bank of India[40].

Box.4: Is the integrated structure less risky? Is the risk level similar with standalone banks and the top level in the integrated tier?
The major risk faced by cooperative banks is credit risk. Even in case of frauds the underlying is mostly credit. In integrated networks, credit function will be primarily with the standalone banks at the village or regional levels. Possibly the regional banks may also issue retail loans. As such these banks will face the full credit risk in the event of default. It is expected that these banks will manage the risk to certain extent. However in case of larger volumes of credit risk, there may be no default in payment of deposit or repayment to borrowers by the bank as liquidity support is available to these banks from the higher tier or the central unit. As the central unit or higher tier is supporting many units it has the benefit of geographical diversification of risk and will, normally, not face difficulty in managing credit risk on account of affiliated banks. However the matter could become complicated if the higher tier/central unit also faces large defaults and has simultaneous liquidity issues. This is however rare as could be inferred from higher NPA levels in the lower tiers of cooperative structure in India but lower NPA and good liquidity with higher tiers. Similarly NPA levels are higher in the lower tiers in the networked and federated structure of Europe but lower at higher levels/tiers. This aspect is critical for the sustainability of cooperative banking.

(iv) Network with a demutualised banking group: The most integrated type of cooperation among cooperative banks is the formation of a centralised and diversified mutual banking group. This is a "hybrid" or "inverted pyramid" model[41] that exists in Europe. In this model local banks/unions owned by individual members control regional mutual banks. These demutualised banks in turn hold a majority stake in a corporate. The corporate which functions as group's apex body is licensed as a commercial bank, with group-wide risk management responsibilities and other corporate responsibilities. This includes group-wide compliance with all legal and regulatory requirements. Naturally the corporate has the power to insist on corrective actions from affiliates and regional FCs. The commercial bank, owned by the cooperatives, can also offer investment banking and corporate lending services, raise market based funding, and hold stake in specialised companies such as leasing or insurance activities or in foreign subsidiaries. At times the central unit could be a company owned by the cooperatives. Raiffeisen Bank International in Austria is a listed corporation and the holding company of the Raiffeisen Banking Group in Austria. An even more integrated mutual banking group may result from if cooperatives are merged into a single large demutualised financial unit that holds participations in specialised and foreign affiliates.

Figure.2: Explanatory diagram on various cooperative models[42]



Given the strength of the networked organisations, co-operative banks in many countries are organised as federated/integrated networks of individual co-operative banks with a central body focusing on strategic management and achieving economies of scale. The central bodies mentor the federated units/banks, undertake investment and risk management on own account and on behalf of member banks. They source funds for the banks, extend liquidity support and also supervise the member banks.

The form of the centralised structure however varies across the countries. Among the European systems, the Dutch co-operative group is an example of the most centralised system while Italian co-operative system is an example of most decentralised system[43]. The Austrian and German co-operative sector take up a middle position. <u>In all these cases one can infer the regulatory push. It appears that regulators have greater comfort with the company form of Governance and that regulation should pursue norms resulting in " too big to fail" banks.</u>

In most countries, co-operative groups have created second- or third-tier structures in order to overcome the constraints or limitations intrinsic to their small size and purpose specific organisation. In many cases, legislation has endowed the central bodies with powers for guidance and supervision over local co-operative banks. In all countries the lowest tier has the primary task of managing contacts with its members and local community and doing business with members and customers. The higher-tier organisations have governance models that resemble company or commercial form but tend to conform to co-operative principles, since they intrinsically perform a service function for their co-operative members. It is however possible that the Board of Directors of the central unit may not be members of the cooperatives at all. In fact, in Germany the regulator wants a Board to be exclusively made up of independent and professional members.

1.3 Membership and Capital

Every bank must have adequate capital that in the event of risk and loss capital is sufficient to meet the loss. In terms of regulation this is known as capital adequacy. This means if a bank takes high risks it should have more capital than a bank which takes less risk. Generally, a shareholder bank will take more risks as its aim is higher shareholder value whereas a stakeholder bank (cooperative bank) which does not work for profit maximisation will take less risk and therefore, theoretically it can have lower capital. The difficulty in this is 'risk' is uncertain and its incidence is not predictable. Therefore regulators prescribe 'capital adequacy' based on certain assumptions, size and the position of the bank in the market. In the circumstances capital assumes importance in a cooperative bank because the characteristics of member capital and structure have certain issues.

Share Capital and Deposits are the main sources of funds for a Cooperative bank. Members (shareholders) have "one member one vote" notwithstanding any number of shares owned by a member. This is unique and in contrast to equity in companies where voting rights are proportional to shares owned. However, if the cooperative bank were to declare dividend it will be proportional to the shareholding. Sharing profit with members is not an important objective and therefore the motive behind a person becoming a member of a cooperative is not a share in the profit but access to credit and financial products/services and not dividend.
Another unique issue in cooperatives is that shares are not traded in the market but redeemable when the member wishes to leave the cooperative. Member shares are typically redeemed at par. Members have no right to a share of the banks retained earnings when leaving the society/association unless it is dissolved. Member shares generally generate little if at all, income. Unlike company equity, they do not appreciate though the net worth/value of the cooperative may increase overtime. In some countries shares cannot be redeemed but membership can be transferred to others similar individuals- in fact the cooperative arrange for the same. In some jurisdictions the regulator gives a limit within which shares can be redeemed in a year.

Table.2: Equity of Companies and Cooperatives: Comparison

	Item of comparison	Company Share	Cooperative Share
1	Negotiability	Can be sold. Could be Listed in the Stock Exchange and Traded. Unlisted shares exist	Not sold. Not traded
2	Profit Distribution	Profits are routinely distributed. Linked to annual profit. Management decides the quantum	Minimal Dividend. Loan prices are concessional and reasonable
3	Voting Rights	Proportional to shares held to total shares issued	One member one vote despite number of shares held
4	Share Redemption	No. Companies can buy back	At the choice of the member. Redeemed at PAR. Of-late redemption restrictions have been imposed
5	Share Value	Could be high as it is traded in the market	Always PAR

These days the primary emphasis of regulatory norms is capital adequacy. In this regard cooperatives find that they face reduction in capital when a member leaves and cannot increase capital unless new members are inducted and/or retained earnings are increased. In some jurisdictions banks adopt share linking norms i.e. certain shares have to be bought/subscribed as % of the value of credit so that capital can be augmented[44]. At the same time the redemption possibility make the regulators worry about the sustainability of level of capital. Therefore some regulators consider only retained earnings/reserves as capital of cooperative banks and treat share capital as non-interest bearing deposits.

The non-tradability and non-negotiability of cooperative shares makes it unattractive for investors. Member shares cannot be accumulated to gain control of a cooperative bank since voting rights are linked to individual membership and not to the number of shares held by an individual. Cooperative shares are, generally low-yielding also they do not allow capital appreciation since the value of share does not change over time.

In view of the importance of capital adequacy ratio and the legal provision that a member can withdraw the capital there is a current debate that capital of cooperative banks should be measured/treated differently. Should it be treated as a liability or Capital? Different regulators, as given in table 5 below have different stance on this issue.

Box.5:	**How the share capital of cooperative is treated: Status in some countries.**		
	Country	Accounting Treatment	Is it regulatory capital
1	Australia	As deposits	No
2	Brazil	Equity	Yes
3	France	Equity	Yes. Tier 1
4	Germany	Equity	Yes Tier 1
5	Ireland	Deposit	No
6	United States	Deposit	No
7	India	Equity	Yes Tier 1
8	Poland	Equity	Yes Tier 1

Capital to risk weighted asset ratio known as (CRAR) is the relationship between the amount of capital and risk weighed investment and loans & advances. Under Basel II/III risk could be assessed for each institution based on Internal Rating Based Approach[45]. Individual institutions' risk will be a function of its control systems, governance, business mix, products, processes, procedures and counterparty selection and limits for its credit and investments. Under Basel III the qualifying criteria is focused on maximum loss-absorption capacity. General criteria for eligible capital is that

a. The structure should allow, in case of equity, full discretion to pay out dividends.
b. It is important that share holders' rights to the firm's net worth in case of liquidation should be subordinate to other instruments and that qualifying instruments should never be repaid outside liquidation.

These conditions apply to cooperative banks as well[46]. In jurisdictions where member share is treated as deposit, as shares in cooperative banks can be redeemed by its members any time and are not fully subordinate to other qualifying claims that a bank may have, in arriving at CRAR retained earnings and reserves alone qualify as capital. In view of this regulators of some countries, by law limit holders' rights in case of liquidation and, more importantly, do not allow redemption outside of liquidation.

In some countries, it is seen that as shares cannot be sold in the market, banks have evolved a scheme to transfer of shares from one member to another member or new members. This ensures that compliance to CET 1 is not depleted. For example; the EU's Capital Requirements Regulation (CRR) stipulates that member shares may qualify as CET1 when redemption rights are restricted. Under EU regulation, member shares qualify as CET1 if the institution is able to refuse the redemption of the instruments or if the provisions of the instruments allow the institution to restrict their redemption in cases where right of redemption is granted by the national law. The ability to restrict redemption could be in terms of deferment of redemption or restriction in the amount to be redeemed. It is important that such refusal to redeem or the restriction of redemption is not treated as a default by the institution. It is seen that the European Banking Authority's (EBA) Regulatory Technical Standards (RTS) on Own

Funds have defined the scope of redemption limitations, redemption being subject to supervisory authorisation.

Capital adequacy is, possibly the most important financial stability norm. To augment capital cooperative banks may issue different class of capital, like preference shares, investment certificates, member certificates and interest bearing capital deposits[47]. The challenge for co-operative banks is how to ensure member interest when they do not normally give a return or dividend on capital. The net profit or surpluses are either reinvested in the business or passed on to member-borrower in the form of concession in the interest rates. This is a cost price mechanism that ensures the customers benefit, but it is not transparent to members. In this connection, a European bank[48] has issued non-voting share to its members and has over a third of the members who have 'an interest in the bank's financial performance as well as in its service to customers'. The aim of issuing such instruments is to obtain capital from a larger number of investors. Most of the regulators have allowed cooperative banks to reckon such resources as tier I. These are similar to member shares and have three common features.

(i) There will be no voting rights attached to these instruments. This ensures that existing members retain control of the cooperative bank and that the 'one member–one vote' principle is respected.

(ii) These instruments, generally, carry a higher yield/return than that is paid on members' savings deposits or money market instruments. An existing member can choose these options instead of investing more of share capital. Moreover, members who do not take active part in management and feel constrained by 'one member one vote' could choose these instruments.

(iii) In order to qualify as regulatory capital these instruments are subject to
   a. strict norms about withdrawal or closure before maturity and
   b. a stipulation that there must be sufficient restrictions to ensure that amounts are not withdrawn without valid/sufficient reason.

Issuing of such hybrid capital instruments is not possible unless the legal provisions allow the banks to do so. As of now laws of many countries do not allow such instruments. In Germany, for example, where cooperative banks generally meet regulatory capital requirements on the basis of their member shares and retained earnings no cooperative bank has issued Additional Tier 1 (AT1) instruments under Basel III. In Brazil[49], existing legislation allows cooperatives to issue subordinated debt but the outstanding amounts are insignificant. In France, the mutual banking groups tend to issue most capital instruments through their corporate holding companies.

In India, cooperative banks have been permitted to issue of subordinated debt instruments to augment capital. Credit rating is an important precondition for issue of such fixed income securities. But credit rating is not viable small size issues. In view of this, smaller cooperatives may find that issuing these instruments is not cost-effective even when the instruments are designed to address their needs.

Networking and development of different models of organisation helps in capital management as the capital adequacy norms will be applied for the structure as a whole and not for individual banks in the network.

Box.6 : The role effectiveness of local Networking structures.[50] Case study of Germany

German savings banks and credit cooperatives were created two centuries ago to provide access to financial services to the poor as well as small and micro enterprises and farmers. The key facets of the movement were (i) focus on the local region, (ii) prioritization of savings mobilization, (iii) pursuit of profitability rather than profit maximization.

Rather early in the journey they realised the importance of networking among the cooperatives which resulted in their unique strength i.e. collaborating among themselves as a network of autonomous institutions. This has ensured their sustainability over the years.

A network is a formal arrangement among banks to work together and pool identified resources and strengths while retaining the individual bank status. In the net worked cooperative banks

a) Primary level cooperatives establish organisations at regional level such as regional/apex banks, and commodity & service centres.
b) The central organisations and primary cooperatives are complemented by special institutions at regional level for data-processing and supply of latest banking/computer technology.
c) The primary level and regional level cooperatives establish a central bank/national centre. They are joined in this endeavour by cooperative mortgage banks, leasing and investment societies and agricultural and small-scale industry centres.
d) The network does not emanate from the top but is facilitated by the institutions at primary level and is more of bottom upwards.

Standalone financial cooperatives are unlike commercial banks. Their governance mechanism is different and member involvement in the management is high. Given the small size, compliance to regulation is costly for the stand alone banks. It is for these reasons that networks are formed. Networks help in better compliance and also enables differential regulation for lower tier banks. Net worked FCs have stronger link to real economy, and are more resilient to extreme shocks and have stronger links to the real economy.

Banks in Germany

1. Banks for Poor: Conceived as 'banks for the poor' during the latter part of the 18th century, the Sparkassen idea spread across Germany in the first half of 19th century against the backdrop of the rapid industrialization and urbanization. In 1778, the first Sparkasse was established as a private foundation in Hamburg, and in 1801, the first municipal Sparkasse was set up in Göttingen. It became a prototype for the Sparkassen, which to this day have close connections to local authorities. 19th century was an era of unprecedented economic modernization in Germany. This period also saw social upheaval, bouts of mass unemployment and rising poverty. With increasing parts of the population left behind, social unrest and political instability became a threat that the upper classes sought to address. Among other things, this situation motivated the creation of banks for the poor in the rapidly growing urban areas. Success realised over the years resulted in popularity and turned them into a financial service provider for all ('Bank für Jedermann') by the end of the 19th century.

2. Peoples Bank: The emergence of the cooperative banking idea is associated with initiatives to provide food aid to the poor during the last great German famine of 1847/48. Similar to the geographic origins of the Sparkassen, one strand of the cooperative banking model had its roots in urban areas is the People's Bank ('Volksbanken')

3. Village banks: Another similar movement was villages and farming Communities. They were named 'Raiffeisenbanken' (after their founder Friedrich Wilhelm Raiffeisen).

Both People's bank and Village Banks soon broadened their business reach to cover urban as well as rural areas. In view of the common mission and pursuing rather similar business objectives, the Volksbanken and the Raiffeisen groups formally united in 1972.

The progress of these small innovative financial institutions was not without any difficulties. However they overcame the challenges and have continued to flourish till date. Another reason for this is that they were able to play a stabilizing role during the boom and bust cycles associated with Germany's development into an industrialized economy. The Sparkassen in particular benefitted from the widespread cultivation of thrift in society. They were also advocates of thriftiness, offering innovative savings and payments services. Interestingly, though initiated as a scheme for low-income groups to insure against economic risks, savings remained strong even after the government introduced a mandatory social insurance system. Savings has continued to expand as the economy and incomes kept growing.

As an initiative towards strengthening themselves and also access market for funds, the cooperatives established Cooperative Central Banks ('Genossenschafts-Zentralbanken') and the Sparkassen formed banks of states ('Landesbanken'). The central banks are owned and controlled by their member institutions. As against this the respective federal states and the regional association of Sparkassen (via their regional associations) that jointly own the Landesbanken. Over the years, step-by step, these larger banks have grown into wholesale banks that served the individual member entities, as also a bridge to the international financial markets.

Formation of network to take care of the sector is an important reason for the lasting success of both savings bank and cooperative bank. These networks facilitated cooperation and information sharing between the many individual banks. Affiliation also allowed the local banks to let these associations perform certain essential functions such as (i) regular professional auditing of individual member banks, (ii) organization and management of group-wide joint liability and deposit guarantee schemes and (iii) development of new products enabled by technological advances. These measures helped in achieving economies of scale for the entire group. It was also possible to set up subsidiary entities and companies for activities such as employee training, printing services IT support, payments systems/electronic clearing house functions, etc.

It is noteworthy that the regulator is using network as an instrument to achieve financial stability. This also helps in making these banks BIG. Looking at the merger efforts taken by the regulators it appears that regulators want more big banks. European regulations seem to follow "too big to fail" objective and feel big banks are more suitable for financial stability. Both networks in Germany have followed a self-sustaining business model over two centuries. These two form part of the 'three pillars' in the German banking system, with the commercial banks (publicly listed or private) constituting the third pillar. Together, both of these two decentralized local banking groups account for the largest market share in retail deposits and small business loans in modern day Germany. Sparkassen have leading market share in savings deposits as well as deposits overall.

Nearly 250 German co-operative banks cannot fulfil the new capital requirements according to Basel III. These are helped by the network concept.

2: Managing Cooperative Banks.

In Ireland, a statutory body, the Credit Union Restructuring Board, has been established to facilitate voluntary, time-bound, incentivised restructuring of cooperatives. Due to its efforts, between 2011 and November 2018, the number of CUs fell from 406 to 253. In Germany, where the total number of FCs was reduced by 57 and some 900 branches were closed in 2017 alone, FCs have regained market share over the past decade. There are similar happenings in other jurisdictions as well. This is because financial cooperatives have faced and continue to face many challenges in terms of availability of capital, availability of resources, compliance to regulations and managing competition. It is a matter of record that these banks have responded to these challenges mainly through mutual cooperation, offering of Institutional Protection by Central authorities/ umbrella organisations, creating subsidiary companies etc., all of which are aimed at improving the cooperative bank's business capabilities. Almost all cooperative banks have focused on enhancing risk management, internal controls and capacity-building. In some cases, second-tier entities have contributed to the network's crisis management framework by providing emergency liquidity assistance, stabilisation funds and deposit guarantee schemes. Consolidation through mergers has been a common response to competitive pressures.

At the same time it is noticed that as coop banks grew in size, member involvement has been substantially reduced[51]. Possibly, coming from grassroots, members of cooperative banks may not have all the competencies that a banks' board needs because of which professionals have joined the Boards and top management. This has come in the way of active member involvement and made them customers rather than members. Noticeably, though most of the central banks of the network are owned by the cooperatives the board and management of those banks have little in common with the members.

Post GFC the risk management structure in these banks has been revised a few times. Currently, risk management is a very complex mechanism due to increasing market complexities, new financial products and intricate regulations. In this background managing cooperative banks call for professional banking skills, good member connect, appropriate products and a very competent and experienced board of directors.

Co-operative banks have, in the recent years moved away from being exclusively focused on member or retail or small business to an organisation more resembling commercial banks in products and processes. Some of these banks, in addition to retail banking, undertake leasing, factoring, insurance and investment activities. This has resulted in an increase in the product range offered to members by local member banks. Yet member has not been completely forgotten and the cooperative principles are being continued. By reorganising themselves and adopting technology the cooperative banks have served their members and also achieved a good share of the financial system.

Box.7: Strategies and necessary environment for the success and sustainability of small standalone cooperative banks.
1. <u>Area of operation</u>: A small bank could focus on providing its financial services within a limited geographical area. This means every client/customer should be given all the products appropriate to him/her such that the bank gets adequate volume of business. This calls for very close knowledge of the customer and build long-term bank client relationships. Bank has to exploit its common interest with the local businesses and communities. Bank should innovate and introduce appropriate products and services best suited to local needs and demand. At the same time given the rigours of modern regulations, a small contiguous area of operation may come in the way of diversification of risks. This aspect needs to be carefully managed. Similarly growth prospects will be limited if area of operation is limited unless there is good economic growth in the area.

2. Focus on Deposits/Savings: Small banks should focus on mobilization of savings from all members and customers. Savings is a definite way to achieve financial inclusion. Savings help in intermediation. It gives an opportunity for local people deposit money and to transact safely, and helps them in case of need. For every bank savings is possibly the most sustainable funding at very reasonable rate of interest and helps reduce the dependence on costly borrowings. Fund mobilised through deposits is used in extending loans, which will also help the local communities.
3. Double bottom line: Small banks should pursue (i) profitability—rather than profit maximization—and (ii) support for the economic and social development of the local region. This will naturally result in the growth of the bank.
4. Integrity and Trust: Trust, by members and customers is a function of integrity and fulfilling promises. For this, bank should have (i) transparent and well laid out policy about correct dealing with members and customers, (ii) well-qualified and performance oriented management and staff and (iii) be customer focused and customer friendly products and processes. In addition the bank should have well implemented internal/external control systems and accountability structures which will ensure institutions' financial integrity.
5. Risk Management: Bank should have a diversified business mix and follow appropriate exposure norms. For risk management and other related aspects, the small bank could belong to a network which has an apex (higher tier institutions) institution that could be approached in case of emergent liquidity needs and support for managing investment, risk management, staff training and compliance issues. In this way it could benefit from economies of scale and yet be independent and small. Network intuitions are very helpful in managing regulations. Network should not be at the cost of member service.
6. Conducive environment:
    a. Legal and regulatory aspects: The legal framework, regulatory norms and guidelines should be supportive of the bank taking into account the size, geography and the focus on small deposits and small loans. Regulations should factor the usefulness of small institutions in achieving financial inclusion and the negligible impact they may have on financial stability.
    b. Entry point norms: Since cooperative banks are first registered as cooperatives and then licensed as banks, it is necessary to have a clear policy on what type of new entrants should be registered and allowed entry into the sector. It is better to permit registration of only those who fulfil basic criterion.
    c. Regulatory Norms: It is, extremely critical to set organisation specific conditions for authorizing lending and deposit taking.
    d. Role of Governments: Governments can facilitate and help the cooperatives but should refrain from intervening in the banking operations.
7. Good Governance: The Board of the bank should be well structured and have people with appropriate skill sets and competencies. Board should have a reasonable mix of members, professionals and independent directors. Board should get policies developed by experienced people, approve and implement them.
8. Caution points:
    a. Cooperatives should not depend on grant or subsidy. Such funding does not allow institutions to become self-sufficient. Initial subsidies, if at all should be for a limited period and quickly phased out.
    b. Donor funding comes with conditions loaded to prove the donor's mission. Grants and concessional donor funds could end up undermining the discipline and prudence in the loan origination process. People will repay their loans more responsibly if they know that their loan is financed out of their or their neighbours' savings than funded by donors.

Cooperatives have the advantage of cheaper and more stable funds than commercial banks in the form of member deposits and member shares. Needless to say they have closer member-customer relationships as well. They are able to give financial services closer to the members place. Yet it should be said that members, themselves being in need of funds and conducting most operations within in a small area expose the cooperative bank to concentration and co-variance risks. This is because members of the cooperative bank who can also be its borrowers and creditors belong to same economic activity or area and are all typically exposed to similar risks. In view of the multiple roles that a member can play it is reported that 'member-manager conflicts' or 'management capture' and 'mis-management' are the major causes of failure of financial cooperatives. In many countries cooperative leadership is the stepping stone for politics and therefore cooperatives and cooperative managements are often political in nature. Wherever government intervenes in the cooperatives the growth of cooperatives have been impacted.

Generally, funds availability is a limitation on cooperative bank's capacity to expand. Their solvency rests mainly on the ability to accumulate retained earnings and expand membership. Also, the financial market in which the bank operates and sources funds is commercial in nature. At the same time, the nature of financial cooperatives in terms of ownership and their basic tenets namely (i) member-owners as clients, (ii) one-member-one-vote and (iii) members themselves managing and governing the institution underlines governance risks are quite unlike those associated with investor-owned banks. A closer analysis of the above leads to some interesting points

1. Cooperative banks should offer products which are good for its members.
2. Products offered should be correct and reasonably priced. It should be kept in mind that as markets mature margins will be under pressure and therefore price should be reasonable and not low or unviable for the bank.
3. Cooperative banks should comply with regulations which could be somewhat similar to what is prescribed for commercial banks. Cost of compliance should be kept low.

Box.8: Views of World Bank on Cooperative banks[52]

1. Cooperatives banks (FCs) are important providers of financial services to poor and middle-income people. That the financial service of cooperative bank is available locally in villages make them important.
2. There is a strong presence of cooperative banks in Europe and North America. In other countries they may not have similar market presence/share but still they play a significant role.
3. Legal and regulatory aspects should be such that:
   - (i) They facilitate smooth and efficient functioning of these banks. There should be appropriate safety nets aimed at the development and growth of these cooperatives. These are very important for the stability and growth of cooperatives.
   - (ii) Should recognize that these banks have unique capital and governance structure and are promoted by people who do not have commercial objectives.
   - (iii) Should clearly define: (a) the authority to regulate; (b) entry requirements (including tiered systems); (c) governance rules; (d) risk management controls; and (e) resolution (exit) mechanisms.
4. Effective regulation and supervision are essential to help cooperative banks achieve scale. This could be achieved by fostering mergers or facilitating integration of individual retail entities into federated (apex) structures or creates an umbrella organisation.
5. Approaches that have combined legal and regulatory reforms with support to the institutional strengthening of the cooperative banking sector have shown good results in terms of financial inclusion, and fostered the modernization of financial cooperatives as effective financial institutions.
6. There is an urgent need for quick introduction of electronic banking in cooperatives. This also requires a degree of preparedness, and a functional structure that most FC networks have yet to attain.

7. Regulation and supervision of cooperative banks is in the domain of the financial sector authority. However like all public enterprises, Governments have a role in the regulation and supervision. Cooperative laws that may or may not explicitly recognize the financial nature of cooperative bank can open the door for significant regulatory and supervisory arbitrage. This could come in the way of effectiveness of financial regulation.

Today regulatory issues/guidelines cover (a) Capital Adequacy (b) Customer identification, (c) Interest rates (d) Exposure limits, (f) Accounting standards (g) business mix, (h) Asset Liability Management, (g) Deposit Insurance, (h) Income Recognition and Asset classification, (i) customer service etc. Implementing all these and complying with all these involve certain efforts, costs and impacts.
Before the outbreak of the global financial crisis there were no international homogeneous rules of conduct for banks in terms of risk management. Regulations in those days were 'light/soft touch' which underlined the belief that banks will behave responsibly. Also regulation was left to the broad discretion of individual national supervisory authorities who focused on monetary policy and credit control. Depositor protection was practiced. The soft touch approach has changed on account of global financial crisis (GFC). After GFC, stringent regulatory norms, requirements and standards have been introduced. <u>It is noteworthy that after GFC no major financial crisis has happened yet the norms are getting revised and made stringent with every passing year.</u> Countries have adopted the underlying philosophy of these norms though the actual prescription could vary from country to country. Apparently regulation is proportional among various banking segments like commercial banks, cooperative banks, and small banks. But within a segment the norms are 'one size fit all'. In this regard some of the following points are important.

1. Implementation of the regulatory norms and reporting compliance to the regulations involves efforts and cost which could be high for smaller banks[53]. These requirements, which keep changing frequently, coupled with supervisory expectations, come in the way of banks increasing their leverage. Capital adequacy is technically a leverage ratio. If the bank has capital just enough to comply with stipulated CAR it cannot increase its business.
2. The 90 day NPA norm is applied, in most jurisdictions uniformly[54] on almost all accounts despite variations in size (of the bank and the credit limit), geography and purpose of the credit. The regulators apprehension is that banks may manipulate the NPA figures. This apprehension has resulted in very minute guidelines which makes it difficult for banks to follow and causes difficulties to customers who could be facing temporary cash flow problems. In some jurisdictions, such rigidity has also resulted in government intervention in the recovery process which tends to increase defaults. This has implications for credit flow in emerging economies. There is a need for proportional regulation in the case of Income Recognition and Asset Classification Norms. In India, NPA rules for Agricultural Loans are slightly different than SME and other loans. Due to the current Covid-19 Pandemic NPA norms have been kept in abeyance in almost all countries. Covid-19 has shown that there are yet unknown risks. It is a pointer to the need to revisit regulatory norms.

Compliance to regulations is not easy. Let's consider Capital Adequacy which helps in ensuring financial stability. If a bank is short of capital for maintaining the required level of capital and finds it difficult to raise capital from existing members and new members are not forthcoming it will face compliance risk and attract penalties from the regulator though it may be meeting all member demands and faces no immediate possibility of failure. A way of augmenting capital is increasing retained earnings. But if the market interest rates were to be lower and therefore the bank lends at lower rates to its members whereas its costs cannot be reduced immediately, it

will earn lower profits which in turn will affect the retained earnings and ability to augment capital funds. Having adequate capital funds is however a regulatory necessity.
Such difficulties are true of other regulatory norms as well. Take the case of adopting base rates for arriving at the ROI on loans and advances. Some of the jurisdictions have issued guidelines on the adoption of base rate or MCLR[55] to arrive at the lending rate which will be difficult for banks which source market funds but follow a fixed lending rate and not a floating rate. Floating rate concept is less suited for cooperatives and SME lending.
Liquidity Coverage ratio (LCR) has similar issues. If a bank has to maintain LCR and NSFR it has to necessarily opt for low risk and short term investments which will impact income. Higher liquidity will result in lower income. The point is that all regulatory compliances have cost and cooperative banks face more challenges than commercial banks in ensuring compliance.

Technology is disrupting banking. Technological innovations in the operations space of banking, improvements in product delivery and remittances system have created huge expectations from customers. Access to on-line banking is changing customers approach towards banking. Just like regulatory norms, technology is not only costly but also changes frequently. Viability of technology is volume driven. Keeping up to date in technology is becoming a costly challenge for cooperative banks. Networked cooperative banks may be able to adopt latest technology at affordable costs whereas standalone cooperative banks find the costs prohibitive.

Automation of financial services and the ability to provide them over the internet by commercial banks and fintech companies are eroding cooperative banks' traditional competitive advantages. Being close to the customer is no more a criteria for offering quick service. Technology allows commercial banks; non-bank finance companies and fintech companies reach their products to all including the cooperative members/customers, quickly and in a cost effective way without the need to maintain brick and mortar branch networks. It is seen that, for the customers, the ease of operation and low cost of online services is more advantageous than physical proximity. In this regard the following points are important.

(i) Technology driven banking products may challenge cooperative banks' way of banking and its viability. It is a fact that these banks, may not, as they are close to their members, need all technological products but they will be constrained to adopt all the technological products and processes that other banks use lest they lose their customers. Selection of appropriate technology is therefore critical for these banks.
(ii) Competition to lend is increasing. It is well known that members of cooperative banks would like to access credit and other financial services at affordable prices. In addition there is, now increasing expectations on seamless and quick delivery of financial services. Studies also show that they look forward to good returns on the share capital as well. Cooperative banks should reengineer their processes to be more nimble and accessible.
(iii) It was stated earlier that cooperatives have been able to mobilise funds at competitive (low) rates. This could also change on account of increased competition. People who become members of Financial Cooperatives for getting financial services expect reasonable rate of interest on loans at the same time a higher yield (market related) on their savings and want returns on their investments in shares as well[56].

In addition to being small and not having economies of scale cooperative banks in rural areas are situated in unfavourable demographics. They are not able to manage the 'higher credit needs but lower savings' of members. The need to generate income to at least cover operating costs could constrain these banks to move into higher-risk activities. Cooperative banks need to increase their internally generated financial resources. Given the reality that they have to keep the prices of their financial products/services less than those of commercial banks so as to attract customers, they have to take steps (i) reduce operating costs by adopting technology with simultaneous reduction in branches and (ii) innovate products so as to increase the average outstanding per member and (iii) take steps to increase members/customers. Given that countries are pushing for consolidation and reduction of banks/branches, cooperative banks must look for appropriate technology which helps them retain/attract customer and at the same time maintain the unique personal touch for which sets them apart from other banks.

3. Governance

Cooperative banks are not investor owned banks. Their members are their customers and owners. These banks depend on their managers and boards of directors to take appropriate banking decisions and meet with stakeholder expectations. Barring big banks majority of the board of directors of the cooperative banks are from their members. They have the support of a few independent/professional directors. Yet cooperative bank board's cannot act in a way substantially different from investor owned commercial banks as banking practices are similar, technology is the same and products on offer are similar. But, though business is similar cooperatives have different motivations as unlike commercial banks profit maximisation is not their goal. Their risk appetite, if at all will be very different from an investor owned bank. They have a participative model of Governance. These aspects/differences result in a different business mix and pricing strategies.
Post GFC it has been realised that most of the cooperative banks do not take the kind of risks that resulted in the collapse of many commercial banks. Some banks in some jurisdictions did invest in toxic instruments (at the time of investment no one knew they were toxic as the financial world was exuberant at that time!) but did not collapse when the investments failed as members came to their rescue. Evidently, some banks suffered governance failure due to 'ill informed' decisions and 'failure in the control functions' etc. Over all it can be said that 'Co-operative governance emerged on balance as healthy and effective compared to investor-owned business. The quality that marks out the most successful is being member-centred'.[57]

Study reports and current regulatory push seem to suggest that the only way to improve governance is to have two committees at the top-level namely (i) a full board – a council larger in size and representative of all the members with full oversight and (ii) a smaller committee of board of directors actively involved in decision making. (Yet there are no statements about which one will be liable if there are failures). The members of the later committee could be a few of the full board/council and independent experts. This would, to a certain extent, free the board members from the need to prove their expertise. This will also allow some of the senior executives to be in the Board of Management as they possess the necessary expertise. In this method authority is distributed and so the member council and the committee of board of directors can each get on doing with what they do best.

To understand governance issues let's consider the following cases.

1. "The Co-operative Bank[58], it was reported that, had largely avoided the consequences of the market turmoil. 'Our cautious and responsible approach to business development limited our exposure to the problems that have afflicted many in the sector' said the chief executive, David Anderson[59] when the bank, in 2013 hit the news headlines as it faced difficulties (in the aftermath of 2008) to meet the increased capital requirements (result of higher risk) which impacted the Bank. It was reported that the merger of the Britannia Building Society (2009) with the bank and consequent failure to manage capital adequately only aggravated the situation. It was pointed out that (i) a very large board and that (ii) members did not generally possess the required depth of knowledge of banking and banking products in the modern age, contributed to poor strategic planning and to weaknesses in the risk management aspects of the business.

2. Raiffeisen is an Austrian-based co-operative banking group, with a history that dates back to the 19th Century. It had one of Europe's largest banking operations, with subsidiaries across central and Eastern Europe. In one of the Raiffeisen Schweiz subsidiaries FINMA[60] identified 'various control issues and problems, including significant shortfalls in the group's overall corporate governance practices related to the management of shareholdings and related persons' as reported by Moody's credit ratings agency. The bank failed to effectively oversee and control its own management and mitigate potential conflicts of interest arising from the management's and the

board's involvement in day-to-day decision making. 'This led to breaches of several supervisory laws and best practices'. Failings included inadequate risk management around loans to individuals connected to the bank and a miscalculation of the capital held by the bank. An internal report conducted at the bank's subsidiaries confirmed FINMA's conclusions of major corporate governance failings and lack of management controls.

3. 'An official investigation will consider the causes of Cypriot bank's (Cyprus cooperative bank) failures'[61] said a news item. It was reported that poor lending practices, staffing weaknesses, lack of internal challenge and inadequate regulatory oversight were the causes. That the bank improperly charged wrong interest rate on loans put a question mark on its ethical practices.

4. Punjab and Maharashtra Cooperative Bank (PMC)[62] an UCB in Mumbai India has run into difficulties (2019) on account of governance deficit. The Reserve Bank of India (RBI) has appointed an administrator and superseded the board of directors at PMC, after the discovery of major financial irregularities, failures of internal control and systems, and wrong/under-reporting of exposure. PMC appears to have far exceeded prudential exposure norms in extending loans to a distressed real estate company which was close to a director.

5. Norinchukin, Zen-Noh's[63] bank was badly hit during the financial crisis. In response to growing competition the bank had invested heavily in US asset-backed securities –now known as sub-prime mortgages- which after GFC became worthless. It had to raise ¥1.9 Trillion through share sales to its farmer members. The bank bounced back with a net income of ¥29.5 billion in the year 2009.

6. Credit Muetel went through a downgrading of its credit rating. It had invested heavily in "AAA" rated instruments which went bad later.

7. Rabobank was fined $1 billion by regulators in the USA, UK and Netherlands, because some of its traders were implicated in the Libor rate-fixing scandal. BPCE and Credit Agricole have also been fined for involvement in the Libor rate rigging scandal.

It is difficult to say if all the above cases are of poor governance, and it is equally difficult to say if the governance failure was deliberate? Prima facie all of them show poor corporate governance, which led to poor quality or biased decision-making. In some cases accountability mechanisms were defective. Internal control and processes were deficient. There are instances of borrowers who were close to the management/board being favoured in terms of loans and T&C on loans. In all cases there have been compliance failures. Poor accounting practices, lack of ethical values, misreporting to the regulator, boards (decisions) being hijacked by a few members and lack of professional skills are pointers to poor governance.

It is also seen that what was clearly a market practice i.e. investing sub-prime mortgage, investing in AAA rated bonds etc., at a given point of time could be cases of poor governance later unless these are amply supported by appropriate board policies, i.e. board policies which explain the rationale and need of such investments for the functioning of the bank, particularly as cooperative banks are not for profit maximisation.

Poor corporate governance is not an exclusive characteristic of Cooperative Banks. Commercial banks and financial institution have their own share of poor governance. It is possible to quote a large number of cases in commercial banking sphere. Indeed the reason for GFC is poor corporate governance by many commercial institutions! Also it will be too hasty to conclude that 'governance is an issue only in big institutions/banks'. It is equally difficult to say that governance failure is specific to a specific to a type of organisation.

Cooperatives are member driven and member managed organisations. Members of standalone cooperative bank's board come from the same region or business or economic strata where the cooperatives are established. Given this expecting them to be thorough in all aspects of banking is a bit too much. This could lead to some governance failures. At the same time adding one or two professional directors, by itself will not lead to good governance unless they guide the board properly and the board listens to them!

Of late there is much talk about "corporate governance' with banks. The discussion about bank Governance has become something similar to the Indian Story of "Blind men and Elephant"[64]. Because

a. From the regulatory perspective, compliance to regulatory norms is Good Governance.
b. From the cooperative perspective and the principle of 'one member one vote' board decisions if supported by majority member is good governance.
c. From country's perspective, contribution to the growth of the economy is good governance.
d. From the government point of view supporting its development programmes is governance.
e. From the customer perspective, seamless and error free availability of financial product is good governance.
f. From the bank management perspective good governance is taking decisions which are at the time of decision good and remain good years later.

How will a board ensure that it conforms to all the above expectations? Will independent and professional directors be concerned more about regulations or about member benefits? How will the board deal with a very good credit proposal where the deviation from the approved exposure limit is just 5 basis points?
It is well known that cooperative banks do not pursue profit maximisation as a goal. Profitability is important for them as 'retained earnings' is an important source of capital. Given this, will they invest their surplus funds for best returns, subject to approved credit rating or keep it idle? Will the board decide by majority knowing well that it violates a regulatory norm? Is majority decision possible when various regulatory reports point out that in case of cooperative banks there are instances of (i) low attendance in general meetings, (ii) not much of rotation in boards, (iii) skill sets not matching with modern bank management needs and (iv) few members, who are in the know of things dominating the board etc? Good governance indeed is a complicated matter.
One of the regulatory concerns about cooperative governance is that conflicts could arise when making decisions where they have some personal interest. This is true of every organisation. But more so in the case of cooperatives as it is coming together of people of similar economic status for meeting common needs. Conflict management is the role of the Board Chairman. It is for this reason the regulators are particular about fit and proper status of Chairman and CEO. Another concern is that a member of a cooperative as a board member may take part in the management but may not be fully aware of the banking practices resulting in sub-optimal decisions.

Table.3: Comparison of Governance and Management needs and Style

SN	Issue	Commercial Banks (company form)	Financial Cooperative
1	Objective	Shareholder value Maximisation	Provide financial services to members at affordable rates
2	Board	Directors drawn from (i) Independent Professionals and (ii)	Member dominated boards supported by independent

		promoters with business experience	directors
3	Conflict of Interest	Shareholder -Manager	Member-customer-borrower
4	Risk Management	Employ Professional Team	Follow norms. Difficult to have exclusive staff
5	Capital	Initial and follow on issues- Right issue- subordinate debt. Shareholder, exist by market sale will not impact capital.	Member can withdraw –opt out. Difficult to get more members. Share linking to credit is possible
6	Dividend	Important for shareholders. Company cannot post pone dividend during normal times	Not important

It is important to note that the corporate governance expectations and guidelines issued by regulators do not distinguish the cooperative banks from a commercial bank. Regulatory observations seem to indicate that the cooperative advantage of 'one-member one-vote" which will enable good member participation will not necessarily ensure professional management in cooperative banks. As a matter of fact, autonomy and discretion of local member banks in self-management of banks could diminish due to ever increasing regulations as also inability of members to raise their level up to the required extent of management competencies. It is observed that as the level of compliance increases, the distance between the management of co-operative banks and their members' increases.

Box.9: Is poor governance peculiar to financial cooperatives?

Cooperative Bank boards have member directors, independent directors and professional directors. Given this how does governance failure happen? Is it because of being a 'Cooperative'? In a commercial bank also there will be promoter directors, nominee directors, professional directors and independent directors. How does governance failure happen there? Is it because of being commercial?

There are many instances around the world wherein cooperative banks and commercial banks have been found wanting in Governance. This is despite fit and proper criteria being advocated and avowedly followed by banks. A closer look at the issue and failure (see cases above) will show that <u>it is not the type of organisation or board composition that leads to poor governance but the failure of the set of people who are given the responsibility of Directorship at a given point of time that leads to poor governance.</u>

Poor governance happens

a. Where one or two persons are dominating the board and others do not mind or question it. Poor governance happens when decisions have a personal interest component and others do not question it.
b. When independent and professional directors- who will always be in minority- do not take up issues in right earnest. If they are more sitting fee and other benefit oriented.
c. When the board is full of independent Directors who have no real ownership of the bank.
d. Where law (in some countries) allows government officials to act on behalf of the board or execute the board powers.
e. Where the Chairman or CEO develops a larger than life image and others do not voice against them.
f. Where members of the board connive for personal interest.

Viewed in this background it should be clear that good governance is a virtue and reflection of the integrity and serious intent of the directors and the Chairman. It is not possible to mandate and ensure good governance through rules and regulations. Regulations, guidelines and board approved are useful only if the board understands them and has intent to follow them.

Periodical rotation of directors is a good method to build better governance. Strong <u>Supervision</u> is important to ensure better governance. The information on governance failure lags the event hence building capacity of the Directors is important for cooperative boards. One of the methods adopted by regulators to bring better governance is to suggest constitution of many committees and insist that committees should be headed by different persons. In some jurisdictions more than 10 board committees have been recommended which defeats the purpose of suggesting committees.

One of the reasons for poor governance could be the increasing complexity in rendering financial services, use of technology, establishment of subsidiaries (by some of the cooperatives) for complying with regulations, offering specialised products, undertaking international activities and investment banking. All these activities call for professional management, which a member of the cooperative may not be able to provide. Also wherever cooperatives have developed federal structure the management of the federation is not as much member driven as the front line or stand-alone cooperatives. In such cases pursuit to profit maximisation for personal incentives is not unknown.

Compliance, which is an important expectation from the Boards, in the case of standalone small cooperative bank will be difficult as it involves creation of many dedicated staff positions and maintain exclusive staff. It is also difficult to ensure that important job-profiles/duties which have to ensure that internal controls are robust, exclusive and not segregated. Lack of sufficient knowledge of internal controls and oversight/control functions among the supervisory committee members causes inefficiency.

Of late different governance models are being attempted in cooperative banks. In many countries cooperative banks have, typically two governance bodies and a supporting executive committee namely (i) board of management consisting of directors responsible for determining business plans, strategies and management policies, the (ii) supervisory committee which is responsible for overseeing the board and senior management to ensure that they have adequately fulfilled their respective roles. These are supported by a (iii) committee of senior managers (CEO and team) being in charge of executing and implementing them. In some jurisdictions like France and Germany there exists a dual governance structure, with a management board or committee exercising an executive function and a supervisory board/council in charge of overseeing the former's actions. In Australia one comes across board of directors, along with board sub committees but no management committee.

Box.10 : Different Governance Models a view of some top cooperative banks[65]

Basically, some of the members of the cooperative will be elected to its board. In case of banks, on account of licensing and regulatory norms, board could nominate some experienced professionals as independent members. There is a strong belief that independent members will ensure better governance. Generally standalone banks will have larger number of board members from its members. As cooperative banks network among themselves, the board composition will change. Following are some of the variations in board constitution observed in some of the top 10 cooperative banks.

1. Credit Agricole has a three-tier, indirect system of governance. This is a demutualised cooperative. As such the cooperative banks, which are 'shareholders of the mutual' elect some regional banks which in turn elect members to the board of the national bank. Voting is proportional to their shareholding because the central unit is a company.
2. BVR (Germany) has an indirect, representative system of governance, with a member council. Each member bank has one vote each in the annual general meeting, where a 50 strong council is elected. This council in turn elects a 12 person board of directors known as the administrative board. Further, BVR has a smaller three member committee known as management board.
3. Credit Mutuel has an indirect representative system. In this, individual members through the general body elect/appoint the boards of directors of local banks. These

boards in turn elect regional boards, who elect the board of the central confederation in the confederal general assembly. This is, reportedly a very elaborate and expensive process. Further at the national level there are two bodies: the central federation that represents the Group and acts as banking supervisor and inspector, and a central bank, which manages liquidity and ensures the financial solidarity of the regional groups. There are no independent expert directors.

4. Rabobank has a direct representative system. Its local banks (divided in to 12 regions) constitute the general assembly and have annual general meeting of Rabobank Nederland. Each region has one member in the member council that discusses policy. The general meeting appoints 10 persons as Group's board of directors. Generally these are all experienced professionals selected more for their skills than their ability to represent a region.
5. Desjardins has a similar structure, though with only two tiers. Desjardins Group has a unitary board, with a CEO who is also President. It has a democratic structure of regional general meetings, councils and an assembly of representatives.
6. Raiffeisen ZB is an investor-owned bank that has the conventional board of directors (known as a supervisory board) and a management board. The directors are elected at an annual meeting of shareholders, after being proposed by a nominations committee of board members, with proportional voting rights.
7. The US farm credit co-operative banks have a three-tier, indirect structure that balances representation with expertise. The local associations elect representatives to the boards of the four banks, and the banks in turn elect the board of the Funding Corporation.
8. In Urban Cooperative Banks of India, as suggested by the regulator there are two management teams namely Board of Directors and Board of Management the former responsible for policies and overall management and the latter more closely involved in management and critical areas like risk and financial management.

The following are some of the variations in composition of board seen in cooperative banks[66]

a. All members of the supervisory board must be non-executive- Germany
b. CEO cannot be a board member- Ireland
c. CEO cannot be a board member in full-service cooperatives or in classic cooperatives with total assets of R$ 50 million or more- Brazil
d. CEO can attend board meetings but cannot vote (no voting right)- Kenya
e. CEO can be a board member but cannot be the Chairman of the board. - Australia- India.
f. CEO may chair the board if authorised by the supervisory authority. Further most board members at regional levels could be members/customers but with no executive position- France
g. Cooperative Law[67] requires banks to induct two professional- independent directors in FC's Boards- India.
h. Law gives powers to the State (province) Government to supersede the boards for any reason and appoint a government official as Special officer in lieu of the board. In some of the rural cooperative banks the Chairman post has remained with a few persons and their families over many years[68].

It is apparent that countries will adopt governance models suitable to them. It is also clear that the board structure does not by itself induce poor governance. However scrutiny of reports and board composition of banks show that;

a. In case of small standalone banks it is preferable to have a board with some independent members. At the same time, some central agency should help them with model policies and procedural framework for effective review and follow up.
b. In most cases board is non-executive in the sense that they do not have any operational role, with the exception of sanctioning higher credit limits. As such in most of the banks

one or more board member is involved, on a committee basis, in sanctioning of high value credit.

c. Generally Board's role is three pronged i.e. preparation and approval of policies and procedures, review of operations to see if the policy is implemented as intended and control and supervision.
d. It was said previously that boards are not involved in operational matters. However in case of large banks, committee of board- by whatever name called- could be involved in sanctioning large credits.
e. In some countries a Board of Management or Committee of Management has been put in place which takes major decisions along with the CEO. This COM is regulation driven. Its efficacy is not yet proved.
f. In most jurisdictions there is well defined separation between (i) executive roles and operations roles and (ii) non-executive and governance roles.

One area that needs independent authority within a board is internal control function responsible for overseeing, evaluating and proposing improvements to the banks risk management, internal controls and governance processes. Generally, Audit committee has oversight over these functions. Three kinds of audits are seen in cooperative banks. (a) Internal Audit which is carried out by the audit department of the bank, (b) Concurrent Audit which is normally performed by banks operational staff as and when transactions take place and (c) statutory audit or balance sheet audit that is performed by government department officials or Chartered Accountants. To illustrate, in Australia, banks have their own staff performing internal audit functions, while others, often the smaller entities, hire an independent audit firm for this purpose. In France, central bodies have an internal audit function that covers the whole group, including all direct or indirect subsidiaries. In addition, all cooperative banks are required to have own internal control function. In Germany, each cooperative bank must have a functioning internal audit department or a manager performing the tasks of the internal auditing department. In South Africa, internal auditing is usually performed by the supervisory committee itself. In Kenya, in addition to the Supervisory Committee, cooperatives are required to have an internal audit function and the board must have an audit committee. In India the annual financial statements and regulatory compliances must be audited by Chartered Accountants.

Regulators have been expressing concern at governance failures. They have suggested constitution of various committees and also indicated the scope of each committee. Almost all regulators have insisted in Directors of Boards being 'Fit and Proper'.

Box.11: Fit and Proper and competencies of Board of Directors of financial cooperative: [69]

Board of Directors is a body of individuals elected by the members to govern a cooperative bank. They are expected to frame policies on all aspects of banking, approve appropriate systems, procedures and rules to implement the policy. They select a CEO and the executive team to run the day to banking operations and monitor/control the operations to ensure that the bank is indeed run as per policies and regulations. They do not, as said earlier, normally take part in the day to day management of the FC.

A member of the board of a bank should definitely know banking. BIS and national regulators have issued guidelines which are explicit that a director should be fit and proper to Govern a Bank/FC.

Given below are certain expectations on 'Fit and Proper' and a list of traits and competencies.

<u>Fit and Proper</u>: Fit and proper is about appropriate age, qualification, experience and knowledge that a board member should posses.

A board of Director of a cooperative bank should have knowledge about

- ✓ Cooperative principles
- ✓ Resource and Business planning
- ✓ Banking rules and regulations
- ✓ Corporate Governance

- ✓ Financial statements
- ✓ Market Practices
- ✓ H R practices for Bank

In addition to the above, these days it is important that board members have good knowledge about (i) Information Technology (ii) Payment & Settlement Systems (iii) Human Resource Management (iv) Risk Management (v) Business Management (vi) Accounting for banking and (vii) Regulation and compliance.

Obviously one person cannot know all the above. It is here the Governance plays a role. A good board will allot specific areas to a director or a member of the management team who has knowledge and expertise in that area. It will defer to the expertise of such persons. For example, it should be ensured that Audit committee has members with expert knowledge on accounting and finance so that most of the important issues can be reviewed by that committee.

Since bank handles lot of public money and the board has huge powers it is necessary to understand who cannot be a director. The following is a partial/incomplete list of people who should not be directors.

a. Persons with criminal and financial misdealing record
b. Persons who are having business or customer relationship with the bank
c. Auditors who have professional relationship with the bank
d. Persons who are directors in other banks or financial institutions or doing business which are identical or similar to banking, say hire purchase, leasing etc
e. Politicians
f. Relative to a sitting director

It will be a good policy to stipulate that a director of a bank should not be a director in any other company, cooperative or organisation.

<u>Traits and competencies:</u> It is not practical to expect that each member of the Board will have all the below mentioned traits and competencies. However integrity and honesty should be a trait with all the directors. It is important that all of them understand these and that each trait or competency is present in more than two persons in the board such that Board can discuss issues and arrive at reasonable and informed decisions. Board has a Chairman and he/she has a casting vote. This should not come in the way of all members having an equal say. Board members should ensure that decisions are consensus driven and appropriate and that no one or two persons dominate the board. The traits are

- ✓ Personal integrity
- ✓ Ability to do structured and strategic thinking
- ✓ Ability to take decisions
- ✓ Negotiating and communication skills
- ✓ Leadership skills
- ✓ Fluency in local language
- ✓ Willingness to spend time for the bank
- ✓ Being a team player

Failure of a cooperative bank might impact other cooperative banks and even other banks as there are transactions/business dealings among them[70]. As such control by board is of critical importance.

Good governance is important. As failure of governance is not rare banks should endeavour to prepare policies and procedures in such a way that good governance can be practiced. It is an oft repeated statement in financial world that past performance is no guarantee that future performance will be similar. Given this fit and proper criterion by itself or a director being good in the past by itself will not ensure good governance. People may change and things can go wrong any time. In view of this what is need is well informed directors willing, keen and capable of ensuring good governance. Unless the Board is proactive and seek all necessary information and review, closely the correct compliance to board policy and regulatory norms good governance cannot be ensured. Also board should avoid decisions where board members are interested. Even if such interested board members excuse themselves from the board others are unlikely to take a correct decision. Bank should have a policy that interested party loans and transactions will not be done. Board efficiency depends on the type of information sought and submitted by senior management of the bank. It should ensure that all information is given to the board in time and that board understands the meaning and importance of the information.

4.1: Banking Regulation and Regulatory Powers

Cooperative Banks intermediate between savers and users of funds. They do this by accepting deposits in their name from members and others and lending to members and others or investing it for specific periods. These banks are also involved in enabling financial transactions and in payment and settlement systems. In doing these activities banks are exposed to many risks including credit risk, market risk, operations risk and liquidity risk. Risk is the essence of banking. It must be said that if there are no risks there can be no gainful intermediation. As such banks must take risk; to the extent they can manage it efficiently. If these risks are not managed efficiently banks may not be able to pay back the depositors and they may destabilise other institutions, with which they do business and the financial system of which they are a part. Failure of a bank will impact its customers and other banks/institutions. Failure should be avoided as it has contagion risk. Depositors should be protected. These two are among the various reasons why a bank is regulated. In a majority of countries, Cooperative Banks are regulated[71] by Central Banks of the Country. It is seen that in some countries where the cooperatives do not use the word banking they do not come under banking regulation. Following is a list of Regulatory Powers.

1. **Licensing/Registration.** A cooperative bank cannot do banking business unless it is licensed by the Central Bank of the Country. The license will indicate the financial activities that the bank can carry out. Conditions could include the minimum capital that the bank should possess, permitted activities, books of accounts to be maintained, governance, and a requirement to act according to regulations (a set of standards). Failure to comply with the terms and conditions could result in fines, penalties, remedial actions, revocation of license etc.

2. **Making Rules and Regulations:** Banking and Finance is concerned with financial products, processes, markets and people (customers and employees). Banks are intermediaries and interconnected. Stability of banks and banking system is important. Given this, the objective of regulation is financial stability i.e. avoiding failure of the banking and financial system. Towards this end, regulators have issued many (i) Norms and (ii) Guidelines. Regulatory norms are a set of rules on banking and finance business. Cooperative banks should act according to the rules and comply with regulations. From the compliance angle there is not much difference between norms and guidelines. These are a set of Do's and Don'ts along with definitions and clarifications such that it is implemented as intended.
3. **Oversight and Supervision.** Regulators must ensure that licensed institutions adhere to rules and regulation. This is achieved through oversight and supervision. Oversight and Supervision are concerned with verifying if banks comply though off-site and on-site review. Based on the observations of such reviews and powers vested in them, regulators issue letters and guidance to banks to enforce regulation. Supervisory powers include authority to levy fines and penalties, issue "cease and desist"[72] orders, initiate criminal or civil actions in court, initiate administrative proceedings or arbitrations; and to revoke licenses. Regulators can initiate such action against a bank based on their review, or government orders, and consumer/investor complaints.
4. **Resolution.** One of the objectives of regulation mentioned earlier was 'Avoid Bank/Financial Institution Failure'. A related issue is resolution of banks which are about to fail or failed. Regulators have the power to resolve a failing institution by encouraging merger with other institutions or changing the management or taking it through winding up or bankruptcy process.

Box.12: Resolution
When a cooperative bank is not able to carry on business it needs to be wound up. This means it should pay back the depositors and wind up its business. Resolution of cooperative bank is somewhat more difficult than commercial banks because of its ownership structure. Recapitalisation or takeover by others, which are feasible in the case of commercial banks (company /corporate form of organisation), may not be possible in the case of cooperatives. For such a takeover it may be necessary for the concerned cooperative bank to go through a process of demutualisation before the takeover. Cooperatives cannot make a public issue for shares. Its members contribute to capital for getting credit and financial services. In view of this it has been observed that raising capital during times of stress (dissolution) is difficult for cooperative banks due to limited member base and lack of interest with such members. Members will be reluctant to give money to a cooperative bank which is failing. This is true for all cooperatives. In view of this standalone cooperative banks which operate in rural areas, whose main objective is to provide credit for a given economic activity, will find resolution more difficult. In view of the above regulators recommend merger of failing or likely to fail cooperative banks. These banks could also be encouraged to network themselves and pool resources. Such networks can create an Emergency Liquidity Assistance (ELA) funds to save such banks[73]. The last option is allowing a cooperative bank to wind up. It is seen that cooperative laws provide for such winding up. Deposit Insurance is of critical importance in such cases.

5. **Market Efficiency and Integrity.** Market efficiency is the cornerstone for an efficient financial system. Regulators have to ensure that markets operate efficiently and that market participants conduct themselves properly. This will ensure that everyone has confidence in the market's integrity. Market driven but reasonable pricing (cost), liquidity, optimal transaction volumes (adequate number of participants/institutions to buy and sell in the market), control over hyper-volatility etc., have to be ensured by the regulator. Market efficiency is a function of transparency, correct and timely information available to all participants and efficient performance of transactions and financial contracts through a well-developed delivery or settlement mechanism. Regulators have to frame the business rules for the market, monitor it closely and take timely corrective action such that markets remain efficient.
6. **Consumer and Investor Protection.** Shareholders and depositors often find it difficult to reach the management of the bank. This is true in the case of cooperative banks as well particularly in the case of big cooperative banks. Many a times, big banks tend to treat members/customers very routinely (casual/offhand) at times not fulfilling their promises or terms of business. There could be depositors, borrowers and persons using remittance systems who may have certain issues about the product quality and delivery. Some of them might have suffered due to misinformation, fraud, discrimination, manipulation etc. Such customers are encouraged to register their complaints with the regulator who takes it up with the bank and gets errors rectified and ensure that customer service is rendered as promised.

   In the recent years, where the banking products have become very complex regulators have taken steps for financial education so that more risky products or products with complex features are accessed by well-informed customers.
7. **Deposit Insurance**: Regulators also take care of depositor protection. For this purpose they have created deposit insurance companies. Deposit insurance could be common for all banks. In many countries there are exclusive arrangements for insuring deposits of cooperative banks.
8. **Access to Credit.** Functions of banks include lending and investment. Proper and equitable distribution of credit is important for ensuring growth of the country as also orderly growth of regions, industries, trade and commerce. Regulators have to ensure

that every type of persons/borrowers is able to access credit and capital to meet their needs such that credit and economic activity can grow at a healthy rate. There should be no discrimination on the basis of race, gender, and location.

9. **Prevention of illegal/illicit activity.** Banks have huge economic power as they control huge amount of funds. This concentration of money power should not be misused. Steps should be taken to ensure that financial system is not used for money laundering purposes by unscrupulous people. Regulators should also ensure that financial system is not used to fund or support illegal, criminal and terrorist activity. Regulators have to ensure that banking and financial system is not used for money laundering (Tax avoidance or evasion) and financing terrorism.
10. **Financial Stability.** Failure of financial system will have catastrophic impact on a country's economy as well as global financial system. The GFC of 2008 is a recent example of such crisis. In the recent years, therefore, financial stability has become a very important role of the regulator.
11. **Financial Inclusion.** An equally if not more important objective of regulation is financial inclusion. Objective of inclusion is to ensure financial access to one and all. This alone will ensure the sustainability of the economy. Regulators encourage banks to reach banking services and products to poor and unreached.

Types of Regulation

From the above it is clear that the regulatory oversight has many objectives for which it needs many instruments. To implement these regulations and also strengthen the banks many regulatory norms/instruments have been developed. All these regulations are applicable to cooperative banks as well. Some of them are:

Prudential Regulation: Prudential regulation is concerned with the stability and safety of financial system, market and institutions. Financial stability is about ensuring that no financial institution is "too big to fail." The focus of prudential regulation is risk management and risk mitigation. The aim of this is to prevent failure of institutions. This is achieved by maintaining adequate capital with the bank.

Disclosures/Reporting. Disclosure and reporting requirements ensure that all relevant financial information are accurate and available to the regulators and public so that the former effectively monitor the system and the later can take informed financial decisions. Disclosures build trust. As these information passes through the bank boards' it helps in compliance as well. Disclosures enable study the bank and take corrective action if the review reveals some concerns.

Standards. Regulators prescribe standards for products, markets, and professional conduct. These include permissible activities, limits and rules for market participants. Standard setting is used to achieve (i) market integrity, (iii) efficient delivery of financial contracts (ii) Customer protection etc.

Competition. Good competition builds market efficiency. Regulators ensure that no single institution exercises undue monopoly in the market or engage in collusion or price fixing.

Price and Rate. Regulators can stipulate maximum or minimum prices, fees, premiums, or interest rates. These regulations are needed to ensure reasonable prices at the customer's hands.

For achieving the above regulators use various instruments as indicated in the table below.

Table.4: Various Regulatory Instruments[74]		
SN	Objectives/Issue	Instruments
1	Financial Stability/Risk Management	1. Minimum Capital Requirement also known as Capital to Risk Weighted Assets Ratio. Banks must have capital which is a stipulated % of risk weighted assets. Weights for Credit, Market and Operation risk stipulated by regulator. 2. GSIBs and DSIBs could be asked to maintain additional capital based on assessment by regulator.
2	Financial Stability/Credit Risk	1. Income Recognition and Asset Classification Norms particularly about NPA/NPL. Normally bank accounts are maintained on accrual basis. But under IRAC norms income is recognised not on cash basis in the case of defaulted/stressed assets. Also banks have to provision for anticipated loan/asset losses. 2. Counter Party Credit Exposure Norms beyond which banks will not take exposure on a given client. 3. Loan to Value Norms to be adopted by banks in their lending to certain sectors like real estate ensure reasonable valuation and that the borrower has some stake in the business.
3	Financial Stability/Avoid Misuse of Banking system	1. Anti-Money Laundering and Countering Financial Terrorism Law and procedures 2. KYC rules and customer acceptance policy
4	Financial Stability/Liquidity Risk	1. Liquidity Cover to be maintained at a given % known as LCR or Liquidity Coverage Ratio made up of HQLA 2. Banks to maintain Net Stable Funding in terms of highly liquid assets (NSFR)
5	Interest Rates/Reasonable rate for the customer	1. Base rate or Marginal Cost of Funding Rate. Banks have to follow the criteria given to arrive at the lending rates which could vary based on risk perception
6	Ensuring Access to Credit	1. Priority Sector Norms prescribed by regulators in India, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam
7	Bank Management	1. Corporate Governance Guidelines and Fit and Proper Criteria for Board Members and CEO
8	Credit Risk	1. Collateral Norms 2. Credit Rating Norms 3. Margin Norms These are norms to be followed by banks in their business. Further these are nature of guidelines but are concerned with maintaining

		the asset quality with banks. These aspects are important in calculating RWA for credit risk for arriving at Regulatory Capital

In addition to the above regulators are concerned with the safety net of the bank and depositors. For this purpose, as indicated earlier, all countries implement deposit insurance schemes. Insurance for cooperative bank is not always common with commercial banks. Some examples of Deposit insurance for cooperative banks [75] are as under.

a. In Germany deposit insurance for cooperative banks is provided by either (i) National Association of German Cooperative Banks' Voluntary Scheme (BVR-Sicherungseinrichtung), or (ii) National Association of German Cooperative Banks' Mandatory Scheme (BVR Institutssicherung GmbH),
b. In Italy coop bank deposits are covered by an exclusive organisation known as "Fondo di Garanzia dei Depositanti del Credito Cooperativo".
c. In USA deposit protection of credit unions (termed share accounts) is provided by the National Credit Union Administration (NCUA). All federally chartered and most of the State-chartered credit unions are insured under the National Credit Union Share Insurance Fund (NCUSIF). Remaining State-chartered credit unions are allowed to obtain primary deposit insurance from a source other than NCUSIF.
d. In South Korea there are 5 insurance schemes namely (i) Credit Union Guarantee Fund, (ii) Agricultural Cooperatives Mutual Credit Depositor Protection Fund, (iii) Community Credit Cooperatives Safety Fund, (iv) Fisheries Cooperatives Mutual Credit Depositor Protection Fund and (v) Forestry Cooperatives Mutual Credit Depositor Protection Fund.
e. 'Einlagensicherung Austria (ESA)/DGS Austria' is the deposit insurance fund for all credit institutions domiciled in Austria.
f. Cooperative banks in Colombia are covered by the Fondo de Garantias de Entidades Cooperatives (FOGACOOP).
g. In India DICGC an organisation managed by RBI implements deposit insurance for all banks

Regulation has become intensive over the past decade. The changes in regulation are more frequent these days and making compliance difficult and costly. It should be added that though all the instruments mentioned above are in use in all countries the rigor and applicability could vary from country to country and within a country from banks to bank on being systemically important or otherwise. Take the case of **Capital requirement.** It is evident that every financial institution has to maintain own funds (Capital and Reserves) and subordinate funds of stipulated levels to comply with the set norms. As per this, amount of capital should be maintained at the prescribed % (prescribed ratio) level equivalent to or more of the institutions risk weighted assets. This is also called regulatory capital and is the main stability instrument that regulators are using. Under Basel III, the Regulatory Capital Ratio could vary according the status of the institution if it is (ii) Globally Systemically Important, (ii) Domestically Systemically Important, and (iii) Less Systemically Important[76].
It is observed that in most jurisdictions these norms are generally applied on a 'One Size Fit All' basis within a given classification. For example in Europe all GSIBs have similar norms. Also cooperative banks may have norms somewhat different from commercial banks. There are some proportionality in regulation and an increasing demand from cooperative banks and its associations on more proportionality.

4.2 Proportional Regulation:

Since the Global Financial Crisis, banking regulations are ever on the increase. The journey from Basel I to III has been hectic. The complexity of regulations is also in the increase. Basel III is very complex and difficult to understand. Circulars issued by Central banks of countries on various items covered by regulation runs into hundreds of pages leaving almost very little scope for Boards of banks to add anything from their side[77]. Banks are afraid of deviating even if a particular regulation is inappropriate to them. Banks are also concerned about high cost of compliance. Currently, in Europe where Basel III is being implemented more vigorously than elsewhere there is a feeling that 'Large banking institutions face the risk of failure if interest rates in Europe will continue to stay negative'[78]. This is because European banks have been working under pressure of regulation and very low rates of interest for quite some time now. Low margins hurt the banks. Low margins hurt smaller banks more than the bigger banks. It is in this connection that proportional regulation is being talked about.

In the recent months, Covid-19 the pandemic has impacted people, business, employment, market and almost everything in the world. No one knows when the world will overcome Covid-19 and at what cost. It is in this context that a question arises 'will these norms save the banks in case of another crisis?'[79]. One will recall that GFC was called a 'Black Swan'[80] and since then banking regulators have been piling up regulations one after another. Therefore this time around when Covid-19 happened banks should be able to manage it without much difficulty related issues. Yet without exception every regulator has relaxed or suspended many regulations (Capital, Accounting, NPA/NPL etc) for the period of Covid-19. As of now it is not clear as to how long it will take to get the vaccine ready and how much will Covid-19 impact, and whether compliance to capital adequacy and other norms will save the banks. This time around whether financial cooperatives in Europe will do well and better than commercial banks cannot be predicted as many cooperatives have been merged and become bigger institutions. Member support was critical for saving from the impact of GFC. Whether similar member support will be there? Because, unlike the past the distance from the member is more now!

With regard to the main instrument, i.e. capital adequacy there have been, many changes in the recent years and there have been certain bank failures as well[81]. Some of the other norms and guidelines (Table 4) have a role in estimating the risk and arriving at the correct amount of capital. Basically the philosophy of regulation is same in all countries and the principles underlying these standards remain relevant for all. At the same time it is debateable/questionable if full set of international standards should be applied to less complex and smaller financial markets/institutions and in countries whose financial systems/infrastructure and supervisory capacity may be still developing. National regulators must take decisions appropriate to their country[82].

The metrics that go into arriving at the stipulated CRAR etc., is not known. Given the one size fit all approach, apparently, it seems adequate work has not been done in terms of arriving at the segment wise possibility of risk or probable impact on financial stability and then stipulate capital adequacy. The effect of IRAC norms on credit risk and consequent impact on capital adequacy has to be closely studied. That some of these norms have been kept in abeyance in the current pandemic also points out to the need of understanding outliers in the risk line/graph. Possibly, it is for these reasons that the debate of proportionality has taken centre stage, particularly in advanced economies. That Basel III, despite its avowed proportionality, is very complex has only added to the debate. This is because there have been no known relaxations on the % of CRAR in respect of banks under Basel III. Related issues, where proportionality is critical are reporting requirements and supervisory practices.

Proportionality advocates the need to limit the rules, sanctions and oversight to what is actually needed and appropriate to achieve the main policy objectives namely (i) financial stability, (ii) financial inclusion, (iii) market integrity and (iv) consumer protection. Following are some issues concerned with regulation.

a. Regulation increases costs. Costs include resource costs of the banks to meet with capital and liquidity norms, compliance costs in reporting and monitoring and regulatory costs due to increased supervision. Compliance involves more fixed cost on account of the need to establish exclusive compliance function and systems.
b. Regulation might induce changes in bank business mix and models which are not needed except for complying with regulatory norms. Cooperative banks in rural areas in many countries have started issuing retail loans (housing and vehicle loans) to non-members which could help in risk diversification but end up in depriving credit to members for agricultural activities.
c. Capital regulation is only one among the many guidelines issued by regulators. Some of these guidelines are so much in detail that there may be no need for the banks to make policies on the subject. Regulation should not make one feel that regulator is effectively taking over the management of banks by limiting bank management's discretion. Regulation should not make the role of Board redundant in policy making. Else governance will be limited to banking operations.
d. Regulation tends to impose a disproportionate burden on small players in the market and new entrants, making it harder for them to compete with established players. Disproportionate regulation may induce arbitrage within the banking system. It may also compromise competition in the banking system by increasing barriers to entry.

Proportionality is about matching regulation with the possibility and likely impact of risk. It is concerned with balancing the costs and benefits of regulation. Regulators must consider:

a. Whether a regulation that has been designed to apply to all regulated institutions is disproportionate to some in relation to the objective sought.
b. All regulations are interconnected. For example if NPL of a bank increases without corresponding increase in capital the compliance to CRAR will be impacted. In view of this every piece of regulation should be considered independently and in totality with other regulations whether it is appropriately designed and applied to the sector, segments and banks.
c. Regulation should not be disproportionate for the key regulatory objectives.
d. Regulation should balance the two objectives of 'Financial Stability and Financial Inclusion'
e. Regulation should be exact but not complex. Complexity increases cost of compliance and does not make it easy to achieve regulatory objectives. There is no need to review and keep increasing the regulation as if to justify the existence of regulators.
f. Regulation should not be uniform across the country and across institutions. Uniform norms will have different impact on banks and lead to financial arbitrage. In such cases the result of regulation will not be ideal and some banks could be impacted more than others. Differentiation is needed and should be well thought out.

Proportionality in regulation is being demanded by cooperative banks and has become a very important issue in the context of implementing the post-crisis regulatory reform and sustainability of cooperative banks and small banks. There is a serious concern that the number of cooperative banks is on the decrease. Cooperative banks and smaller banks face a relatively higher compliance burden. It is now an acknowledged fact that that cost of regulation could be high on small banks and could have unintended results.

Currently, regulatory norms, which are frequently reviewed and revised, are decided on an international basis by Bank for International Settlements (BIS). Along with this there is an increased reporting requirement that has increased the costs of compliance for the banks and financial institutions. A closer reading of these norms will show that they are not intended to be applied as 'one size fit all' to the whole banking system in all jurisdictions. For example, there is no need for all countries to apply Basel III capital adequacy regimes of to non-internationally active banks. In that context, most of the National Regulators have already introduced or are currently considering the adoption of a more proportional regulatory approach. Reports of Financial Stability Institute (FSI) show that regulation is not common across countries and there are variation in respect of the regulations on (i)Liquidity Risk –LCR and NSFR (ii) Counterparty Risk (iii) Large Exposure guidelines, (iv) Credit Risk, (v) Market Risk, (vi) Minimum Capital Ratios (vii) Disclosures and (viii) recovery and resolution. This is in line with the emphasis on global financial stability and fair competition in international markets.

A caveat that must be mentioned here is that proportionality as a way of reducing the regulatory burden should be used only and only if less burdensome rules are adequate and effective to ensure sufficient solvency and liquidity for smaller and less complex banks. Striking a good balance between minimising the regulatory burden and respecting the prudential objectives is the key to implementing proportionality. This would ensure that that proportionality does not threaten financial stability and/or the resilience of individual banks.

Box 13.: Proportional Regulation Some observations from a BIS Report[83]
1. The regulatory response to the 2007–09 international financial crises has resulted in a more robust but also more <u>complex</u> regulatory framework. The Basel standards are designed <u>to be applied to large and internationally active banks</u>. But many jurisdictions have decided to apply the Basel standards to a wider set of banks. 2. The additional complexity of Basel III has triggered discussions on the principle of "proportionality", i.e. on how best to tailor regulatory requirements to non-internationally active banks, especially smaller and less complex ones. The discussion about applying a proportional approach to banking regulation is not new. The Basel framework has offered a menu of approaches since the advent of Basel II. 3. Several countries have implemented specific regulatory standards for smaller and less complex banks. 4. Since the introduction of risk-based supervision, the principle of proportionality has been factored into day-to-day bank supervision. 5. A study (by BIS) has shown that some countries have adopted adopt different criteria/thresholds to decide which banks are subject to a specific set of rules, and also in terms of the regulatory standards that are subject to a proportional implementation. The key feature of a proportionality regime is the criteria used to identify the banks to which a proportional framework is applied. The criteria for identification/segmentation vary widely across jurisdictions, although a bank's size plays a major role. In addition to size, the bank's business model and business activities are critical considerations when applying a proportional regulatory treatment. 6. Generally, full Basel standards are enforced, as a minimum, on mid-sized to large banks. In many jurisdictions, banks with balance sheets of more than € 20–30 billion are, generally subject to the full Basel standards. 7. Some countries apply Basel-based standards to large international banks. However prudential requirements applied to other banks are not necessarily less stringent. 8. The criteria used in segmenting banks for possible exemptions in regulatory requirements follow different schemes. In three countries – Brazil, Japan and Switzerland – banks are divided into specific categories according to their size and/or international activity. <u>Banks in the same category are subject to a specific set of rules that differ from the ones applied to banks in other</u>

categories. By contrast, in the European Union, the United States and Hong Kong SAR, rules corresponding to specific Basel standards are adjusted for banks meeting set criteria, e.g. market risk can be measured according to a simplified method for banks with a small trading book. These two different schemes are often applied in combination, meaning that specific exemptions can be granted in addition to the selection of banks into different regulatory categories.

9. A noticeable feature is the scope of the regulatory adjustments for smaller or less complex banks. These proportional adjustments aim at reducing the operational burden for banks.
10. Exemptions are seen in the liquidity framework, the disclosure requirements, counterparty credit risk, the large exposures framework and the measurement of market risk.
11. Other regulatory areas, which are more principle-based by design, such as Pillar 2 and interest rate risk in the banking book, offer more scope to further reduce the regulatory burden.

BIS recommends that the "proportionality strategy" should acknowledge the limits posed by other relevant policy objectives. Regulators must weigh the implications for financial stability and for the domestic competitive environment. Policy choices face complex trade-offs in this respect. It would be proper to aim for a proportional compliance and reporting burden for smaller and less complex banks without jeopardising their minimum desired solvency and liquidity. In other words, proportionality should entail rules which are simpler but not necessarily less stringent.

Seeking regulatory relief on specific prudential norms which are not significant has certain merits. This would however call for categorisation of banks which are similar in business and risk. This could lead to specific set of simpler regulations for each category and bring about consistency in regulatory, supervisory and resolution approaches for each category. In this connection, it must be, at this juncture – based on literature review- mentioned that the impact of current regulations on (i) risk management and (ii) sustainability of regulated entities has not been fully researched. *It is very important to underline the fact that most of the regulatory norms are applied on a balance sheet basis and does not factor the future business plans. This would typically mean that the approach of regulation is on a "gone concern" basis and not on "going concern basis". Regulatory action in case of failed compliances is on a "going concern" basis.*

It is also necessary to raise another issue. There have been bank failures despite regulation. Did those banks fail because of failure to comply with a particular regulation or the failure was on account of other reasons? How to evaluate proportionality?

Barring some Financial Cooperatives in Europe and USA which are big, most of the standalone cooperative banks are small. The approximate share of cooperative sector as a whole in overall banking business in these countries is less than 10%[84]. As such the market share of **Individual banks share will be insignificant from the angle of financial stability.** Most of them have simplistic business model. This is an important factor to consider when implementing proportional regulation. Possibly due to these considerations, many country regulators practice proportional regulation. Proportional regulation is concerned with stipulating differential regulatory norms taking into account the size and complexity of the regulated entity. But applying differential regulation for each bank and each variation in size and complexity will be impractical. It would be appropriate to group the banks into unique or somewhat similar categories and apply proportional regulation. Once the grouping is done applicable proportional regulation will be common across all institutions in that category.

The following is a quick review of proportional or differential regulation as it applies to cooperative banks.

a. In all countries, supervisory expectations and therefore the regulatory prescriptions are higher with respect to large and more sophisticated financial institutions regarding governance, processes and systems. The main tool/plank of regulation being capital adequacy proportionality is seen in capital and liquidity adequacy ratios.
   In some of these countries smaller institutions are given concessions in capital ratio and LCR.

Some regulators want the cooperative banks to either merge or become demutualised at the central level. To achieve this, regulators stipulate higher capital ratio for them and seem to nudge them towards merger. In France and Germany (and more generally EU countries) Basel III standards apply, in general, to all financial institutions regardless of their size and complexity. It must be added here that both Basel II/III norms advocate Internal Risk Based Assessment which will invariably lead to proportionality. More over the size and contribution of cooperative banks in to the financial market in Europe is high[85].

b. Proportionality in prudential regulation usually takes the form of simpler but not necessarily lighter requirements. (Proportionality does not mean a lower capital ratio). This is typically a policy choice when the regulator wants to reduce the regulatory burden without compromising the soundness of smaller and less complex financial institutions.

   In these cases proportionality could take the form of (a) simpler and higher capital and liquidity ratios and simplified supervisory reporting requirements or (b) very low ratios where the institutions are not important in stability angle.

   In India for example Rural Cooperative Banks have to maintain Regulatory Capital as per standard norms (Basel I), and Small Finance Banks (new commercial banks with a higher mandate to serve the small borrowers) have to maintain a higher CRAR while some commercial banks have been already moved to Basel III.

   In Brazil, the minimum CET1 ratio under the simplified prudential approach ranges from 12% to 17%. In some countries regulators depend solely on a non-risk-weighted metric.

   In Ireland, Kenya and South Africa, a minimum ratio of 6% to 10% is applied based on a non-risk-weighted ratio of retained earnings to total assets. Such approach incentivises the cooperative banks to avoid an excessive distribution of their annual surpluses and improve retained earnings which is the main (and often the only) source of capital for them.

   In some jurisdictions compliance data is mainly form financial statements making compliance with regulatory requirements less costly.

c. In some countries risk-sensitive capital adequacy ratios are prescribed, but the assessment and calculations are simplified. In Brazil capital adequacy ratio is solely based on financial statement figures for small and less sophisticated financial institutions, including cooperative banks. There are instances where the regulator nudges the cooperative banks to consider merger or other methods to cooperate. For example, in Brazil minimum capital adequacy ratio for standalone cooperative is 17% while the minimum for networked cooperative is 12%.

   Under the simplified approach, risk-weighted assets are mainly on balance sheet credit risk items. Also risk weights are commonly calibrated to a higher level to compensate for the fact that several other components of risk are not reckoned.

d. Several countries exempt small financial institutions from compliance to the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). Instead they stipulate a simple liquidity requirement at a given % to total assets or deposits. In Ireland, for example, cooperative banks are required to maintain a minimum liquidity ratio of 20% of their unattached savings in liquid assets. In Kenya, at least 15% of total savings deposits must be held in the form of liquid assets. India does not prescribe LCR for cooperatives; however it stipulates Cash Reserve Ratio (3%) and Statutory Liquidity Reserve (19.5%) of Net Demand and Time Liabilities which adds to 22.5% pre-emptive reserves, among the highest in the world[86]. SLR is a financial repression[87] instrument aimed at increasing investments in Government bonds.

e. Compliance to regulation has a cost[88]. Therefore, reporting requirements can also be proportional. In Brazil, small financial institutions are exempted from Pillar 3 disclosure (information relating to their risks, capital adequacy, and policies for managing risk with the aim of promoting market discipline) requirements. In South Africa, large FC's are required to submit monthly returns while small ones report on a quarterly basis. In Australia, Australian Prudential Regulation Authority is planning simplifying the disclosure requirements for 'less sophisticated' or smaller financial institutions.

f. Credit risk is the most critical risk for banks. Cooperative banks are no exception to this. Possibly the volume of default in commercial banks could be higher but the number of members in default could be higher in cooperatives. Generally cooperative banks – within that stand alone banks -are not much into investments and therefore do not have to face high market risk.

g. Provisioning rules are essential part of the prudential regulatory framework in all countries. Given the relative complexity in accounting rules under IRAC norms, some countries have come up with a simplified or automatic approach to provisioning. In Australia, Kenya and South Africa number of days in default is the main input for determining the provisioning rate. In Ireland under Financial Reporting Standard, Cooperative banks have to follow an incurred loss approach to provisioning while commercial banks comply with IFRS norms i.e. an expected loss-based approach.

h. Further, as regards NPA and provisioning norms, most countries apply same rules to cooperative banks regardless of risk profile and size. In the case of India, Ireland, Kenya, Bangladesh and South Africa, prudential requirements applicable to cooperative banks differ from those of commercial banks. For example while asset classification norms are common in India, asset valuation norms for investments are different for cooperative banks with a provision that cooperative banks which do not trade will classify the investments on permanent and current basis while cooperative banks which trade will classify on HTM, AFS and HFT norms similar to commercial banks.

i. The measurement of capital differs among countries. In Ireland and the United States where capital is mainly made up of retained earnings, member shares are not eligible for regulatory capital because they are redeemable and are therefore considered to be liabilities. In Kenya member shares may count as regulatory capital, but they cannot be redeemed. If a member wants to leave the cooperative that member's share must be transferred to another member. In European Countries member share is considered as part of capital. In most of the countries member share is not transferable and can only be redeemed at face value. Member does not have a right to ask for retained earnings when redeeming the capital.

j. Regulators have prescribed Exposure limits[89] which are linked to owned capital (Member share Capital plus retained earnings). It is observed that most of the standalone banks and do not have much capital. As such exposure norms constrain these cooperatives more than others.

k. Given their small size and regional focus concentration risk is high in the case of small and/or standalone banks.

Almost all countries practice some sort of proportionality. It is concerned with applying Basel I norms to some institutions and Basel II or III norms to some other institutions. This is because right from the beginning, proportionality has been recognised by Basel norms[90]. For example in credit risk it allows advanced <u>internal ratings-based approach</u> wherein banks are allowed to, subject to regulatory approval develop their own model to quantify required capital for credit risk.

Generally, proportionality in the context of financial regulation involves the imposition of simpler, less-risk sensitive requirements to identified banks/institutions. Naturally there will be an apprehension about the possibility that proportionality may not be a perfect fit, could be misused to offer a sort of regulatory subsidy to specific institutions, and prevent or delay a possible restructuring of the industry. Also there is no assurance that banks which receive proportional regulation will not indulge in more risky business[91]. One unintended consequence could be that it can encourage risky behaviour by banks that benefit from the simplified rules.

In view of the above it is necessary that

a. Simplified regulatory requirements should not be at the cost of prudential safeguards like capital requirement and liquidity backup needed to sustain confidence in regulated institutions and the financial system be it big or small bank.
b. Supervisors should be well informed and have sufficient information about the overall risk profile of entities that are subject to simplified regulatory rules
c. Proportionality should not shield banks from competition, particularly in a well-developed banking system.
d. Proportionality should be applied where it is evident that bank does not pose systemic risk and that bank has risk management systems in position.

It is seen that, in the absence of any pronouncement or guidelines by B I S on what is proportionality and how to arrive at the same for different segments/institutions, countries have used their own criteria to differentiate institutions and areas in deciding proportionality. However these indigenous rules are woven around the basic philosophy of Basel. Most of the countries have used proportionality in the case of 'Less Systemically Important Local Institutions'. For example, in India Urban and Rural Cooperative banks have to comply with Basel I guidelines for Capital Adequacy. This does not mean less capital as some of these banks may qualify for lesser capital if Basel III norms were to be applied. In South Africa the capital adequacy is around 5%. Europe is considering the request of banking associations for proportionality. In the United States, only a few banks with total assets of $250 billion or more or $10 billion or more in total on-balance sheet foreign exposure are subject to Basel III's risk-based capital and leverage requirements, with additional capital requirements applicable to US GSIBs[92]. In regard to the LCR, the full LCR requirement generally applies to US banking organisations that are under the advanced approaches to regulatory capital measurement and their subsidiary organisations that have consolidated assets of $10 billion or more. In contrast, in the European Union, nearly all banks are subject to Basel III, with a few exceptions for smaller banks. These vastly different approaches, while well within each jurisdiction's purview, illustrates the need to arrive at a common understanding of the pros and cons of the varied proportionality approaches that have been taken or are being considered.
An important dimension to proportionality is concerned with differentiation i.e. to what extent the regulation applied to particular class of banks should differ and reflect their specific position/circumstances. For this purpose, it could be considered if banks could be, for the purpose of proportional regulation grouped into categories based on the type of organisation, business size, business mix (whether it includes investments and dealing with derivatives and exotic instruments) subsidiaries owned, market presence, interconnectedness, track record of write offs etc. These categories could be used as the basis for differentiating requirements. Indeed, this is the approach followed in countries such as Brazil and Switzerland and it is the one that the United States is planning to adopt soon. Ideally, the defined categories could be used not only to establish specific prudential rules but also supervisory criteria and resolution planning requirements. It is however clear that banks which are classified as GSIB and DSIB should be subject to most appropriate regulatory, supervisory and resolution policies, in relation to other entities operating in the country.

5. Summary of Observations and Conclusions

This study report is based on a secondary data, reports and information available in the web and portals of banks, regulators, associations etc. Every effort has been taken to collect as much information as possible/available[93]. In this chapter we connect various issues discussed previously[94].

5.1 Summary of observations

A. Applicability of regulatory norms on cooperative banks, as per extant rules.

   i. In most countries small sized cooperative banks are covered by Basel I norms. In these cases the standard approaches for the risk measurement of the credit portfolio introduced under Basel II do not apply. It is observed that the financial leverage of a bank is a function of the a stipulated ratio of tier I and II capital to the total assets, and this ratio must be at least 4%. Small banks are exempted from certain disclosure requirements. The rules for solvency, leverage ratio and disclosure are stable, simple and implemented with conservative calibration.

   ii. Medium size banks constitute the largest chunk of banks. Here, in most countries risk measurement is as per the standard approach of Basel II to the bank's loan/investment portfolio in full. Within this, banks which are somewhat bigger and have a diversified portfolio could come under Basel III.

   iii. Large banks i.e. institutions with total assets below $700 billion—must meet a CET 1 of at least 4.5% for solvency as well as both capital preservation and countercyclical capital buffers. Moreover, they have to estimate the risk using internal models with reference to a minimum/floor. In comparison to not so diversified banks (non-advanced banks), the calculation of the leverage ratio according to Basel III is used for large and very large banks. In these cases the ratio of the core capital to the leveraged exposure must be at least 3%. Further, large banks are subject to more detailed disclosures.

   Further, banks with more than $700 billion of total assets must additionally maintain capital buffer between 1.0% and 2.5%. If they are also globally systemically important then the leverage ratio (capital to leverage exposure) must be at least 5.0%.

B. The financial cooperatives (Cooperative Banks) could be broadly classified as[95]

   i. Standalone – Many countries

   ii. Net worked. Within net worked there could be varieties

      i. Network with an institutional protection scheme, IPS. Example: BVR(DE) Germany, Fachverband der Raiffeisenbanken -Austria

      ii. Networked without IPS- Rural Cooperatives of India

      iii. Networked- but not federated - with others for financial and other support and no formal IPS- USA

      iv. Integrated (co-operative) network. Example: Credit Agricole, Credit Mutuel, BPCE - France

      v. Consolidated co-operative group: Example OP-Pohjola Finland, Österreichischer Genossenschaftsverband- Volksbanken Austria, Credito Agricola –Portugal, Raiffeisen Luxembourg

C. An important item in the networked institutions is the Institutional Protection system. This entitles the banks in the network to draw up annual consolidated report comprising the balance sheet for the network as a whole. Central institution of IPS has more disclosure requirement. Most of the central institutions in the IPS are established as Joint Stock Companies owned by cooperatives. In a few cases there are outside shareholders as well. Banks within the IPS remain largely independent in their day to day business. IPS,

i. Ensures Liquidity and solvency of networked institutions
ii. Extend support to banks within the network from readily available funds
iii. Central bank implementing the IPS conducts its own risk review of the banks in the network, and
iv. Supervises institutions in the network instead of the Regulator/Supervisor.

D. Proportional regulation varies from country to country. For quick understanding we give below the proportional regulation as practiced in Europe. This could be the broad approach in most countries and can be taken as the basis and measure of proportionality. Current extent of proportional regulation is, briefly:

i. Standalone banks could be under Basel, I, II or III as national regulators have different approaches. BIS has observed that some sort of proportional regulation is being practiced.
ii. Banks within the Network enter into a contractual or statutory liability arrangement which protects the local/regional co-operative banks. In Europe, they enjoy 0% risk weight on intra group exposures.
iii. In the Integrated network, the local/regional co-operative banks and the central body are linked by a parent-subsidiary relationship. There is a higher level of control of the central institution. The local/regional banks remain the owners. Nevertheless, they have ceded control powers to that central institution, on certain items of business, to ensure oversight. Here again 0% risk weight for intra-group exposures have been allowed.

    These banks are monitored as 'one set of institutions' on the basis of consolidated accounts and not individual banks. The central body of the network is subject to the same risk evaluation, measurement and control procedures as the local co-operative banks. There is no legal impediment to the transfer of own funds or repayment of liabilities from the central body to the local/regional bank.
iv. In the Consolidated Cooperative Group model there is a high degree of integration wherein the Local/Regional banks which are permanently affiliated to the central unit. In this model central institution and the local/regional banks are treated as if they were one bank. In these cases supervisors waive the fulfilment of certain prudential requirements by the local bank (solo) level which are applicable only on the consolidated level. The central body is empowered to issue instructions to the management of the local/regional co-operative banks. The central body and the affiliated banks are jointly and severally liable for many commitments. The solvency and liquidity of the central body and local/regional co-operative banks are monitored as a whole on the basis of consolidated accounts.

E. Proportional regulation is said to be risk and size based. How much should be the proportionality and how it is arrived for the coop banks in each country could not be ascertained. There are no indications on what proportionality is allowed on risk weights or method of arriving at risk for cooperatives. Evidently regulation does not factor the type of organisation like company, cooperative etc in its evaluation matrices. It is clear that in respect of cooperatives which are classified as GSIB and DSIB Basel III norms on par with commercial banks is applicable. Also some banks are under Basel II and III which allows internal rating based (IRB) approach has proportionality built in it. However the continuous demand for proportionality – despite allowing banks to opt for IRB etc., would indicate that the extant proportionality in the case of cooperative banks does not meet their full requirement.

F. Networked cooperative banks are large in number in Europe and most of them are under Basel III. In contrast, in India where the short term cooperative banks that have some sort of networking but does not have IPS. The primary societies (lowest tier) are not regulated and cannot accept public deposits. The banks are under Basel I.

G. Outside Europe and USA there are no systemically important cooperative banks. Given this most of the countries follow proportional regulation for coop banks woven around Basel I and II. It appears that National regulators take Basel standards as a basis and do a plus or minus for proportional regulation. If there are other methods to arrive at this number it is not evident. But in most cases capital ratio is between 4% and 9%.

H. The Basel Committee on Banking Supervision has indicated that its stress-testing principles have become disproportionately burdensome on community-based institutions. There is a need for supervisors to conduct stress tests proportionate to the size, complexity, resources and risk profile of each institution.[96]

<u>5.1.1 How are the cooperative banks performing</u>? Is regulation for financial stability alone or does it also help banks in anyway? In this regard a perusal of various studies/articles has shown that

i. Membership of cooperative banks has gone up from 50 million in 1998 to 84.8 million in 2017. Membership has recorded an average growth rate of 2%. It is reported that the driving forces behind surging number of members are financial benefits, material advantages, the ambition to participate in internal governance bodies, affinity with the brand, satisfaction with products and services, the pursuance of a dual-bottom approach etc.

ii. At the same time <u>it is a matter of concern that in countries where financial markets are well developed there is definite reduction in the number of cooperative banks.</u> Evidently reduction in number of banks has not impacted the growth. For example the number of cooperative banks in Europe[97] was 2900 (2018) but 4200 in 2011. In USA the number of banks was 6010 in 2018[98] (7708 in 2009). Europe has witnessed decline in the number of banks due to mergers, governance changes and a consolidation process. At the same time the ratio of cooperative banks' members to the total population increased continuously from 12.9% in 1997 to 18.1% in 2014. Africa has witnessed increase in the number of banks but not all cooperatives are regulated by banking regulators.

iii. The region-based or limited area of operation business model of cooperative banks faces the challenge of cost reduction and sustaining their local branches[99]. At the same time their efforts in using digital channels etc., seem to decrease costs and help reach new potential customers.

iv. Apparently in all jurisdictions there are some efforts/moves by regulators to nudge the banks to merge and become bigger and come under Basel III and be subject to close monitoring. There[100] exists a strong belief that these norms have strengthened the systemically important banks. In this connection as indicated above there is definite reduction in the number of cooperative banks in countries where coops are well entrenched and regulation is nudging them towards Basel III. Also, it is a matter of concern that very few, if at all, cooperative banks are being newly established. No entry norms for coop banks have been developed.

v. Cooperatives covered 21% of the world population as of 2018[101]. In Europe where cooperatives are recognised as important players in financial system the market share in deposits was 22.0% (20.9% in 2011), Loans 23.1% (20.2% in 2011) and Branches were 33% (29.1% in 2018). It is seen that, in the recent years, only cooperative banks have recorded growth in loans while others in the banking sector have not recorded any growth since 2011. Cooperative banks in France had about 45% market share in deposits, though the banks were big and work like commercial banks. Outside Europe the cooperative banks had a market share of about 10%-15%

vi. Cooperatives in Europe had a ROE of 6.8%. Capital ratio (Tier 1) of Cooperatives was 15.9% in 2018(11.5% in 2011) against 15.3% of commercial banks (11% in 2011). In Europe, the cost to income ratio of Cooperatives was 65.5% bit higher than commercial banks ratio which was 62.5%. The cost of compliance and cost of networked structure could be the reason for higher cost to income ratio. Needless to add that, in Europe, on account of low interest rates and high cost to income ratio the margins of cooperative banks are very low. NIM was 1.2 % in the year 2018.

vii. In a study, researchers have observed that in case of smaller banks loan volumes have either remained stable or increased while loan loss provisioning has decreased. "Cooperative banks as a group of have shown the least pro-cyclical effects and the most income smoothing behaviour[102]".

viii. A "z" score based analysis has shown that cooperative banks in advanced countries have lower volatility in returns which more than offsets their lower profitability and lower capitalisation. They have higher z-scores[103] than commercial banks and (to a smaller extent) savings banks, suggesting that cooperative banks are more stable[104].

ix. Is high presence of cooperative banks a challenge to commercial banks, in particular those commercial banks that are weak to start with? A study report says that presence of non-profit entities like cooperative banks can impact other financial institutions and pose threat to stability. This is not tenable as the size of non-profits will be small and cannot pose any real threat to stability. Moreover, cooperatives are for profit but not profit maximisation. As such it will contribute to market stability. Actually it is not the cooperative bank but the cost structure and financial weakness of commercial banks that could threaten its viability. It is true that higher cooperative bank presence could mean less space for weak commercial banks in the retail market more so because they have greater reliance on less stable revenue sources such as corporate banking or investment banking. The IPS like support mechanism seem to ensure sustainability of coops having lower variability in returns

Cooperative banks have continued to grow in terms of deposits and advances. Their share in business has improved. Most importantly, in terms of financing SME and agriculture portfolio these banks have a higher market share. Cooperatives have recorded growth despite high cost to income ratio and low rates of interest. As such regulation has not negatively impacted the cooperative banks. Also it is an indisputable fact that a bank being regulated gives rise to high public confidence and continued business. This explains why cooperative banks have strived to comply and change their business model and seek differential or proportional regulation. A perusal of websites of some of these banks also shows that they have been able to offer new tech-driven products to their customers. Some of them are also active in international fund transfers for their members/customers. In many countries there is a definite recognition of the contribution made by cooperative banks.

5.1.2 Governance:

One of the important issues is Governance. Board of Directors of a bank are elected or appointed based on certain criteria. It is expected that they follow rules and regulations. As such, be it a company or cooperative the constitution and composition of board does not encourage poor governance. Yet government failure happens. This is because the members at a given point of time have failed. Actually governance failure happens if one or a group of board members do something out of the way or inappropriate and other members do not stop it or unable to stop it. This can happen with any organisation. This can happen even if rules are tightly framed. There can be no prior notice of governance failure. It is not predictable.

Post GFC studies and analysis have shown that governance failures happened due to error of judgement or pursuit of profit/incentive maximisation. It is indeed well documented that Governance failure in coop banks has been more due to error of judgement than pursuit of profit maximisation. Failures have been very small in comparison to commercial banks. Yet a close reading of articles, regulator speeches, pronouncement seem to suggest that quality of Governance in cooperative banks is poor and presence of independent and professional directors will help the banks to overcome these issues. Reading between lines would also show that Regulators favour company form of Governance. Possibly this is the reason why regulators in some jurisdictions are nudging cooperative banks towards demutualisation. Also in many jurisdictions government has stake in the cooperative banks and this does affect governance. Of course it is well recognised that a demutualised cooperative is distinct from investor owned banks.

5.1.3 Some of the issues that emerge out of the study are:

a. Standalone banks are smaller in size and Less Systemically Important. Current trend and regulatory designs indicate that these bank will be, eventually merged into bigger banks. The regulatory approach seems to be nudging them towards becoming a part networked institutions.
b. The cooperative principles of "one vote one member", share linkage to credit, not pursuing profit maximisation etc are not factored in regulatory estimate of risk. As more banks move towards IPS the general assembly and 'one member one vote' concepts become less effective. As banks become demutualised these aspects loose importance.
c. There are concerns about the redeemability of cooperative bank shares. Some regulators indicate an annual amount of redemption while some do not allow any redemption. These actions have implication for the cooperative character of the banks. This ends up dissuading people from becoming members of cooperatives.
x. Once networked the standalone cooperative bank loses its individuality.

xi. Governance is a big challenge because as banks become bigger members find it difficult to be board members. Regulators insist on more number of independent directors. If the board has majority independent directors, then members lose control over the bank. This stipulation of fully independent board being made on cooperative banks however is not seen in case of commercial banks.

xii. Proportional regulation is ad-hoc/arbitrary and Basel has not developed any metrics for the same. Basel has not, apparently arrived at any methodology for proportional regulation. It is the structure of Basel II and III that ensures proportionality.

xiii. Cost of compliance is on the increase. The cost to income ratio of cooperatives is higher. This could be due to compliance cost and cost of capital when fixed cost borrowings are resorted to for maintaining CAR.

5.2 <u>Recommendations on Proportional Regulation</u>

This study is about proportional regulation. It has shown that financial cooperatives (banks/unions/credit societies) of different size, shape exist across the world covering on average about 10% of the population. Study has revealed that regulation is not even across countries and to certain extent it is proportional. Though proportionality in regulation varies from country to country the basis of proportionality is not apparent.

Regulation is a set of norms, mandates and guidelines about many aspects of banking. A study of regulation and guidelines in various countries shows that barring human resources management, physical infrastructure and look and feel of banking most other aspects of banking are covered by certain norms or mandates or guidelines. This is borne out by the existence of, in most countries, detailed guidelines on items such as Deposits, Credit, Investments, Risk Management, Customer Service, accounting standards, disclosures, IT, Cyber Security, Payment and Settlement and Corporate Governance etc. There are many regulatory instruments (Table 4). It should be noted that norms are kind of uniform across the banking system or a given sub-set of banking sector say cooperative banking. Banks are also supervised by the regulatory authorities.

It is seen that post GFC and SDC regulatory norms have increased. The GFC and GSC crisis have showed that some organizations which are large in size and have large transactions with other institutions could, if they fail impact the financial stability of a country. This led to the term 'too big to fail' in case of large banks on one side and 'too many to fail' in case of small banks on the other side and the need to develop of norms to protect the system from their failure. Traditionally the regulation was 'deposit protection' oriented and after the crisis the focus got enlarged. Between GFC and now, the development of appropriate regulation has gone through phases resulting in Basel I, II, and III etc and already there is tale of Basel IV! In fact Basel III should have given appropriate norms for banks in both 'too big to fail' and banks in 'too many to fail' group, to each bank as per its overall risk profile. By now, norms, compliance systems and reporting requirements should have been proportional for all banks. This has not been achieved. Possibly the sheer variety of institutions, number of institutions and differences among them in size and risk profile makes it an impossible.

The journey of the cooperatives, over the years, from standalone society to bank to networked bank to the modern behemoth of big cooperative bank (often referred to as central bank) with many affiliated banks and unions makes an interesting reading. It shows that cooperative banks have been repeatedly reorganizing themselves due to market conditions and on account of regulatory guidelines or push. Briefly:

i. Cooperative banks are established under cooperative acts of the country. These Acts are common, for all sizes/types of cooperatives irrespective of the purpose for which the society is formed.
ii. In almost all countries there is some kind of involvement of Governments in Cooperative banks. Initially cooperatives were encouraged by Governments, as they dealt with agricultural credit etc. Later when the credit societies became banks the government involvement, albeit low, continued. Even today cooperative law in many countries provide for governments to own shares in cooperatives as also to decide on certain aspects of management. Generally cooperative Act is more intrusive on banks than company form of organisation.
iii. Right from the beginning it was evident that cooperatives cannot meet all the needs of their members due to funds constraint and high co-variance risk (the word is recent but the risk is old!) and therefore networking and levels (tiers) were thought of. The idea of two or three tier cooperatives/banks has evolved as coops knew their weakness i.e. collateral free loans and hence high credit risk and limited funds as member's capacity to save is limited.
iv. In view of low fund availability but higher demand for credit the cooperatives needed access to deposit from others. As this comes under banking cooperatives became banks. Banking is a highly regulated area. Prior to GFC &SDC bank regulation was only concerned with deposit protection regulations were soft. At that time, cooperative banks had somewhat lesser regulation than commercial banks.
v. Post GFC, in many countries the regulatory or growth push nudged these institutions towards IPS. (IPS did exist prior to GFC as well). This has resulted, noticeably in Europe emergence of two or three 'tiered' cooperatives with an apex or central intuition/bank under IPS. Also, in most of these cases the central institution is not a cooperative but a company owned by cooperatives and in some cases there are non-cooperative shareholders as well. The central institution is governed and run like a commercial bank. As such these banks were also into investments both normal and exotic. They were also into cross border transactions. Some of them ran into difficulties during GFC. Yet most governments did not have to bail out cooperative banks from the impact of GFC as much as they had to do for commercial banks. Members of the banks came to their rescue. A few banks, in UK for example were saved by the Governments.
vi. Today there are Globally Significant Cooperative Banks, Domestically Significant Cooperative Banks, Big cooperative banks, small cooperative banks etc. These are subject to somewhat proportional regulation.
vii. Some of the cooperatives, though in banking business, do not use the word bank but are known as credit unions. As a general rule, with some known exceptions it is seen that, wherever the work 'bank' is not used those cooperatives do not come under banking regulator of the country. In many such cases (i.e. where the name bank is not used the regulation and deposit protection arrangements are exclusive (example Credit Unions of US, SACCO of Kenya and PACS of India).
viii. It is seen that banking regulators- possibly on account of some provisions in cooperative law that enables governments intervene or manage the cooperatives closely (by making it implement government programs) or other reasons are seen more comfortable with company form of organisation though it is well known that failure in governance is not attributable to a given form of organization. As mentioned previously, it is people in the

helm of affairs who violate not the organisation. It is due to this insistence on company form of organisation that cooperatives- at the central bank level- are constrained to demutualise.

In this background a quick study of various countries reveal that

i. Regulation for cooperatives was developed from the basic norms applied for commercial banks. Proportional regulation is therefore + or – from the norms applicable to commercial banks
ii. Due to globalization and technology risks have multiplied. As such, as mentioned earlier a lot of regulatory norms and guidelines have been issued. As regulatory norm cannot be bank specific the best that can be hoped is sector specific norms which will be **'one size fit all'** in a given sector.
iii. Also though 'too big to fail' is worry it seems regulators are pushing banks to become big!
iv. As globalization and technology increased risk the regulatory norms keep adding up every day and today there are a large number of prudential guidelines and regulations. Compliance is a major work for banks. Regulators agree that cost of compliance is more on small banks (Annual report of regulator and some BIS talks point out that compliance is more burdensome on cooperatives and small banks).
v. As a result of networking and IPS the role of member has been marginalized as the general assembly has nothing much to do. Regulators dictate who should be on the Board! Yet it is well recognized that coop banks are not likely to cause any financial instability.
vi. It is well known that the norms are tough yet, cooperative banks have no option but to accept them as they have to be in the business. The central bank (of the IPS) is working – wherever IPS has been well established- more and more like a commercial banks.

As a result

i. In every country there is a definite decline in the number of cooperative banks and new cooperative banks are not being formed. This reduction is, barring a few cases, not on account of these banks incurring losses in GFC or SDC. In fact most cooperative banks escaped unhurt in these crises. The reduction is due to regulatory push towards merger and consolidation and small banks finding it too costly or difficult to comply. The cost of compliance on small banks is very high. Critics who believe that regulation is unduly burdensome point to the significant decline in the number of small banks over time[105]
ii. Also, it is apprehended that slowly but steadily all cooperative banks will get demutualised (i.e. converted) into commercial banks very soon
iii. On average cooperatives banks/unions have a market share around 10%. However their share of SME credit and agricultural credit and small borrowal accounts is more. Despite long years of existence cooperatives have not been able to, in almost all countries, mobilize as much deposits as commercial banks. This is but natural because members of cooperatives do not belong to the higher echelons of the society and have no saving ability. Members come together mainly for credit. Given the small size of these banks they fall under 'too many to fail' category of financial

stability risk. Historically they have withstood normal risks and even event risk like 'GFC' 'SDC' etc.

iv. The number of cooperative banks and their total assets are known. It is therefore easy to aver that barring a few most of the cooperative banks in a country will have a very miniscule share in the market and they are unlikely to cause any impact on financial stability if they should fail.

Recommendations of this study, made earlier are that there should be proportional regulation because cooperative banks are necessary for financial inclusion. Cooperatives also offer certain diversification of risk in the banking sector. Study has brought out the fact that there are proportional regulations but the basis of proportionality is not known. Everybody says there should be proportional regulation but none indicates what it should be. Cooperative banks are clearly demanding more proportional regulations.

Literature review clearly shows that BIS and others have indicated that regulation should not put customers of small banks on more risk and also that being small cannot exclude a bank from regulation. In a BIS speech it has been said that 'The call for greater proportionality in banking regulation and supervision is growing louder – not just in the United States and Europe, but also globally'. Further, 'it can generally be assumed that the failure of a small bank poses a smaller risk to the financial system than the failure of a big bank. So it might make sense to apply a different regulatory and supervisory regime to small individual banks'. Also 'proportionality means simpler rules for smaller banks. But it does not mean that the rules should be generally less stringent or that banks can hold less capital or liquidity'[106] DNB[107] says 'Regulation and supervision should be tailored to differences in size and complexity and, particularly, the risks borne by financial institutions. Prudential concerns are not the same for all financial institutions, as they vary with business models. Consistent regulation and supervision should therefore not take a "one size fits all" approach, but be tailored to the characteristics of institutions'. In a paper titled 'Proportionality in EU banking regulation: the case for a step-change to accompany the introduction of "Basel 4" BVR says 'we respectfully call on the European authorities to embrace more completely the principle of proportionality by introducing a systematically differentiated SEGMENTED REGIME ("SR"). The SR would be suitable for banks ranging from global systemically important banks (G-SIBs) to small and non-complex banks ("SNCB"), in place of the current patchwork of derogations under CRR and CRD, without compromising on resilience or customer-facing standards and quality'

As indicated earlier, the cooperative banks have market share of about 10% but the sector is made up of many small banks and few big banks. It is evident that majority of the cooperative banks will not be capable of causing any financial instability should they fail. It is also well recognised that regulation gives a market status to cooperative banks and leaving them completely unregulated will have negative impact. It is clear that cooperatives could benefit from a proportionate regulatory regime for small and unsophisticated institutions, with the aim of moderating compliance costs that are unwarranted on prudential or stability grounds. Also some differentiation in the rules specific for cooperatives banks could be justified on account of cooperative banks ownership structures and IPS/solidarity mechanisms. It is important to add that no proportionality regime or any other regulatory differentiation for cooperatives should have the effect of shielding specific types of institution against competition. In view of this it is suggested that

i. Cooperative banks whose total assets are less than 1% of a countries banking system need not be closely regulated. They should be, however subject to lower capital adequacy norms (say 2%), lower reserve ratios, and deposit insurance premium and

NPA norms. Investments to be allowed in G Sec and other bank deposits (liquidity purposes) only. No market trading. Sell investments if any through IPS system. The reporting and disclosure system should be simpler. These banks should be encouraged to be part of IPA and supervised by the central bank of IPS

ii. Banks who have total assets between 1% and 2%, norms could be similar to 1 above and in addition Exposure norms, a higher reserve ratio, and CAR of 4%.
iii. Banks who have total assets above 2% but less than 3% should have in addition to the above CRR on par with big banks and CAR of 6%. If they trade in the market the CAR could b 7%.
iv. Banks who have total assets above 3% as per Basel Norms. These banks should be supervised by the regulator.
v. In countries where IPS is well settled the cooperative banks which are part of IPS could have similar norms as above and the central bank could be given some benefit of the above norms while reckoning the consolidated position.

The above are some suggestion on how to approach proportionality which should be size and risk linked. Risk is a function of business mix. These proposals can be firmed up of fine tuned by conducting a study.

Let us see how this will work out. Take for example Indian Cooperative banking sector. The Indian banking system has total assets of Rs 170 Trillion. Cooperative banks account for approx 6% to 7% of this. A large number of these cooperative banks (may be more than 75% of the banks) have business of less than Rs 5 Billion i.e. less than 0.005% of the county's banking assets. Within this short term cooperatives have some ownership from the State Governments as well which gives them some sort of sustainability. In the Urban cooperative side, other than the 57 scheduled cooperative banks all UCBs are very small. For deposit insurance all of them are covered by (Deposit Insurance and Credit Guarantee Corporation - DICGC). All these banks will fall within the less than 1% norm given above. If they are given very low proportional norms they can have a higher leverage and be able to finance more members.

Every country has detailed information about cooperative banks and it should not be difficult to categorise the banks into the above or somewhat similar categories and offered appropriate regulation. One of the immediate advantages of this will be that these banks will do more financial inclusion. Also, as the supervisory powers are not proportional or reduced supervisor should be able to take up corrective action should banks show a poor performance and/or more risk. This will also reduce supervisory and compliance cost.

5.3 Other recommendations/points

Regulatory norms are applied on the basis of balance sheet data, financial statements and disclosures on a given date. As such it is on a "gone concern basis". Compliance to regulation is also with reference to a particular point of time. While arriving at the riskiness of a cooperative bank its growth is not factored. Regulator does not take into account the business plan or action plan for risk management though it has access to all this information from every bank and every banking group. It is further observed that the regulatory follow up is on a "going concern" basis. Given this, business plan, governance and other aspects could be given due place in IR based risk estimate. For example there is a time lag between the time the first provision for an NPL/A is made and the time an asset becomes a loss asset. During this time, banks submit data on NPL/A movement which shows the collection efficiency of the bank. This could be used to fine tune provisioning norms. It could be a function of age of NPL/A and collection efficiency.

A bank which has better collection efficiency could be given some proportionality in risk estimate.

Capacity of a cooperative bank to expand its business is a function of its capital which can be leveraged and deposits that it is able to gather. Capital can be augmented by admitting more members (capital inflow) and accumulating retained earnings. In this regard cooperative banks have, traditionally enjoyed the benefits of proximity to their customers and the ability to offer more affordable services. However, technologies such as online banking increasingly allow its competitors to reduce or eliminate these advantages by cutting fixed costs and gaining better access to remote areas. To manage such competition these banks have to make heavy investments to improve processes, systems and staff qualifications, which probably exceeds the resources available to small banks. Without such investment, these banks may fail to attract new members or end up losing existing members and eroding their franchise. In these background small banks, particularly standalone cooperative banks need more capital, financial and human resources. Currently the only solution for this is hybrid capital instruments which are mostly "fixed cost" instruments and poor substitutes for capital.
Proactive policy interventions might be necessary for cooperative banks to meet current challenges such as Risk, lack of scale, difficulties in raising new capital, lack of professional governance etc. It may not be possible for these banks to manage these issues merely by cooperation among themselves. Regulators should recognise and promote a level playing field to allow cooperatives to do what they do best- namely finance agriculture, SME, small business and consumption needs of members- which the commercial banks are not so much interested.

Emerging economies should strengthen their financial systems by implementing the main elements of global regulatory reform. But to build an effective prudential framework, these norms have to be customised and dovetailed to the country's needs based on the depth, sophistication and size of their financial markets/institutions, the granularity of information available and supervisory capability. National regulators should share their approach, not merely the norms, so that cooperative banks can understand and take steps to comply the same without compromising their business performance.

It is observed that changes in business models and business mix of cooperative banks have been due to regulatory norms/changes and market pressures. At the same time it is known that the ownership[108] structure also influences the internal dynamics and business orientation of a bank. In this background, if members (representatives in the case of networked banks) are able to exert a disciplinary influence on management of co-operative banks and to set the strategic course, then the banks' performance can be distinct from those of banks with other ownership structures. For example, listed banks are primarily driven by the demand of anonymous owners (shareholders) to provide a regular return on their invested capital in the form of dividends whereas members of cooperative banks could be satisfied with credit at reasonable rates. "The point is that different ownership structures prevent the banking landscape of becoming monotonic"[109].

<u>There is some pressure on cooperatives to merge and become bigger. It seems demutualised structure is a way to achieve this. In this connection it should also be recognised that too much uniformity and lack of diversity and depending on one type of bank, namely company form of organisation, could render the financial sector and countries vulnerable to shocks. In fact it could pose a high systemic risk.</u> Policy-makers and supervisors should, therefore, refrain from measures that aim at convergence of business models, governance structures and scale of banks. Diversity in the financial system is important for financial stability. Diversity can be

easily destroyed, but will be very difficult to regenerate. Marginalisation of diversity in banking could have a detrimental impact on competition and stability. It could also, as demonstrated in some jurisdictions, lead to negligence, or exclusion, of customer segments, business and/or economic segments in society.

In the recent years the financial systems world over have been relatively stable as there are many types of institutions (banks, financial institutions, non-banking finance companies etc) which lowers the risk of fierce market disruptions. It must be acknowledged that a complicated trade-off exists between the two trinities of economic, regulatory, supervisory objectives and competition, efficiency and financial stability of markets.

It is apprehended that stability could be compromised if there are only commercial or cooperative banks in a system and all banks are in the category of “too big to fail”. Rather, cooperative banks, other types of financial institutions of all sizes and commercial banks should co-exist from the angle of stability and inclusion. Cooperative banks play a valuable complementary role to profit-seeking shareholder owned commercial banks. If this is not recognised and the trend in recent decades towards demutualisation and pressing cooperatives to behave more like shareholder banks continues, it could hurt the economies.

The words “too big to fail” say this loud and clear that if they fail it will be difficult to manage. Why then push all the banks to that category? Is this based on some empirical analysis? Is not cooperative banks important as farmers and SMEs need organisations that understand them and willing to work with them. The cooperative banks have more than demonstrated their affinity and ability to work with them. It is true that reduced number of cooperatives have not impacted the growth of total assets and financial health. Instead is it not possible to nurture rather than close the banks so that a higher growth and larger outreach could have been achieved?

Hence, regulators should nurture a heterogeneous financial system in terms of scale, ownership structures, business orientations and risk profiles. This requires genuine interest in and an unbiased attitude towards different types and categories of banks.

It is in this regard, that proportional regulation becomes important. The objective of regulation is financial stability. Stability could be compromised if regulation is similar across the spectrum of in the modern financial system for Commercial Banks, Cooperative Banks, Non-Bank Finance Companies, Financial (term lending) Institutions, etc., each of them having dedicated customer base and a role to play. All of them cannot be measured in a single norm or standard. Diverse and healthy types of organisations should be encouraged with appropriate proportional regulation.

Given the above, nations without cooperative banks would be wise to encourage their growth, and those with cooperative banks would be wise to protect them and help them to flourish. This is because cooperative banks have thrived where independent local institutions have collaborated in networks to gain economies of scale, and where the regulatory environment has recognised and protected the cooperative ownership model. Germany’s three pillar approach, to cite an example, recognises this aspect but its regulation seems biased towards shareholder organization. Regulatory and Political pressure in various jurisdictions are pushing cooperative banks into adopting increasingly less cooperative structures. This has not factored the superior performance of cooperative banks during and since the financial crisis. There is a need to understand the importance of cooperative banks and develop appropriate regulations.

The point being made is that financial system cannot, despite the "too big to fail" argument depend only on commercial banks[110]. It needs various types and sizes of institutions. There are certain distinct advantages of cooperative banks. Firstly it is clear that cooperative banks will help in achieving financial stability and help balance the concentration of banking in commercial banks. Also, cooperatives play a more important role in financial inclusion by extending (i) small loans and (ii) credit to agriculture, SME and similar areas. In fact they have good market share in these areas. What is not apparent in market share is that to achieve such market share they have deployed, in comparison to commercial banks, a higher % of their total assets in these sectors. Cooperatives are able to reach banking to villages and small places. Though commercial banks have started using technology driven banking it is kind of confined to transaction banking and payment system and not so much in credit dispensation. It is here that cooperatives have a clear edge and greater focus due to their proximity to customers. Their ability raise resources from members are also unique. These are not profit seeking ventures.

The above are overwhelming advantages. Of course there are certain issues about capability and governance by board members of cooperatives which can be improved by focused mentoring. While cooperative banks have their advantages and disadvantages, it is clear that they have a valuable and important complementary role to play alongside commercial banks. At the cost of repetition it is worth saying that "Emerging Economies that lack cooperative banks should be wise to encourage them while those that already have cooperative banks should be wise to protect them and help them to flourish". Developed economies should go back to the drawing board to redraft the regulatory norms. Proportional regulation should be more closely arrived at based on a banks size and its likely impact on stability, its business mix, contribution to financial inclusion and financial performance. If these things happen financial cooperatives/cooperative banks have a future else they may all get demutualised or marginalised.

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[1]Central Banks in many countries regulate coop banks and through them. The words "Cooperative banks' used in this article will over all forms of financial cooperatives.

[2] "Resolution Issues for Financial Cooperatives" Overview of distinctive features and current resolution tools. 17/09/2017

[3]

Information on financial Cooperatives: WOCCU Statistical data 31/12/18

Area	Institutions	Members Mn	Savings	Loans	Reserves	Assets
Africa	39447	35.78	9.60	8.13	1.06	10.78
Asia	33004	57.45	147.23	138.19	5.77	180.83
Caribbean	374	3.43	6.27	5.00	0.77	7.66
Europe	3491	9.10	24.10	11.65	4.07	32.96
Latin America	2891	35.81	59.84	54.21	17.21	90.86
N A	6010	127.97	1485.18	1326.19	170.22	1786.60
Oceania	183	4.68	70.03	66.76	6.42	81.39
Total	85400	274.23	1802.24	1610.12	205.53	2191.09

[4] Every country has Laws on companies and cooperatives. These are recognised legal forms of business organisations.

[5] Primary Agriculture Credit Societies (PACS) in India are not regulated by the Reserve Bank of India.

[6] During the global financial crisis, financial co-operatives out-performed traditional investor-owned banks, according to the International Labour Organization. The study, Resilience in a downturn: The power of financial cooperatives, has observed that member/customer-owned banks were much more stable and more efficient than the big traditional banks.

[7] The concomitant long-term view and risk-averse stance translate into a more conservative banking strategy directed towards retail banking: Piet Moerland Chairman of the Executive Board. Rabobank. Preface to "Co-operative banks in the new financial system"

[8] Some of the cooperative banks/demutualised cooperatives like Northern Rock had to be bailed out. NR was nationalised by British Government.

[9]Wikipedia

[10] Source EACB- Annual Report 2008 and many other years

[11] In Asian Countries the government control and intervention in management is high.

[12] Co-operative Bank PLC is a publicly quoted limited liability company. It is a fully owned subsidiary of CWS and CWS is apparently the only shareholder. It is an innovative bank which is owned by a co-operative. The bank seems to put people first and provide good service. https://www.solhaam.org/articles/coops.html

[13] Urban Cooperative Banks in India, have 2 classes of members' i.e. regular members and nominal members. Regular members subscribe to the share capital of the bank, participate in the affairs of the bank, have right to contest to the Management Committee and can avail of any type of loan facility. Nominal members are those, who are not interested in the management of the bank but desire to avail of loan facilities at infrequent intervals, and who do not subscribe to the share capital of the bank. Hence they are not eligible to vote or for dividend. Under the existing policy of RBI, nominal membership is limited to 20% of the regular membership. Source: https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?ID=138

[14] A credit union is a cooperative bank that is owned and managed by its members, all of whom have accounts in the bank. There are over 50,000 credit unions worldwide, and thousands of credit unions in the United States holding assets ranging from over 10 billion dollars to under 1 million dollars. Credit Unions may be chartered under state or federal law: https://www.co-oplaw.org/co-op-basics/types/credit-unions/

[15] A credit union can have many cooperative societies as its members. Some of these societies offer financial service to their members. https://www.co-operativecreditunion.coop/aboutus/

[16] Thrift and Credit societies are formed by employees of organisations.

[17] In India

[18] As a part of this report country reports are also prepared which includes Germany, France, Netherland, Poland, India and Bangladesh which are also covered briefly

[19] http://www.cooperativedifference.coop/co-operatives-in-canada/credit-unions/

[20] Alphonse Desjardins opened the first *caisses populaires* (people's bank) in Quebec in the early 1900s.

[21] http://eco.u-szeged.hu/download.php?docID=40415

[22] Data from EACB statistics publication

[23] Picture from the presentation made by David Blache, Dep. Director for Resolution, ACPR/Banque de France

[24] "Financial Sector Assessment Program". Technical note-cooperative banks and credit unions-IMF

[25] Data from WOCCU as of November 2018

[26] Cooperatives, Legislation and Public Policy: Political, strategic and technical pre-conditions to make Financial Services Cooperatives work by Peter van Dijk, Consultant Microfinance

[27] "Co-operative banks should not be seen as an appendage to the current banking sector, but as an alternative in providing access to sound financial services. The effective implementation and enforcement of the Act, through increased registration of co-operative banks, should not only promote access to finance, but also support the economic and financial empowerment of communities. Organic growth of co-operative banks has the potential to increase effective participation of community members in the economy resulting from responsible member-based funding of new economic activities." Finance Minister, Pravin Gordhan in the 2010/11 in a Combined Report of the Supervisors of the Cooperative Bank Agency and the South African Reserve Bank

[28] Bangladesh Investment Development Agency BIIDA http://bida.gov.bd/?page_id=673

[29] Bangladesh: Financial System Stability Assessment: By International Monetary Fund.

[30] Data Source: RBI Report on Trends and Progress of Banking In India-2019 : Chapter Developments in Cooperative Banking

[31] The Rural Cooperatives came into being in early 1900. These were facilitated by the Central and State Governments in India. There is no national level bank or office for this segment. As these were facilitated by Government there is noticeable lack of member involvement in this sector. About 4 or 5 decades back cooperatives had a higher share of outlay towards SME, Agriculture etc. It was only in the 1970's (after nationalisation of some banks) that commercial banks came forward to extend credit to people such as craftsmen, retailers and farmers etc who had little or no access to affordable financial services. Events such as launch of lead bank scheme, and introduction of priority sector norms by RBI ensured a greater involvement of commercial banks in rural and SME lending. In view of this the share of cooperatives in banking sector has reduced considerably. Till then it was cooperative banks which were providing more than 50% share of agricultural credit though their resources were meagre compared to commercial banks.

[32] See note 28 above. Indian Central bank created funds and lent monies to cooperatives for financing agriculture. Indian cooperatives are also unique that most of them have been facilitated by government to involve them in development process.

[33] RBI. Report on Trends and Progress of banking in India-2019

[34] Source: "Regulation and supervision of financial cooperatives" BIS 2019. Data as of June/Sept/Dec 2019.

[35] EACB data

[36] Authors calculations based on RBI data

[37] Excluding nearly one lakh societies which are not regulated by RBI

[38] Example Primary Agricultural Credit Society in India

[39]Urban cooperative banks_(UCBs) are expected to have an umbrella organisation for liquidity support and self-regulation, by the end of this financial year. Business Standard, 11th October 2019

[40] Rural Cooperatives in India are federated firstly at District level and then at State (province) level. The central agencies finance, inspect and undertake capacity building of the lower tiers. There is no formal understanding as to how the central organisation will help the district level banks. Thus despite the intent of this structure these banks are not successful. Also there is no centralised structure at country level and unlike Europe no Institutional Protection Plan.

[41] Source: Regulation and supervision of financial cooperatives" BIS 2019

[42] Source: Regulation and supervision of financial cooperatives" BIS 2019

[43] RABO bank: Cooperative banks in the new financial system

[44] In the case of Primary (Urban) Co-operative Banks (UCBs), the regulator has prescribed share linking norms: (i) 5% of the borrowings, if the borrowings are on unsecured basis. (ii) 2.5% of the borrowings, in case of secured borrowings. (iii) In case of secured borrowings by SSIs, 2.5% of the borrowings etc. www.rbi.org.in

[45] The internal ratings-based approach to **credit risk** allows banks to model their own inputs for calculating **risk-weighted assets** from credit exposures to retail, corporate, financial institution and sovereign borrowers, subject to supervisory approval. Under foundation IRB, banks use only the probability of default. Under the advanced IRB approach, banks

can use their own loss given default (LGD-absolute money lost if a borrower defaults) and exposure-at-default (EAD- the amount a bank is exposed to at the time of the same default) levels. Under the **Basel III** package finalised in December 2017, banks can no longer use the advanced **IRB** approach for exposures to financial institutions or corporates with consolidated annual revenues of more than €500 million. https://www.risk.net/definition/internal-ratings-based-irb-approach.

[46] Basel III indicates that "the criteria also apply to non-joint stock companies, such as mutual, cooperatives or savings institutions, taking into account their specific constitution and legal structure".

[47]A new instrument in the form of Share Capital Deposit from members could be treated as Tier-I Capital. This instrument may have options to give a special dividend in the form of a fixed interest being paid. In this, individual banks could issue such capital deposits with a lock-in period of at least 5 years and maturity period of 10 years or more. after attaining sustainable CRAR level, banks could convert these deposits into regular shares eligible for payment of dividend. Vaidyanathan Committee Report, https://www.rbi.org.in/scripts/PublicationReportDetails.aspx?ID=697#6

[48] Rabo Bank on 'The governance of large co-operative businesses'. Coop.org UK

[49] BIS report

[50] Background paper for the 2019, by the UN Inter-Agency Task Force Report on Financing for Development.

[51] Several studies highlight a low participation rate in the general assembly, which is the most democratic moment of the year for cooperative banks. This fact suggests that the sense of belonging to a community is weak and that clients are ambivalent about the way they consider the specificities of cooperative banks.: Being a member of a cooperative bank: ethical or financial decision? **Damien** Egarius **et Patrick** Roger

[52] Financial Cooperatives: Issues in Regulation, Supervision, & Institutional Strengthening. 2018 world bank group

[53] Indeed, in recent decades, increasing regulatory requirements unintentionally raised the compliance costs of regulation. This may harm coop banks: Giovanni Ferri: Regulation and the Viability of Cooperative Banks.

[54] Managing Non Performing Assets. Need to de-stress process. Author: Dr. R Bhaskaran. FIAKSWRIT

[55] Marginal cost of lending rate

[56] For instance, many FCs in Kenya are under pressure to distribute a larger portion of their annual surpluses to their members. Meanwhile, FCs in both advanced economies and in EMEs such as in Brazil or China are under pressure to offer more competitive rates to increase or maintain their existing deposit funding.

[57] The Governance of Large Co-operative Businesses: A research study by Professor Johnston Birchall: https://www.ica.coop

[58] The Co-operative Bank plc is a retail and commercial bank in the United Kingdom. The Co-operative Bank is the only UK high street bank with a customer-led Ethical Policy which is now incorporated into the Bank's Articles of Association

[59] https://www.thenews.coop/131594/sector/banking-and-insurance/co-op-banks-crisis-cant-put-price-values/

[60] Swiss Financial Market Supervisory Authority

[61]https://www.thenews.coop/130192/sector/banking-&-insurance/investigation-ordered-downfall-cyprus-co-operativebank

[62] https://www.business-standard.com/about/what-is-pmc-bank-crisis

[63] This and the following cases have been referred in the book The Governance of Large Co-operative Businesses: A research study by Professor Johnston Birchall: https://www.ica.coop

[64] The Blind Men and the Elephant is a parable from India. It is about a group of blind men who attempt to learn what an elephant is, each touching a different part, and disagreeing on others findings. Their collective wisdom leads to the truth: https://americanliterature.com/author/james-baldwin/short-story/the-blind-men-and-the-elephant

[65] The governance of large co-operative businesses ibid. Authors articles and other sources

[66] BIS report

[67] In fact this was a constitutional amendment

[68] Authors study for NABARD

[69] Regulatory websites and BIS. Also, https://www.danskebank.com/en-uk.

[70] Madhavpura bank failure in India is an example of such impact. From Madhavpura Mercantile To PMC Bank: Why little has changed in cooperative banking: https://www.bloombergquint.com/opinion/pmc-bank-crisis-from-madhavpura-mercantile-to-pmc-bank-why-little-has-changed-in-cooperative-banking.

[71] Every country has banking regulator, Insurance regulator and capital Market (securities market) regulator and deposit insurance authorities

[72] A cease and desist order is issued to stop purportedly illegal activity (cease) and not to restart it (desist).

[73] Euro area credit institutions can receive country's central bank credit not only through monetary policy operations but exceptionally also through emergency liquidity assistance (ELA).ELA aims to provide central bank money to solvent financial institutions that are facing temporary liquidity problems, outside of normal Euro-system monetary policy operations. The rules and procedures surrounding the provision of ELA are laid down in the ELA agreement, which sets out the Governing Council's role in the provision of ELA by national central banks (NCBs), in particular when assessing, pursuant to Article 14.4 of the Statute of the European System of Central Banks (ESCB) and of the ECB, whether the provision of ELA by Euro-system NCBs interferes with the objectives and tasks of the ESCB. https://www.ecb.europa.eu/mopo/ela/html/index.en.html.

[74] This is full list of regulatory instruments. The names of instrument and contents could be used somewhat differently named in various jurisdictions and also all instruments may not be used by some countries

[75] https://www.iadi.org/en/deposit-insurance-systems/dis-worldwide/#2

[76] Over the years the regulations are getting more and more complicated and granular. There are elaborate guidelines on what constitutes capital, varying weights etc. Understanding the regulation and complying with the same has become a specialist job within a bank.

[77] Reserve Bank of India Circular RBI/2015-16/58 DBR.No.BP.BC.1/21.06.201/2015-16 July 1, 2015 on Capital Requirement under Basel III is of 327 pages! Basel I circular is 107 pages.

[78] Simon Baptist, global chief economist of the Economist Intelligence Unit, told CNBC.

[79] "The financial impact of the corona virus surpasses the old worst-case scenarios, threatening a credit crunch or even a new financial crisis". "It was supposed to be a drill" says the News item. New York Times "Government overseers would test whether European banks could survive a hypothetical perfect storm that included a steep economic downturn, plunging stock prices and a collapse in consumer spending". "But before bank regulators could begin their planned stress test this year, they were confronted with the real thing. The financial impact of the corona virus — visible in shuttered factories, empty airports and

desolate downtowns — makes their worst case scenario, a 4.3% decline in European Union economic output by the end of 2022, seem mild by comparison. European economy is likely decline by more than 10% in the first half of this year because of the pandemic, threatening an explosion of bad loans, deteriorating assets and plummeting share prices. The question that regulators/ central bankers are asking themselves now is whether the measures they took in recent years to crisis-proof the banking system will be enough to prevent a credit crunch, bank failures and a financial meltdown with global ramifications".

[80] Covid 19 can be treated as another "Black Swan" event. But the risk in calling this black swan is that the world could treat the outbreak rare and once it is solved may not think of another and how to prevent the occurrence of the same.

[81] In 2013, one of Italy's 371 small co-operative banks, Banca Romagna Cooperativa (BRC), failed due to heavy losses. It was placed into administration by the Bank of Italy. https://www.thenews.coop/100177/sector/banking-and-insurance/co-operative-banking-attack-europe/

[82] From Basel I to Basel III: Sequencing Implementation in Developing Economies.IMF Working Paper. June 2019

[83] FSI insights

[84] For Example there are nearly 2500 Cooperative banks in India and none of them are systemically important.

[85] Only in Euro the regulator (BAFIN) includes FCs while discussing the banking performance. In most other countries the annual report of the regulator gives more emphasis to commercial banks

[86] The bank reserve ratio is often used as a monetary policy tool since the regulations adjust the available funds that banks have to make loans. Reserve requirements are also designed to help shield the banking system from sudden drops in liquidity that can result from a number of financial crises. While some countries, like the U.K. and Australia, have no reserve requirements, others—like Brazil-have 20% reserve requirements. Lebanon has 30% reserve requirements for its banking system. https://www.thebalance.com/what-is-a-bank-reserve-ratio-1979090

[87] Financial repression on asset side is a by-product of the SLR (Statutory Liquidity Ratio) i.e. the amount of liquid assets which banks are required to hold in form of cash, government bonds and gold. https://icrier.org/pdf/ken1.pdf

[88] From an ad hoc survey of Italian coop banks, it was found that compliance costs–in terms of dedicated employees–had increased on average of 175% between 2000 and 2010–even before the enforcement of Basel III–with peaks of 500% for some coop banks. In addition, in 2010, an average of 1.9% of these banks' staff was committed to regulatory compliance, with peaks above 4%. The costs of staff dedicated to regulatory compliance–as a proportion of the total staff–represents fixed costs for coop banks. After taking into account differences among coop banks in terms of volume of business, geographic location, workforce size and local networks, coop banks play a key role in explaining the costs of staff devoted to regulatory compliance. "Increasing" the total number of employees of coop banks significantly reduces their regulatory compliance staff costs. In other words, this means that coop banks with a smaller total staff bear a cost of regulatory compliance–in terms of dedicated staff–relatively higher than at larger coop banks"

[89] In India Exposure norms are also defined as a ratio of resources which has resulted in large financing for cooperative sugar mills which is a cause of huge NPA with many banks.

[90] An important feature of Basel I, II and III is that they are not designed to be applied to the whole banking system in all jurisdictions. The Basel core principles for effective banking supervision do not require jurisdictions to apply the capital adequacy regimes of Basel I, Basel II and/or Basel III to non-internationally active banks. These accords agree with the aims of international cooperation in this area, which place the emphasis on global financial stability and fair competition in international markets. The Basel framework is therefore consistent, in principle, with the concept of "proportionality", i.e. tailoring regulatory requirements to non-internationally active banks, especially smaller and less complex ones. Indeed, Basel I, II and III already incorporate some limited elements of proportionality by offering a menu of approaches for calculating risk-weighted assets (RWAs) including simpler standardised approaches: Proportionality in banking regulation: a cross-country comparison By Ana Paula Castro Carvalho, Stefan Hohl, Roland Raskopf and Sabrina Ruhnau August 2017.

[91] Urban cooperatives in India are subject to proportional regulation but are known to fail on account of "Credit Risk". Some of the failed banks have repeatedly violated exposure norms and extended credit which has been misused by the recipients. Poor Governance has also been observed in these cases.

[92] On 3 April 2019, Woccu urged the committee to issue a set of high-level principles or weighing-factors national- or regional-level regulators can consider. Even though the Basel III framework is intended only for internationally active banks, Woccu said it continues to be applied to purely domestic credit unions by many policymakers.

[93] **Caveat**: In this regard it is stated information about banks/countries is not of the same date. As such data of some country used in the report could be somewhat dated. Also there could be some recent developments (after we collected information) about a bank or country which would have changed the status mentioned in the report. Readers may please keep this in mind. It is our belief that these will not change the conclusions or arguments made in the report which are drawn from the experience in many countries.

[94] Though the chapters are sequenced each of them are complete on a standalone basis on the given topic.

[95] From EACB website

[96] WOCCU Annual Report 2018

[97] BAFIN

[98] WOCCU. Statistical report 2009 and 2018

[99] Jovanovic, Tanja Arnold, Christian Voigt, Kai-Ingo. Journal of co-operative organization and management

[100] Playing it safe: global systemically important banks after the crisis. BIS. https://www.bis.org/publ/qtrpdf/r_qt1909e.htm

[101] Cooperative banks: international evidence: NEF Study

[102] A study of 4000 banks: The Effects of the Financial Crisis on Cooperative Banks in Europe – A Critical comparison: Klaus Henselmann, Dominik Ditter, Philipp Lupp- June 2016

[103] A common measure of stability at the level of individual financial institutions is the z-score. Researchers use it to compare buffers (capitalization and returns) with risk (volatility of returns) to measure a bank's solvency risk.

[104] Cooperative Banks and Financial Stability: Heiko Hesse and Martin Čihák

[105] An Analysis of the Regulatory Burden on Small Banks Sean M. Hoskins

[106] Is small beautiful? Supervision, regulation and the size of banks Statement by Sabine Lautenschläger, Member Executive Board of the EC

[107] https://www.dnb.nl/en/binaries/Proportional%20and%20effective%20supervision_tcm47-376254.pdf

[108] Snapshot of European Banks 2017

[109] ibid

[110] The financial sector comes of age when it has diverse institutions, catering to different segments, ranging from retail to wholesale, micro-finance to project finance, nurturing specific sectors and offering specialised services and tailor-made products to niche segments. Deputy Governor RBI 18/4/15

ABBREVATIONS

AFS: Available for Sale
ARDBs. Agriculture and Rural Development Banks (in cooperative sector in India)
BAFIN: Bundesanstalt für Finanzdienstleistungsaufsicht. Federal Financial Supervisory Authority
BIS: Bank for International Settlements
BOD; Board of Directors
CCU: Cooperative Credit Union
CEO: Chief Executive Officer
CET 1: Common Equity Tier 1
CRAR: Capital to Risk Weighted Assets Ratio. Also Known as Capital Adequacy Ratio (CAR)
CRR: Capital Requirement Regulation
CRR: Cash Reserve Ratio
CUSO: Credit union service organisations
DCCB: District Central Cooperative Bank
EACB: European Association of Cooperative banks
EBA: European Bankig Authority
ELA: Emergency Liquidity Assistance
FC: Financial Cooperative
FINMA: Swiss Financial Market Supervisory Authority
FSA: Financial Service Authority
FSAP: Financial Sector Assessment Programme
FSI: Financial Stability Institute
GFC: Global Financial Crisis
GSIB/DSIB: Globally/Systemically Important Banks.
HFT: Held For Trade(ing)
HQLA: High Quality Liquid Assets
HTM: Held Till Maturity
IFRS: International Financial Reporting Standards
ILO: International Labour Organisation
IPS: Institutional Protection System
IRAC: Income Recognition and Asset Classification (norms)
IRB: Internal Rating Based (Approach)
IT: Information Technology
LCR: Liquidity Coverage Ratio
MCLR: Marginal Cost of Lending Ratio
MFI: Microfinance Institution
NAFSCOB: National Federation of State Cooperative Banks India
NCUSIF: National Credit Union Share Insurance Fund
NFSR: Net Stable Funding Ratios
NIM: Net Interest Margin
NPL/NPA: Non Performing Loan/Account
PACS: Primary Agricultural Credit Society
RBI. Reserve Bank of India
ROE: Return on Equity
ROI: Rate of Interest
RTS: Regulatory Technical Standards
RWA: Risk Weighted Assets
SACCO: Savings and Credit Cooperative Organizations
SCB: State Cooperative Bank

SME: Small and Medium Enterprises.
UCB: Urban Cooperative Bank
WOCCU: World Organisation of Cooperative Credit Unions

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List of Members of Board of Directors of ICBA

Sl. No.	Name and representing Organization	Position in ICBA
1	Mr. Subrahmanyam **BHIMA** Managing Director National Federation of State Cooperative Banks (NAFSCOB), India	President
2	Mr. K. Sivadasan Nair Chairman ICA AP Committee on Credit & Banking ICA AP Regional Office New Delhi-India	Vice- President
3	Ms. Isabelle FERRAND CEO Deputy Confederation National du Crédit Mutual, Central Body 88-90, rue Cardinet 75847 Paris Cedex 17, France	Board Member
4	Mr. George Magutu Mwangi Board Member Kenya Union of Savings & Credit Co-operatives Ltd. (KUSCCO)	Board Member
5	Mr. Mieczyslaw Grodzki President, National Co-operative Council – NCC, Poland	Board Member
6	Mr. Kabir Ayinde-Tukur MD/CEO Cooperative Mortgage Bank Ltd. (CMB), Nigeria	Board Member
7	Mr. Ravinder Rao Konduru Board Director, NAFSCOB India	Board Member
8	Mr. Ahmed Mohiuddin Chairman Bangladesh Samabaya Bank Limited (BSBL) Bangladesh	Board Member