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Regulation and supervision of financial cooperatives

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Executive summary

In many jurisdictions, financial cooperatives (FCs) are the most numerous financial institutions although their share in total banking assets is typically limited. As such, most FCs are small, with a simple business model based on deposit-taking and lending. However, in some European jurisdictions, FCs make up a larger share of the financial system, with some institutions considered to be systemically important.

How FCs do business and organise themselves differs significantly across jurisdictions. At one end of the spectrum, FCs are small, with a simple business model, and serve only their members. At the other end, FCs pool resources and form federations with internal solidarity schemes or even consolidated groups. These centrally coordinated networks may resemble those of large banking groups, conducting business with non-members and providing a wide variety of services.

FCs and commercial banks differ mainly in terms of their ownership structure and aims. In a traditional FC, each member has one vote, regardless of the number of shares held. In addition to being owners, members are also depositors and borrowers, with some participating in the FC's governance bodies Furthermore, an FC's main purpose is to serve its members by providing affordable financial services. Although FCs need to be profitable to sustain their activities, maximising profitability to distribute revenues to owners is not their sole or even primary aim.

FCs have certain competitive advantages. Funding is frequently cheaper and generally more stable than that of most commercial banks, as it is sourced mainly from members' deposits and member shares. Also, thanks to their local focus, FCs traditionally have – or are perceived to have – closer client relationships and may be better able to customise services. Finally, FCs may be better placed to cooperate with each other to achieve scale economies than are rival commercial banks.

These characteristics also create challenges. FCs' local focus of operations, common bond requirements and typically small size mean that they are more exposed to concentration risks in both their assets and liabilities. In addition, their capacity to increase resilience or expand their business is limited since capital growth relies mainly on accumulating retained earnings and expanding membership. Finally, the governance structure, in which members of the board of directors and of the senior management are also owners and customers, can give rise to a wider range of conflicts of interest than at commercial banks Moreover, the ownership structure and legal nature of those entities make some of the standard bank resolution approaches unsuitable for failing FCs.

Changes in technological developments may be eroding some of FCs' competitive advantages. In particular, the use of technology such as online and mobile banking allows competitors to offer a wider variety of financial services in geographical areas where they have no physical branches, and at a lower cost.

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To respond to these challenges, FCs may need additional human and financial resources. These pressures are particularly relevant for small and standalone FCs, given that they would need to invest heavily to improve processes, systems and staff skills.

In general, the new challenges strengthen the case for increased cooperation among FCs. Resources can be pooled in order to achieve economies of scale and for investment in strategic areas. Common services provided by central entities include capacity-building and support in compliance, risk management and other areas. Common structures may also provide central liquidity management and facilitate payments system access. Mergers between healthy FCs can also generate economies of scale.

Increased cooperation could also support business diversification and access to capital markets. This would help FCs offer a wider range of products, attracting new types of customers. Business diversification would reduce FCs' concentration risks on the asset side and their reliance on interest margins. Larger cooperative networks could gain improved access to capital markets and help to reduce concentration risk on the liability side by diversifying funding sources.

More cooperation would help strengthen risk and crisis management. In networks where cooperation among FCs is more systematic, FCs have developed mutual guarantee systems. Failures of individual FCs in such networks tend to be rare because the central entity has the tools to provide liquidity and solvency assistance and, where necessary, to promote mergers or intervene at an early stage before a member FC's viability is compromised. Timely intervention is desirable as contagion risk across different FCs can be significant.

Policy intervention might be necessary to deal with FCs' challenges. Challenges in relation to risk concentrations, funding, governance and crisis management could be mitigated through increased cooperation, which could be promoted through regulatory incentives or requirements. National regulations could encourage the creation of networks, including the creation of consolidated groups, with sound governance, clear roles for the central body and effective solidarity mechanisms to facilitate crisis prevention and management.

Policy action may be also needed to strengthen the protection of buyers of member shares. FCs typically issue member shares, or other capital instruments that may qualify as regulatory capital, to their own customers in so-called self-placements. Buyers are typically retail customers, who may be investing their savings in instruments that are sold as alternatives to low-yielding savings accounts. This can result in mis-selling, as FC customers may be unaware of the loss-absorption characteristics of these instruments. To address these uncertainties, specific customer protection requirements related to issue documentation, marketing materials and disclosures may be necessary.

Regulators should promote a level playing field for different types of institution. Tailoring of some regulatory requirements may be justified, in cases where they are disproportionately high for entities that due to their size and complexity (proportionality), are less able to take advantage of economies of scale. At the same time, a cautious approach needs to be taken when establishing different sets of rules for different types of financial institution with similar size and risk profiles (differentiation) as this could create market distortions and tilt the playing field. Furthermore, applying the differentiation and proportionality concepts should not lead to overprotecting specific types of institution, thus creating competitive distortions.

Section 1 – Introduction

1. **Up to the mid-20th century, most commercial banks essentially targeted large corporates and the wealthiest population segments.** Other segments such as craftsmen, retailers and farmers had little or no access to affordable financial services, especially if they lacked a steady and predictable income.

To address this issue, these groups pooled their resources, creating the first financial cooperatives (FCs) early in the 19th century in Germany and the United Kingdom.[2]

2. **Financial cooperatives still play a role in providing financial services to customers who would otherwise have no access to affordable credit, especially in rural areas.** This is particularly the case in emerging market economies (EMEs), but also holds true in advanced economies. In some advanced economies, FCs compete directly with other types of financial institutions, whether commercial or savings banks, in providing financial services to retail customers and to small and medium-sized enterprises (SMEs).

3. **In many jurisdictions, FCs are the most numerous category of financial institutions although their share in the total assets of the financial system is typically limited.** As such, most individual FCs are rather small and have a simple business model built around deposit-taking and lending. In contrast, in some jurisdictions in continental Europe, FCs represent a large share of the financial system, with some considered to be systemically important.

4. **The main differences between FCs and commercial banks relate to their ownership structure and aims.** Typically, each FC member has one vote irrespective of the number of shares held. In addition to being owners, members are also depositors and borrowers; some may also take part in the FC's governance bodies. Furthermore, an FC's main objective is to serve its members by providing affordable financial services. Although FCs need to be profitable to sustain their activities, maximising profitability to distribute revenues to owners is not their sole or even their primary aim.

5. **Another distinctive feature of FCs is their ability to cooperate among themselves.** Since they typically have a local focus, and therefore do not directly compete with each other, they are more likely to share resources and undertake joint projects. Such cooperative activities help them achieve economies of scale.

6. **The way FCs conduct their business and organise themselves differs significantly across jurisdictions.** At one extreme, FCs are small, autonomous entities that involve only their members. These typically have a common bond such as a profession, an entrepreneurial interest or simply their location. Such entities are commonly known as credit unions. At the other end, FCs can form complex networks that include a central body which provides services to and oversees individual FCs, with powers to design common policies and enforce them across the whole network. These networks may over time come to resemble those of large banking groups in that they conduct business with non-members and offer a wide range of services, including asset management, insurance and investment banking as well as cross-border banking and corporate lending.

7. **FCs have certain competitive advantages.** Funding and capital are traditionally cheaper than for commercial banks and often more stable, since they are sourced, respectively, from members' deposits and member shares. Also, thanks to their local focus, FCs traditionally have closer customer relationships and may be better able to customise services.

8. **The same characteristics create particular challenges.** Local operations, common bond requirements and their (usually) small size means that traditional FCs are more likely to have concentration risks. These exist on both the asset and the liability sides of their balance sheets. As borrowers, creditors and equity holders, FCs are typically exposed to similar risks. In addition, their funding methods mean that their ability to expand or to strengthen their solvency relies mainly on the ability to accumulate retained earnings and expand membership. Third, FCs typically issue member shares to retail clients, who may be unaware of the loss-absorption characteristics of these instruments, giving rise to instances of mis-selling. Finally, the governance structure, in which board members and senior managers are also owners and

[2] See Bülbül et al (2013) for more on the history of European financial cooperatives.

customers, may give rise to a wider range of conflicts of interest than at other types of credit institutions with common shareholding structures.

9. **Recently, technology and market changes has started to erode FCs' longstanding competitive advantages.** For example, Internet and mobile banking services have increased economies of scale and thus the competitive advantage of larger banks. Moreover, these technologies allow competitors to enter geographical areas where competition against FCs was previously not viable. These challenges may be more severe for smaller standalone FCs, which can ill afford the necessary IT and capacity-building investments to keep up with customer expectations. Mobile applications, cloud computing or the use of big data to better serve customer needs may further erode the competitive position of traditional cooperatives, particularly among younger customer cohorts. This could leave some FCs with an ageing customer base, an excess of deposits and reduced lending opportunities.

10. **Financial cooperatives have responded to these challenges mainly through cooperation.** The aim is to benefit from economies of scale. In some cases, second-tier entities have been created or a commercial bank has been purchased to improve the group's business capacities by providing liquidity and liquidity management, access to capital markets and business diversification to all members. In others, the focus is on enhancing risk management, internal controls and capacity-building. In some cases, second-tier entities contribute to the network's crisis management framework by providing emergency liquidity assistance, stabilisation funds and deposit guarantee schemes. Consolidation through mergers is also a common response to competitive pressures.

11. **Previous studies have discussed FCs' characteristics and their implications from a regulatory and supervisory perspective.** IADI (2018), for example, discusses and elaborates on the specific challenges involved in resolving FCs. Cuevas and Fischer (2006) and Cuevas and Buchenau (2018) seek to provide guidelines for the regulation and supervision of FCs with a particular focus on developing economies and financial inclusion. Poprawa (2009) describes existing approaches for the supervision of FCs and makes recommendations with respect to regulations related to capital adequacy and governance.

12. **This paper reviews the main challenges arising from FCs' specificities in the new regulatory and technological context.** It also assesses how FCs[3] themselves and their regulators and supervisors have responded to those challenges. The paper is based on a survey of nine jurisdictions,[4] drawing on the experience of regulators and supervisors from both EMEs and advanced economies. In some of these jurisdictions, the main role of FCs is to contribute to financial inclusion while in others they compete with other financial institutions in the domestic retail market. Their business models and the way they organise themselves differ substantially across the selected countries. Finally, while in some surveyed jurisdictions, FCs have been active for more than a century, in others they may have started operations only recently.

13. **The paper is organised as follows.** Section 2 provides an overview of the FC sector, including its market relevance, existing business models and other issues related to FCs' operations in the selected jurisdictions. Section 3 describes the main challenges faced by FCs when financing growth while Section 4 discusses governance. Section 5 discusses specific features related to the design of the regulatory, supervisory and crisis management frameworks for FCs. Section 6 concludes. An annex summarises the responses received from the surveyed jurisdictions.

[3] The term financial cooperatives is here used to describe the various member-owned and member-controlled financial institutions governed by the "one member one vote" principle. This follows the Basel Committee on Banking Supervision's definition (September 2016), by which a financial cooperative is "a member-owned and member-controlled financial institution governed by the 'one member one vote' rule. FCs often take deposits or similar repayable funds from, and make loans only to, members, although some also serve non-members. The term includes credit unions, building societies, caisses, cajas, cooperative banks, mutual banks, and savings and credit cooperatives."

[4] The nine jurisdictions are Australia, Brazil, China, France, Germany, Ireland, Kenya, South Africa and the United States. While the jurisdictions were selected to reflect the main types of business model, there was also a need to ensure that all regions were represented. Accordingly, the sample does not include a jurisdiction where FCs that were part of a federation have merged to become a single entity (Rabobank in the Netherlands), although this type of business model is mentioned in the report.

Section 2 – Overview of the FC sector

Market relevance

14. **FCs were created to extend affordable financial services – particularly loans – to segments of the population not served by commercial banks.** The basic concept is for certain segments of the population which have difficulties in accessing financial services,[5] such as craftsmen, retailers or farmers, to pool their resources with a view to accessing credit and other financial services.

15. **Most FCs still play this role, even in countries where commercial banks offer mass retail banking services and therefore compete directly with them.** Related roles include the provision of financial services to "people of modest means"[6] and/or the provision of financial services in remote, rural or sparsely populated areas. In all cases, and irrespective of an FC's size, these roles may be relevant in both advanced and emerging market economies. In many regions, an FC is frequently the only deposit-taking and credit institution to have bricks-and-mortar branches.

16. **The market presence of financial cooperatives varies significantly across jurisdictions.** Table 1 shows how significant these differences are across a sample of jurisdictions and as measured by their share in the banking system's total assets, total loans and total deposits.

[5] Access to financial services starts by opening an account where savings and income can be deposited and from which payments can be made and received. It also includes access to affordable credit, something that is often essential for small businesses.

[6] This phrase is used in the US Federal Credit Union Act (FCUA) of 1934 which defines the purpose of credit unions in the United States.

Importance of financial cooperatives in their respective financial systems* Table 1

Jurisdictions	Number of FCs	Assets**	Loans**	Deposits**	Members***	Customers***
Australia	76	83 (2.3%)	67 (3.4%)	71 (2.8%)	.	.
Brazil	1,006	54 (2.5%)	29 (2.8%)	32 (4.4%)	9.6 (4.6%)	9.6 (4.6%)
China	1,173	1,200 (3.5%)	568 (3.2%)	868 (3.8%)	.	.
France	82****	3,897 (47%)	2,701 (51%)	2,413 (47%)	27 (40%)	65 (96%)
Germany	918	1,052 (12%)	734 (14%)	929 (16%)	19 (22%)	> 30 (> 36%)
Ireland	272	20 (4.9%)	5.3 (2.0%)	16 (5.8%)	3.3 (69%)	3.3 (69%)
Kenya[7]	174	4.3 (11%)	3.2 (14%)	2.9 (10%)	3.6 (7.3%)	3.6 (7.3%)
South Africa	26	0.03 (<1%)	0.02 (<1%)	0.02 (<1%)	0.027 (0.05%)	0.027 (0.05%)
United States	5,646	1,416 (8.1%)	972 (10%)	1,204 (8.9%)	113 (35%)	113 (35%)

* Data are for June 2017 for Australia, September 2017 for Ireland, December 2017 for Brazil, China, France, Germany and Kenya, February 2018 for South Africa and March 2018 for the United States.

** Numbers for assets, loans and deposits in USD billions and the corresponding share of the financial system in brackets.

*** Numbers of members and customers in millions. Numbers in brackets represent the share of the population.

**** This number includes licensed entities only. In France, the local banks of mutual groups are treated as branches of the regional entities and are therefore not subject to distinct licensing requirements. For instance, in the Crédit Agricole group, there are 2,447 local banks but only the 39 regional banks and the central entity are licensed credit institutions. The situation is similar for the Crédit Mutuel Group. However, there are no local banks but only regional ones in BPCE Group (for the organisational structures of the other groups, see charts in Annex 4).

Source: FSI survey.

17. **In terms of market share, the relative importance of FCs in the selected jurisdictions ranges from marginal to dominant.** FCs represent less than 1% of the financial system's total assets in South Africa. This is largely because the FC regime was recently established. In France, by contrast, they account for almost half of total financial assets and total deposits, and more than half of all loans. In fact, two of the country's three largest cooperative banking groups are designated as global systemically important financial institutions (G-SIFIs), while the third is a domestic SIFI.[8] In other jurisdictions, the importance of FCs lies somewhere between these two extremes. In a first group of countries (Australia, Brazil, China and Ireland), FCs represent a relatively small (up to 5%) proportion of total assets. In a second group – Germany,

7 The 174 FCs mentioned in the table relate only to those that are licensed and supervised by the prudential authority (SASRA).

8 The two G-SIBs in France are Crédit Agricole Group and BPCE Group, with total assets, as of end-2017, of USD 1.7 trillion and USD 1.39 trillion, respectively, while Crédit Mutuel Group is a D-SIB, with a total balance sheet of nearly USD 800 billion in 2017.

Kenya and the United States – FCs collectively hold 8–15% of the respective financial systems assets. There is, however, significant heterogeneity within each group.

18. **Another distinction is between cooperative banks, which are essentially found in continental Europe, and the credit union model (CU model).**[9] While both types of FC are owned by their members, cooperative banks can also offer financial services to customers who are not members. By contrast, credit unions typically offer their services only to member/owners, with these generally sharing some kind of common bond such as a specific profession, activity, employer or geographical location.

Business models

19. **Various types of organisation – or business model – can be found around the world, ranging from standalone financial cooperatives to highly integrated and centralised networks that are part of large diversified banking groups.** There are essentially four types of business model: standalone FCs, FCs associated through ad-hoc cooperation agreements, FCs that are part of a network of federated cooperatives, and mutual banking groups.

20. **The traditional business model is that of a standalone FC with a limited and clearly defined membership and franchise.** As members' resources are pooled, a traditional standalone FC is locally focused and characterised by the existence of a common bond among its members. Both features restrict the potential pool of customers, accounting for the typically small size of standalone FCs. The range of financial products and services may also be limited. Moreover, when compared with commercial banks, this type of FC depends more on interest margins, and less on fee-based revenues.

21. **Standalone FCs often cooperate by pooling their resources.** This typically involves setting up one (or several) entities, which are commonly owned by the partnering FCs and provide specific services to each, such as back office activities, IT services, financial settlement and transactions, insurance or the development of common products and brands. The two types of second-tier facility created by US credit unions are an example of this type of arrangement: corporate credit unions (CCUs) are credit union owned by credit unions and set up in order to realise economies of scale. Credit union service organisations (CUSOs) provide products and services (eg payment services) to multiple CUs or to the actual members of these CUs. In 2018, some 11 CCUs and 946 CUSOs were operating in the United States.[10]

22. **A third business model is that of federated or confederated networks of FCs, with a central entity providing common services to the whole network.** While such a model reflects more complex and deeper levels of cooperation, it brings together FCs that remain otherwise autonomous under an umbrella association and offers a wide range of common services, including risk mutualisation through an institutional protection scheme. Again, there is diversity across jurisdictions. One example of such a federated network is the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), which represents the interests of about 900 cooperative banks. The BVR also oversees a joint strategy and manages Germany's oldest deposit protection scheme for credit institutions.[11] 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.

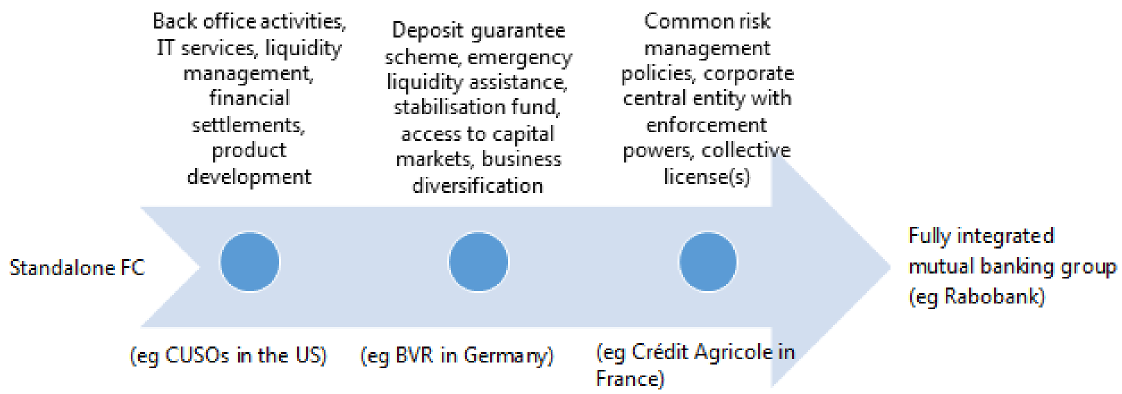
[9] Two main international associations represent FCs worldwide. One is the European Association of Co-operative Banks (EACB), which includes 3,135 mutual banks totalling 80 million members and 209 million customers across 20 countries, and the World Council of Credit Unions (WCCU) with more than 89,000 credit unions and 260 million members in 117 countries, as of end-2017.

[10] The roles and activities of CCUs and CUSOs are further described in Annex 9: Financial cooperatives in the United States.

[11] For more on this protection scheme and how it qualifies as an Institutional Protection Scheme (IPS) under EU legislation, see also Section 5 and Annex 5.

23. **The most integrated type of cooperation among FCs results in the formation of a centralised and diversified mutual banking group.** In the so-called "hybrid" or "inverted pyramid" model, local FCs owned by individual members control regional mutual banks which themselves hold a majority stake in a corporate. This corporate, typically licensed as a commercial bank, functions as the group's apex entity with group-wide risk management responsibilities. In France, for example, group-wide compliance with all legal and regulatory requirements is legally mandated for all mutual banking groups. This includes the power to require corrective actions from affiliates and regional FCs. The commercial bank can also offer investment banking and corporate lending services, raise market-based funding, and hold participations in specialised companies (such as leasing or insurance activities) or in foreign subsidiaries.[12] Examples of such mutual banking groups include groups of FCs in France and in other jurisdictions, such as in Austria, where Raiffeisen Bank International[13] (RBI) is a listed corporation and the holding company of the Raiffeisen Banking Group. An even more integrated mutual banking group may result from the merger of FCs into a single large financial cooperative that holds participations in specialised and foreign affiliates.[14]

Figure 1: Business models



Source: FSI survey.

24. **FC business models are traditionally based on competitive pricing and physical proximity to customers.** The first proceeds from their purpose, which is to extend affordable financial services, at a cost that may be lower than that of commercial banks. The second is that FCs often have – or are expected to have – a closer relationship and a more detailed knowledge of member/customer needs.

25. **The lower cost of providing basic financial services is traditionally derived from FCs' lower cost of capital and of funding.** This also reflects the fact that maximising profitability is not an FC's sole, or even primary purpose. Rather, the member/customer's main interest is in obtaining a reasonably priced service or loan that would otherwise be difficult or impossible to obtain from another credit institution.

[12] For the organisation charts of the three French mutual banking groups, see Annex 4.

[13] RBI is majority-owned by the eight regional Raiffeisen banks, which are in turn owned by 434 Raiffeisen banks belonging to their members (1.7 million members). RBI holds wide portfolios of participations in subsidiaries in Austria and internationally. Some of the Austrian subsidiaries are active for instance in real estate, private banking, factoring and leasing, while others provide common services to group entities. RBI also has almost 30 bank subsidiaries across the EU and eastern Europe, plus a number of servicing, leasing, investment and pension fund companies. Source: RBI International website.

[14] This is for instance the choice made by Rabobank in the Netherlands. See Groeneveld (2016) for more on the emergence and features of this governance model.

Because of these incentives, and because customer/members expect little – if any – distribution on their member shares, there is significantly less pressure on the FC's management to generate higher returns on equity.[15] For similar reasons, there was traditionally less pressure to offer attractive rates on customer deposits. An added feature is that, in some jurisdictions, FCs still have tax advantages and/or may be exempt from taxes on their income, as in the United States.

26. **Proximity to customers can be a competitive advantage.** FCs are often perceived as being closer to their customers than commercial banks and therefore better placed to understand their needs. This is partly because of their purpose, which is to offer financial services at a lower cost and promote financial inclusion, and partly because they belong to local communities. In addition, a comprehensive network of branches supports this physical proximity, with this playing an especially important role in sparsely populated and more remote areas. In some developed financial systems, where FCs' service offerings and pricing have largely converged with those of the traditional banking system, as in France for instance, FCs still benefit from a more favourable perception, which they leverage in their marketing.

Main challenges

27. **Several factors have increased the competitive pressure on FCs.** These include more stringent requirements and standards following the Great Financial Crisis as well as technological innovations that have created more demanding expectations from customers. Faced with such challenges, FCs may have difficulty in adapting their business models and attracting sufficient additional resources.

28. **More stringent regulatory standards and supervision increase the competitive pressure on FCs**. These requirements and heightened supervisory expectations restrict mainstream banks from increasing their leverage, making it more costly to take on risk and raise return-on-equity. As a result, some large institutions have downsized their investment banking activities and reoriented their efforts towards commercial banking,[16] thus encroaching on the core business of FCs.

29. **Technological changes have had a similar effect.** Automation of financial services and the ability to provide them over the internet are eroding FCs' traditional competitive advantages. New technology allows their competitors to operate at a lower cost, without maintaining large branch networks. In addition, online services can reduce the commercial benefits of physical proximity. In some cases, technological changes may even compromise an FC's viability.[17]

30. **Competition to lend is increasing.** FC members traditionally expected access to credit and other financial services at affordable prices. Increasingly, however, member/customers, particularly younger ones, put a premium on seamless and near-instant access to financial services. For instance, while it traditionally takes several days or even weeks to process a loan application, automation can reduce delays to a few hours or less, raising customer expectations.

[15] While this sometimes leads commentators to portray financial cooperatives as being "not-for-profit organisations", the expression can be misleading. In reality, FCs need to make a profit to both invest and build up their retained earnings to absorb losses. The main difference with commercial banks regarding profitability is that there is no expectation for FCs to distribute earnings to owners. This explains why they are exempt from corporate tax in some jurisdictions, as in the United States.

[16] A more detailed description of the changes to banks' business models can be found in Committee on the Global Financial System, "Structural changes in banking after the crisis", *CGFS Papers*, no 60, January 2018, pp 14–24.

[17] A recent example of concentration arising from technological change is the liquidation of Melrose Credit Union of Queens (New York City) in September 2018. This credit union, which had been operating for nearly a century, specialised in extending loans to taxi drivers secured by New York City taxi medallions. These have suffered over the years from the competition of ride-sharing apps such as Uber, so that both taxi drivers' turnover and the value of their medallions have plummeted.

31. **Competition to access financial resources is growing as customer expectations evolve.** Lower service costs were traditionally supported by lower expectations regarding deposit rates and income from member shares. However, FC members and depositors increasingly expect higher returns from their member shares and savings. 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.

32. **Difficulties in attracting younger customers can affect the long-term sustainability of FCs' business models.** Unfavourable demographics affecting the member/customer base can be seen in both EMEs and advanced economies, particularly in the case of smaller FCs operating in rural areas.[18] As younger customers tend to have higher credit needs and less savings than more mature customers, FCs confronted with an ageing customer base may find themselves with customer deposits that exceed lending opportunities. The need to generate income to at least cover operating costs may lead the FC to move into higher-risk activities.

33. **Cooperation between FCs is the most frequent response to these challenges.** As already mentioned, such cooperation can take the form of creating jointly owned secondary entities. An additional aim of such efforts may be to encourage business diversification. More systematic types of cooperation entail the formation of a federated cooperative financial network, which allows for more systematic specialisation. The most integrated types of cooperation result in the formation of a centralised and diversified mutual banking group. Such groups can include, in addition to FCs, a holding company to manage participations and a central financial entity that provides funding and investment banking services, both jointly owned by the FCs.

34. **FCs in many jurisdictions are also consolidating and rationalising their structures to increase scale and reduce operating costs.** Over the past decade, a significant amount of consolidation has taken place in most jurisdictions. For instance, Brazil, Ireland and the United States have each seen a reduction of more than 30% in the number of FCs over the period, mainly through voluntary mergers.

35. **Reductions in the number of branches or FCs do not necessarily imply loss of market share.** In the case of the United States, for instance, the number of FCs has fallen by more than 1,500 over the decade, but assets have increased by more than 80% and the share of FCs in the country's total financial assets has also increased, from less than 6% in 2007 to 8% in 2018, showing that consolidation can lead to greater efficiency and scale.[19] In Ireland, a statutory body, the Credit Union Restructuring Board (ReBo), was established in 2012[20] to facilitate voluntary, time-bound, incentivised restructuring. Between 2011 and November 2018, the number of CUs fell from 406 to 253. In other countries, such as 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.

36. **There may still be a need for consolidation to obtain the resources needed to invest in online distribution channels and digital services.** Whether in EMEs or advanced economies, FCs need to generate sufficient resources in order to invest in the new technologies that will allow them to continue to offer affordable services to their customers. However, their cost-to-income ratios are high and may be higher than those of commercial banks, largely as a consequence of their business model.

37. **Increasing the level of internally generated resources can raise tensions and issues.** There are essentially two main ways in which FCs may seek to increase their internally generated financial resources. One is to align the prices of their financial services with those of commercial banks. The other

[18] FCs in Australia or Ireland provide examples for mature economies while Kenya is an example for EMEs.

[19] Canada provides a similar example. Between 1966 and 2012, the number of credit unions fell to a tenth of its former total, to 370, while the percentage of Canadians who were members of an FC more than doubled during the same period.

[20] While ReBo completed its restructuring operations in March 2017, restructuring of credit unions has continued.

is to cut operating costs and pare down their branch network and headcount. Both raise tensions with the cooperative principles that underpin their activities, and particularly with the aim of offering affordable services to their members.

Section 3 – Access to capital and funding

Main characteristics of member shares

38. **FCs' member shares confer limited voting and ownership rights.** The main purpose of a member share is to confer membership on its holder, as opposed to common equity, which confers ownership and therefore a permanent right to the entity's assets and to the distribution of its earnings. Voting rights are linked to membership, with each member generally holding a single vote, regardless of the number of units held. By contrast, a common shareholder will have at least as many voting rights as the number of common shares held. Member shares are usually redeemable (even if subject to conditions) by the FC when the member wishes to leave the cooperative association but they cannot be traded or sold to another individual. Member shares are typically valued and redeemed at par. The holder does not own a share and therefore has no right to a share of the FC's retained earnings when leaving the association unless it is dissolved. Member shares generally bear little if any income. Unlike common equity, they do not appreciate as the value of the cooperative increases over time. Table 2 below summarises and compares the traditional features of common shares and member shares.

Common shares and member shares: comparing the traditional features — Table 2

	Common shares	Member shares
Negotiability	Can be sold, traded and listed	Not tradable. Not listed on a stock exchange
Distribution rights	Discretionary, variable, linked to annual results	Minimal dividend (if any)
Voting rights	Linked to the number of shares held	Linked to membership (one member, one vote)
Rights on retained earnings	At all times, part of the share value	No rights on retained earnings when requiring redemption. Only in liquidation
Share redemption	No	Yes, when leaving the association, although generally subject to conditions
Share value if sold or redeemed	Market value – no right to redemption	Typically redeemable at par

Source: FSI survey.

39. **The traditional characteristics of member shares make them unattractive for external investors**. Member shares cannot be accumulated to gain control of an FC since voting rights are linked to individual membership and not to individual shares. Member shares are also generally low-yielding – they have low (if any) dividends. In addition, they do not allow for capital appreciation since their value does not change over time and they are non-negotiable.

40. **The main source of capital growth for an FC is traditionally to retain earnings.** An FC's capital base consists mainly of member shares and retained earnings, with the latter generally representing the largest part. There are some exceptions, especially given competitive pressures to distribute a larger part

of annual surpluses to members.[21] As a result, FCs traditionally retain most of their earnings, so that their regulatory capital may be made up almost entirely of reserves. Essentially, the FC model is one that predicates low but steady growth over the long term, built around a core of members who use their own resources only and generally cannot lose control of the entity they own unless they chose to request the redemption of their member shares.

41. **Three sets of uncertainties are associated with member shares and related instruments.** The first set relates to their accounting treatment and whether a given instrument issued by an FC qualifies as a liability or as equity. The second set relates to the prudential treatment of the instrument and whether and to what extent it qualifies as regulatory capital with the ability to absorb losses on a permanent going-concern basis. The third set of issues relates to customer protection, since these instruments are typically sold to retail customers by the FCs themselves (or self-placed) outside the protection of securities regulations.

Accounting treatment

42. **Under international accounting standards, whether member shares can qualify as equity depends upon their specific characteristics.** International Financial Reporting Standards (IFRS) define a financial liability (IAS 32.11) as a contractual obligation to deliver cash or another financial asset to another entity. By contrast, when both the payment of dividends and the repayment of capital are at the issuer's discretion, the instrument qualifies as equity. Accordingly, to qualify as equity for accounting purposes and because they are normally redeemable for cash, the accounting standards require that either the FC has an unconditional right to refuse redemption of the members' shares or that redemption is unconditionally prohibited by local law, regulation or the FC's governing charter.[22] When redemptions cannot be refused, or are not prohibited, member shares would be treated as liabilities.

Treatment as regulatory capital

43. **In prudential terms, whether member shares qualify as regulatory capital depends upon their permanence and their ability to absorb losses.** An FC is traditionally obliged to redeem member shares if and when a member wishes to leave the association. Because of this obligation, it is debatable whether these shares qualify as a permanent source of capital that is unconditionally available to absorb losses. This tension between the right for members to leave the association and the ability of member shares to absorb losses can be exacerbated when an FC faces a run, even when redemptions are limited to the nominal value of the shares.

44. **The redemption obligation may lead to member shares being excluded from regulatory capital.** This is the case in the United States, where member shares of credit unions are treated as regular deposits and are insured in the same way as all other deposits. Member shares are also treated as liabilities in Australia and Ireland. Accordingly, they do not qualify as capital for regulatory purposes in either of the three jurisdictions and regulatory capital is limited to retained earnings and reserves. By contrast, an FC in Kenya cannot redeem member shares. These can be transferred only to another holder, who then becomes a member of the FC. Member shares in Kenya may therefore qualify as equity and regulatory capital. In Brazil, however, member shares qualify as regulatory capital despite being redeemable. Table 3 summarises the accounting and regulatory capital of member shares across a sample of jurisdictions.

[21] Unlike most other jurisdictions, member shares represent the most important source of capital for DT-SACCOs in Kenya, as opposed to retained earnings, because they distribute a larger part of their annual surpluses to their members. In addition, and unless the FC is liquidated, member shares cannot be redeemed at all. However, they can be transferred to another potential member.

[22] In particular, IAS 32 (first issued in 2002) and IFRIC Interpretation 2 on shares in cooperatives (2004).

Comparative treatment of member shares — Table 3

Jurisdiction	Accounting treatment	Qualifying as regulatory capital
Australia	Deposit liability	No
Brazil	Equity under BR-GAAP	Yes
France	Equity under French GAAP/IFRS	Yes, as CET1 if redemptions restricted according to CRR and RTS on Own Funds
Germany	Equity under German GAAP/IFRS	Yes, as CET1 if redemptions restricted according to CRR and RTS on Own Funds
Ireland	Deposit liability	No
Kenya	Equity – transferable/not redeemable	Yes
United States	Deposit liability	No

Source: FSI survey.

45. **Basel III imposes stringent requirements on capital instruments if they are to qualify as Common Equity Tier 1 (CET1).**[23] The 14 qualifying criteria aim at maximising loss-absorption capacity. Those criteria include typical features of common shares such as full discretion to pay out dividends, and holders' rights to the firm's net asset value in case of liquidation. In addition, qualifying instruments should never be repaid outside liquidation. 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". Since member shares often constrain remuneration, limit holders' rights in case of liquidation and, more importantly, allow redemption outside of liquidation, their eligibility as CET1 is not straightforward. To ensure that capital instruments issued by FCs could qualify, EU legislation has established specific conditions that constitute an interpretation of the CET1 eligibility criteria.[24]

46. **The EU's Capital Requirements Regulation (CRR) stipulates that member shares may qualify as CET1 when redemption rights are restricted.**[25] Under EU legislation, 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 the refusal to redeem is prohibited under national law. The ability to restrict redemption must include both the right to defer redemption and the right to restrict the amount to be redeemed. In addition, the refusal to redeem or the restriction of redemption do not constitute an event of default on the institution's part. The European Banking

23 The issues addressed in this and the following paragraphs are only relevant to FCs subject to Basel III and its national implementations (in particular the Capital Requirements Directive and the Capital Requirements Regulation). They do not arise in jurisdictions where FCs have been deliberately exempted from this framework (such as Ireland for instance – see Annex 6) or where international capital requirements for banks do not apply to FCs, with these being subject to a separate framework, as in the United States (see Annex 9).

24 However, the Regulatory Consistency Assessment Programme (RCAP) conducted by the Basel Committee on Banking Supervision on the risk-based capital standards introduced in EU legislation and finalised in December 2014 stated that "Basel III permits some flexibility in order to accommodate the nature of capital instruments of different mutually owned banks. However, the Assessment Team is concerned that the CRR concessions from the 14 CET1 criteria for mutuals go beyond the permissible flexibility in the Basel standard, while noting that this standard does not precisely define the extent of permissible flexibility. This is an area where the BCBS could provide additional guidance on the extent of flexibility considered appropriate for CET1 issued in mutual bank structures". The RCAP Report can be accessed at www.bis.org/bcbs/publ/d300.pdf.

25 Other CET1 criteria have also been interpreted to allow member shares to qualify as CET1 in the EU. In particular, eligible instruments may include a cap or a restriction on the maximum level of distributions but only where such a cap is set out under national law or in the statutes of the institution. Moreover, when an instrument provides its owner with rights that are limited to the nominal value of the instrument in the event of insolvency or liquidation, the limitation must apply to the same degree to the holders of all other CET1 instruments issued by that institution.

Authority's (EBA) Regulatory Technical Standards (RTS) on Own Funds have further defined the scope of redemption limitations, with any redemption being subject to supervisory authorisation (see Box 1).

47. **FCs have also explored ways of raising capital that may qualify as CET1 under national legislation by issuing additional classes of capital instruments.** While these instruments may be variously known as preferred shares, investment certificates or member certificates, they are all derived from member shares and have three features in common. The first is the absence of voting rights attached to them. This ensures that existing members retain control of the FC when they are issued to external holders. It also ensures that the "one person – one vote" principle is respected. The second feature is to offer a remuneration that is higher than that paid out on members' savings deposits or on money market instruments. When directed towards members, the purpose is to give existing members an incentive to increase their long-term investment in the FC. When open to non-members, the purpose is to raise additional capital from a wider range of investors. The third characteristic is to ensure that these non-voting investment shares are also non-withdrawable or, at least, that their redemption is subject to sufficient restrictions to allow them to qualify as regulatory capital.

Box 1

Allowing capital instruments issued by mutuals, cooperative societies, savings institutions and similar institutions to qualify as CET1 regulatory capital

The issue

After the adoption of the Basel III definition of regulatory capital in 2010, there was uncertainty as to whether instruments issued by mutual banks and financial cooperatives could meet the qualifying criteria for Common Equity Tier 1 (CET1) (and, to a lesser extent, those for Additional Tier 1 capital). This was despite the fact that the standard specifically mentioned that "the criteria also apply to non-joint stock companies". The uncertainty arises because the regulatory criteria were designed with common equity in mind. Accordingly, and in the absence of specific treatments, there was a possibility that no instruments issued by such entities, not even their member shares, would qualify as regulatory capital. Two of the most problematic criteria were those related to permanence of capital and the inability to redeem the instrument outside of liquidation.

Addressing the issue

To address these difficulties and allow non-joint stock companies to issue capital instruments that would qualify as regulatory capital, Articles 27 to 29 of the Capital Requirements Regulation (CRR) of 2013 establish a special regime for capital instruments issued by mutuals, cooperative societies, savings institutions and similar institutions. The EBA has been authorised by the EU Parliament to issue delegated regulation. After approval by the European Commission, these Regulatory Technical Standards (RTS) on Own Funds can clarify and complement the capital requirements regulations. The RTS were introduced in 2014 and 2015. The three main sets of measures included in the framework are the following:

A first set of measures is to define, for each Member Country, the scope of financial entities that may avail themselves of the alternative treatments for capital instruments issued by non-joint stock companies.

A second set of measures is to clarify and/or complement the conditions that allow member shares to qualify as CET1 or Additional Tier 1 when issued by FCs. This is particularly the case of redemption limitations with the following clarifications:

- An institution may issue CET1 instruments with provisions that allow for a possibility to redeem them only where such possibility is foreseen by the applicable national law.
- The ability of the institution to limit redemptions must include both the right to defer the redemption for an unlimited period and the right to limit the amount to be redeemed.
- The extent of limitations on redemption included in the provisions governing the instruments shall be determined by the institution based on the prudential situation of the institution (overall financial situation, liquidity and solvency in particular).

- Where membership shares can be redeemed, such redemptions are subject to supervisory authorisation. National law on cooperatives may also specify that such redemptions must be made at nominal value, as is the case in Germany and in France.①
- The supervisory authority can further limit redemptions when asked by a credit institution to allow for reduction, repurchase, call or redemption and either (i) the institution does not replace the instrument with own funds instruments of equal or higher quality at terms that are sustainable for its income capacity or (ii) the institution is unable to demonstrate to the satisfaction of its regulatory authority that its own funds would, following the redemption, exceed capital requirements (minimum and buffers) by a margin that the competent authority may consider (with the margin representing the institution's Pillar 2 requirement).

The third element is Article 80 of the CRR (Regulation EU No 575/2013) whereby "the EBA shall monitor the quality of own funds instruments issued by institutions across the Union and shall notify the Commission immediately where there is significant evidence of those instruments not meeting the criteria set out in Article 28 or, where applicable, Article 29." The first annual EBA report on the monitoring of CET1 instruments was published in 2013.②

① In the case of France and according to Articles 77 and 78 of the CRR allowing for the reduction of own funds, all FCs must submit every year a request to the competent supervisory authority to grant them with the ex ante permission to redeem, on a solo basis, their membership shares up to an amount equal to a maximum of 2% of their respective CET1 capital. A similar requirement also exists in Germany. ② The latest monitoring report of CET1 instruments issued by EU institutions (July 2018) can be found at www.eba.europa.eu/-/eba-updates-on-monitoring-of-cet1-capital-instruments.

FCs' capital and customer protection issues

48. **The issuance of capital instruments by FCs' can raise significant customer protection issues.** FCs typically issue member shares, and may also issue other capital instruments qualifying as regulatory capital, to their own customers. These so-called self-placements can generate a conflict of interest. Buyers are typically small retail customer/members, who may be induced to invest their savings in instruments that are sold as alternatives to low-yielding savings accounts. However, the FCs' customers may not be aware of the loss absorption characteristics of these instruments. While there does not seem to have been any high-profile case to date wi9th regard to member shares, such circumstances may result in instances of mis-selling.[26] Such a risk may be heightened when an FC is under pressure and urgently needs to raise additional capital to satisfy its minimum regulatory capital requirements.

49. **Investor protection requirements are typically established in one of two ways (see Box 2).** The first is to draw a distinction between retail investors and qualified investors, who are assumed to be able to understand the risks they are taking and to sustain the potential losses. Investors are assumed to be qualified when they exceed certain income thresholds and/or net worth thresholds, as in the United States. The second is to require firms providing investment services to ensure, respectively, that a product sold to a customer is suitable and/or appropriate, as is the case in the EU under MiFID and MiFIR.[27]

50. **There is some uncertainty as to whether self-placements of unlisted member shares qualifying as regulatory capital are subject to existing investor protection requirements.** This is

[26] Instances of mis-selling of self-placed financial products have been, for the time being, limited to subordinated debt instruments, as opposed to member shares of financial cooperatives, as shown in Conac (2018).

[27] MiFID refers to Markets in Financial Instruments Directive. MiFIR refers to the Markets in Financial Instruments Regulation. Both texts have been applicable in the European Union since January 2018. Their aim is to enhance market transparency and competition and increase investor protection. One example of the latter is Article 25(6) of MiFID II, which requires that a retail client must be provided with a suitability report when that client has been provided with investment advice. The report must be issued to the client prior to any transaction and must specify the advice given and how this advice meets the client's preferences and objectives. Moreover, according to Article 25(2) of MiFID II, firms are required to recommend to clients only the investment services and instruments that are suitable and in accordance with their risk tolerance and ability to bear losses.

because FCs' unlisted member shares would not qualify as securities. Such shares would accordingly not benefit from investor protection requirements designed to ensure that investors have sufficient information and knowledge to understand the securities' risks and the ability to sustain potential losses when investing in them.

51. **To address these uncertainties, specific customer protection requirements may be necessary.** Where member shares or equivalent instruments qualify as regulatory capital, there may be a need for specific requirements related to issue documentation, marketing materials and disclosures. This is the choice made in Australia, where issue documentation and marketing material for mutual equity interests (MEI)[28] must clearly and prominently state that the instrument is not an insured deposit, that it cannot be redeemed other than in exceptional circumstances and with the regulator's approval, that the holder is only entitled to a residual claim on the issuer's assets after all more senior claims have been paid, that neither the holder nor the issuer may exercise any contractual rights of set-off, and that the issuer has full discretion regarding both the timing and amount of any distributions paid.[29]

Box 2

Qualified investor/client/purchaser and client suitability and appropriateness of investments

Qualified investor, qualified client or qualified purchaser

The concepts of qualified investor/client/purchaser are used in US securities legislation. While there are some differences between the three concepts, the common idea is to identify high net worth or high-income individuals on the basis that this group is presumed to have sufficient financial sophistication to understand and accept the risks of investments that the general public cannot.

A qualified investor (sometimes also termed accredited or sophisticated investor), for instance, is an individual who is legally permitted by the Securities and Exchange Commission to invest in hedge funds, venture capital funds, private equity offerings and other private placements. In the United States, such a qualification may be obtained if either (i) the person has earned income in excess of USD 200,000 (or USD 300,000 when combined with that of a spouse) during each of the previous two years and can expect to earn a similar amount for the current year, or (ii) the person has net worth in excess of USD 1 million, excluding their primary residence. A number of countries, such as Australia, Canada, Singapore or Switzerland, use their own definitions and thresholds for determining sophisticated investors in their respective jurisdictions.

Client suitability and appropriateness of investments

Client suitability and appropriateness are concepts used in the European Union's Markets in Financial Instruments Directive 2 (MiFID II). They generate requirements that investment firms need to meet when providing investment advice or investment services (without advice) to their clients.

Suitability: investment firms providing investment advice to their clients have the responsibility to collect information from their client so that a suitable recommendation can be made. In particular, the information collected must permit the assessment of the client's financial knowledge and experience, financial situation and investment

[28] In Australia, the authorities developed two regimes allowing, respectively, for the conversion of subordinated debt or Additional Tier 1 capital into CET1 capital upon a non-viability trigger and for the direct issuance of Mutual Equity Interest (MEI) – a capital instrument that would qualify as CET1. However, only two FCs have used the first regime, while none have issued MEIs directly because of their cost.

[29] These requirements are part of Prudential Standard APS 111 – Capital Adequacy: Measurement of Capital – Attachment K – Mutual equity interest of the Australian Prudential Regulation Authority (APRA).

objectives. The assessment must result in a report sent to the client. It must specify how the advice meets the client's objectives and preferences and demonstrate that it is in line with the client's risk tolerance and ability to bear losses.

Appropriateness: when providing investment services without advice, investment firms must assess if the financial instrument being provided is appropriate for the client when such an instrument is deemed to be "complex". Financial instruments, such as listed common shares, are automatically non-complex when they trade on a regulated market and/or do not embed a derivative. Instruments with embedded derivatives always qualify as complex. A third category, including shares that are not traded on a regulated market and must be assessed against criteria listed under Article 38 of the MiFID II Directive. Such an assessment requires the investment firm to test the individual client's knowledge and experience of the complex financial instrument.

Although they may not qualify as securities, FCs' member shares qualifying as regulatory capital could – by analogy – qualify as complex financial instruments under MiFID II alongside other types of unlisted equity, especially since they have no price that is validated independently from the issuer and they are not subject to requirements to provide adequately comprehensive information on their characteristics to customers. This raises the issue as to whether some of the provisions of MiFID II should be explicitly extended to them or whether specific protection requirements should be designed for them.

52. **In practice, issuance of capital instruments other than member shares is limited.** There are multiple reasons for this, depending upon jurisdictions and the situations of specific institutions. In many cases, FCs have no urgent need to issue additional capital, as their capital is already above minimum levels. In Germany, for example, cooperative banks generally meet regulatory capital requirements on the basis of their member shares and retained earnings only, and no cooperative bank has issued Additional Tier 1 (AT1) instruments under Basel III. Only a minority (about 150 out of more than 900) have outstanding subordinated debt instruments that qualify as Tier 2 for regulatory purposes. In Brazil, existing legislation allows FCs 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 most cases, issuing a wider range of fixed income products seems largely predicated on size and on whether the instruments can be externally rated. Smaller FCs generally consider that issuing these instruments is not cost-effective even when the instrument is designed to address their needs.[30]

Section 4 – Governance

53. **Governance challenges arise from different incentive structures and, in most cases, a lack of scale.** The most frequently raised issues by surveyed jurisdictions include low attendance in general meetings, lack of renewal of boards and senior management, and the insufficient skill sets, expertise and qualifications of senior managers and members of oversight bodies. In addition, supervisory concerns with respect to governance include the inability of smaller entities to adequately segregate duties to ensure that internal controls are sufficiently robust, and the lack of sufficient knowledge of internal controls and oversight/control functions among the supervisory committee members.

54. **FCs do not pursue profit maximisation as their primary objective.** Profitability is important for an FC insofar as retained earnings are the main source of capital and growth but, unlike a shareholding company, maximising profits is not the main objective.[31] Moreover, members willing to leave the FC typically only receive the nominal value invested and will therefore not benefit from potential market valuation gains. While this may imply that incentives for FCs to engage in higher-risk activities are lower, and returns are likely more stable through economic and financial cycles, another consequence is that

[30] See in particular Annex 1, Financial cooperatives in Australia.

[31] See Cuevas and Fischer (2006), Birchall (2013), Bülbül et al (2013), Groeneveld (2015) and Lang (2016) for a more detailed discussion of the different incentives and corresponding implications for governance arising from FCs' characteristics.

owners lack financial incentives to monitor the FC's performance and that of its senior managers. In addition, some members/customers may be unaware of the fact that they are also owners of the FC and see it merely as a financial institution of which they are a customer and from which they have borrowed.

55. **In FCs, owners are at the same time customers (potentially both depositors and/or borrowers) and, in some cases, members of the governance bodies.** This has the potential to create multiple conflicts of interest. In shareholding companies, the agency problem arises from the fact that a large share of the senior management's compensation is variable and dependent on annual profits. As such, senior managers may have an incentive to maximise short-term profitability and may be more prone to risk-taking than are shareholders, who want to maximise sustainable profitability. A similar type of conflict of interest arises between shareholders and depositors (and other creditors): the former will benefit from higher returns, but the potential for losses is limited to the amount paid for their shares. While depositors share in the risks, their compensation is predetermined and capped at the contractual interest rate. In FCs, these two particular issues are much less pronounced, given that the customers are also the owners. In contrast, the fact that managers are also customers could mean that, when making decisions, their personal interests may not necessarily be aligned with those of the membership. Cuevas and Fischer (2006) call this kind of conflict an "expense preference". They consider it to be one of the major sources of FC failures.

56. **Members often lack the skills to direct, manage and control an FC's activities.** While the preferred option from the FC's perspective would be to look for board members and senior managers within the existing membership, current members might not have the expertise or sufficient time to perform these duties satisfactorily. Although not an issue exclusive to FCs, finding and retaining qualified staff to perform key functions might be more of a challenge for these entities (and even more acute for small, rural, standalone FCs), as members may lack the necessary financial knowledge and dedication.

Differences between commercial banks and FCs affecting their governance Table 4

	Commercial bank	Financial cooperative
Primary objective	To maximise sustainable profits for shareholders	To provide affordable services to members
Owners	Shareholders	Members
Participation rate in general meetings	Generally low for retail investors but higher for institutional investors	Generally low
Management	In principle, by professional bank managers or owners directly	Traditionally by people from the membership
Conflicts of interest	Shareholder/senior management Shareholder/creditor	Owner = customer = member of governance body

Source: FSI survey.

57. **In most jurisdictions, FCs have responded to the challenges by pooling resources and investing in capacity-building.** A higher-level body may have more resources to hire and to maintain qualified staff and be better able to provide advice to affiliates on different topics. Additionally, this central facility can be the venue where its affiliates may discuss and address common governance problems. In South Africa, for example, the National Association of Co-operative Financial Institution of South Africa (NACFISA) provides training for staff and board members. In Australia, most FCs are part of the Customer Owned Banking Association (COBA) and some are also part of the Business Council of Co-operatives and Mutuals (BCCM), which are unregulated entities that provide their respective members with policy advice and training forums. US credit unions have formed the Credit Union National Association (CUNA), which provides them with professional development among other services. Ireland and Germany – among others – also have entities providing training services to FC members.

58. **Improving the skills of senior managers and members of oversight bodies may be achieved by training existing members or through external hiring.** In both cases, adequate compensation for the time spent attending to the FC's affairs and for their expertise is necessary to retain qualified staff. In Australia, APRA has actively encouraged the "upskilling" of FC boards through its governance standards applicable to all authorised deposit-taking institutions (ADIs), with these standards including fit and proper requirements. In France, the supervisory bodies of the central entities of each of the three groups include varying numbers of external directors. In Ireland, primary supervisory expectations regarding governance risk include appropriate performance management frameworks for relevant officers and staff.

59. **In addition to capacity-building, member representativeness can be promoted by adjusting the voting system.** In Brazil, for example, some FCs have developed electronic referendums. In Ireland, the Credit Union Advisory Committee (CUAC), which is an advisory body to the Minister for Enterprise and Employment, published in December 2017 a policy paper exploring alternative means of voting by members including proxy voting and electronic voting. In the United States, proxy voting in general meetings is allowed in some states, such as California and Florida, but not in others, such as Texas. In Germany, the larger FCs, are allowed to convene a "representative assembly" instead of a general assembly where each attendant can represent up to 40 members. A similar approach is allowed in Kenya, where large FCs also have a delegate system of representation.

60. **The lack of renewal among board members and senior managers has been dealt with in different ways across jurisdictions.** In Australia, APRA requires all deposit-taking institutions to have a renewal policy in place, but the supervisor does not mandate a maximum tenure. In France, regional and national boards were renewed over the past years through a combination of supervisory pressures as part of their ongoing supervision (eg appointment of independent board members) and of legal requirements pertaining to gender diversity. In Germany, the renewal of supervisory board members and members of the executive board is supported by the audit associations, which have specialised units offering personnel advice to board members. In Ireland, term limits for members of the board and members of the board oversight committee were introduced into the 1997 Credit Union Act in 2013.

61. **Requirements for the segregation of duties exist in all surveyed jurisdictions.** In Brazil, China, Ireland, Kenya, South Africa and the United States, FCs typically have three governance bodies with the board of directors responsible for determining the business plan, the strategy and the management policies, while senior managers are in charge of executing and implementing them and the supervisory committee is responsible for overseeing the board and senior management to ensure that they have adequately fulfilled their respective roles. In contrast, France and Germany have a dual structure, with a management board or committee exercising an executive function and a supervisory board in charge of overseeing the former's actions. In Australia, a board of directors, along with various board committees is required but not a management board or a management committee. While the former model might achieve a clearer segregation of functions, the latter dual structure might better suited to smaller and simpler FCs, which may have more difficulty in finding qualified members to manage and oversee their activities.

62. **Segregation of duties is reinforced by specific restrictions across jurisdictions.** In Germany, all members of the supervisory board must be non-executive. In Ireland, the CEO cannot be a board member. In Brazil, the CEO cannot be a board member in full-service cooperatives or in classic cooperatives with total assets of BRL 50 million or more. In Kenya, the CEO can attend board meetings but has no voting right. In Australia, the CEO can also be a board member but cannot chair the board of directors. In France, the CEO may chair the board if authorised by the supervisory authority, but, in practice, most board members at regional levels are members/customers with no executive position. In Ireland, prescriptive and detailed governance requirements emphasise the importance of, and provide a framework to implement in practice, a separation between executive or operational roles, and non-executive or governance roles.

63. **Internal auditing requirements are typically applied in a proportionate fashion with similar goals.** These include the need for an independent internal function responsible for overseeing, evaluating

and proposing improvements to FC's risk management, internal controls and governance processes. The results of its evaluations are typically presented to the board or to a board subcommittee (eg an audit committee). In Australia, some FCs 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 FCs with a banking license are required to have their own internal control function. In Germany, each FC 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, and in addition to the Supervisory Committee, FCs are required to have an internal audit function and the board must establish an audit committee.

64. **Proportionality also exists for external auditing requirements although its implementation varies substantially in some jurisdictions.** In Germany, for example, all FCs are required by law to join an auditing federation, which is granted the right to audit by a state authority, subject to meeting specific requirements. Auditing procedures/reviews can cover a wide range of topics including risk management, corporate governance, compensation schemes, IT, restructuring plans, prudential reporting, internal controls, and money laundering. In Brazil, besides internal and external auditing, FCs are subject to the so-called cooperative auditing, which is performed by a licensed entity and is focused on the processes of the FCs. In the United States, smaller federal credit unions may have a third party perform the external auditing function or have the supervisory committee conduct the audit itself. In Kenya, regulated FCs are required to have an independent auditor perform a statutory audit on a yearly basis.

Section 5 – Regulation, supervision and crisis management

65. **Financial cooperatives' characteristics have important implications for the design of regulatory, supervisory and crisis management frameworks.** On the one hand, most FCs are small, have simple business models and are numerous, thus raising the issue of proportionality. On the other hand, their ownership structure and primary objectives differ from those of commercial banks, something which may require some tailoring when considering regulation and supervision approaches because these are often designed with commercial banks in mind.

Regulation

66. **The regulation of FCs typically has some features of proportionality and also some differentiation.** Proportionality commonly takes into account the size and complexity of the regulated entity and is applied across all types of financial institution, whether mutual or not. As such, given that most FCs are small and have a less sophisticated business model, they are usually subject to simplified rules. Differentiation is also frequently used to address situations where a specific treatment is needed to reflect FCs' idiosyncrasies and challenges, being applied to all FCs regardless of size.

67. **Proportionality is embedded in the regulatory frameworks of most jurisdictions.**[32] This is the case with regard to qualitative or principle-based requirements, such as those related to risk management and internal controls. In all jurisdictions, supervisory expectations are higher with respect to large and more sophisticated financial institutions regarding governance, processes and systems. Cases of proportionality for quantitative requirements, such as capital and liquidity adequacy ratios, are also a common feature for small institutions across surveyed jurisdictions, exceptions being France and Germany

[32] See Hohl et al (2018) and Castro Carvalho et al (2017) for more on the application of the principle proportionality in the implementation of prudential regulation in several jurisdictions.

(and more generally EU countries) where EU standards derived from the Basel III standards apply, in general, to all financial institutions regardless of their size and complexity.

68. **Proportionality in prudential regulation usually takes the form of simpler but not necessarily lighter requirements.** This is typically the policy choice when the regulator intends to reduce the regulatory burden without compromising the soundness of smaller and less complex financial institutions. It often takes the form of simpler and higher capital and liquidity ratios and simplified supervisory reporting requirements. In Brazil, for example, the minimum CET1 ratio under the simplified prudential approach ranges from 12 to 17%. In Ireland and Kenya, FCs must hold, respectively, 8% and 10% of total (unweighted) assets in the form of retained earnings. This naturally comes with several trade-offs in relation to level playing field issues and comparability, as institutions that provide similar financial services will have to comply with different sets of rules.[33]

69. **In relation to capital adequacy ratios, some jurisdictions rely solely on a non-risk-weighted metric.** In Ireland, Kenya and South Africa, a minimum requirement based on a non-risk-weighted ratio of retained earnings to total assets is applied. The minimum ratio ranges from 6 to 10% across those jurisdictions.[34] Although simple, this metric creates incentives for FCs to avoid an excessive distribution of their annual surpluses, which is the main (and often the only) source of capital for most of them. Also, by using data from financial statements, compliance with regulatory requirements becomes less costly, given that supervisory reporting may be simpler.

70. **In other cases, risk-sensitive capital adequacy ratios apply, but the assessment and calculations are simplified.** In Brazil, a simpler capital adequacy ratio solely based on financial statement figures replaces the Basel III standard for small and less sophisticated financial institutions, whether FCs or non-bank financial institutions. Under this simplified approach, risk-weighted assets focus mainly on balance sheet credit risk and risk weights are commonly calibrated to a higher level to compensate for the absence of several components.

71. **Several jurisdictions exempt small financial institutions from calculating the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), replacing them with a simple liquidity requirement.** The latter typically takes the form of a ratio obliging the financial institution to hold a reserve of liquid assets that is determined as proportion of total assets or total deposits. In Australia, small institutions must hold at least 9% of the adjusted liabilities in specified types of highly liquid assets. In Ireland, FCs 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.

72. **Supervisory reporting and Pillar 3 disclosure requirements are typically simpler for small and less sophisticated financial institutions.** In Brazil, small financial institutions are exempted from Pillar 3 disclosure requirements. In South Africa, large FCs are required to submit monthly returns while small ones report on a quarterly basis. In Australia, APRA is planning envisaging to simplify the disclosure requirements for "less sophisticated" or smaller financial institutions.

73. **Application of simplified provisioning rules – even to smaller institutions only – is somewhat less frequent.** Credit risk is typically the most important risk for commercial banks and this is even more the case for FCs, including those involved in trading activities. Accordingly, provisioning rules is an essential part of the prudential regulatory framework in all surveyed jurisdictions. Given the relative complexity in accounting rules, some jurisdictions have come up with a simplified or automatic approach to provisioning. In some countries, such as Australia, Kenya and South Africa, this is done through the use of a supervisory formula where the number of days in default is the main input for determining the provisioning rate. In Ireland, FCs are generally subject to the Financial Reporting Standard 102, which

[33] See Restoy (2018) for more on trade-offs of applying proportionality in the prudential regulatory framework.

[34] In Ireland, in addition to the 10% minimum requirement, FCs are required to hold distinct and separate reserves for operational risk.

requires an incurred loss approach to provisions while commercial banks comply with IFRS9 – an expected loss-based approach.

Accounting/prudential treatment applicable to small financial institutions — Table 5

	Capital ratio	Liquidity ratio	Provisioning
Exemption		BR	
Simplified approach	AU, BR, CN, IE, KE, US, ZA	AU, CN, IE, KE, US, ZA	AU, IE, KE, ZA
Same for all banks	DE, FR	DE, FR	BR, CN, DE, FR, US

AU – Australia, BR – Brazil, CN – China, DE – Germany, FR – France, IE – Ireland, KE – Kenya, US – United States, ZA – South Africa.

Source: FSI survey.

74. **The use of differentiation to take into account the ownership structure is also common in surveyed jurisdictions.** Most jurisdictions have some rules that apply only **–** or apply in a different way **–** to FCs regardless of risk profile and size. A broader use of differentiation is somewhat less frequent. This is the case in Ireland, Kenya and South Africa, where the main prudential requirements applicable to FCs differ from (but are equivalent to) those of commercial banks. In other words, FCs must comply with specific regulations and are exempted from the prudential regulation framework that applies to commercial banks.

75. **In many jurisdictions regulatory capital is more narrowly defined for FCs.** This is the case for 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 by the FC. If a member wants to leave the FC, that member's share must be transferred to another member.

76. **In others, member shares are included in regulatory capital, subject to restrictions.** In the EU, Article 29 of the CRR defines the qualifying criteria with respect to capital instruments issued by a list of specified FCs and similar institutions. It includes, for example, conditions under which redemptions may take place and specifies that the prohibition or limitation of redemptions does not constitute an event of default.[35]

77. **Limits on large exposures may be more stringent for FCs than for commercial banks.** Concentration risk is particularly important for FCs, given their small size, regional focus, and the existence of a common bond requirement in many cases. Rather than a case for proportionality, these more stringent limits seem to reflect the need to tailor the requirements to take account of FCs' business models. Accordingly, all jurisdictions apply some kind of quantitative requirement, and some have ratios for large exposures that are more stringent than the Basel standards. For instance, in Kenya and South Africa, exposures to a single counterparty, or to a group of connected counterparties, are restricted to 10% of regulatory capital (in contrast to the 25% limit, as per the international standard).

Supervision

78. **Given that FCs are typically numerous and small, relatively fewer resources are dedicated to their supervision.** Processes and tools are used to identify higher-risk institutions, both in terms of the probability of failure and the impact of failure. In most cases, these processes will be based on the risk profile and systemic importance of the financial institution and not on its type, mutual or otherwise. This typically results in a smaller amount of resources dedicated to the supervision of individual FCs, although, in relative terms (measured, for example, as the ratio of resources allocated to the supervision of a financial

[35] See Section 3 for more about the specificities of member shares, restrictions in redemptions and their capacity to absorb losses.

institution and its total assets) the total amount of resources allocated to supervise FCs are likely to be higher than the total of those assigned to the oversight of larger commercial banks.

79. **Various models are used to structure the supervision of different types of financial institution.** In Australia, a separate division of APRA is responsible for supervising all smaller financial institutions, regardless of type. In China, the supervision of all rural small and medium-sized financial institutions falls under the responsibility of the Rural Financial Institution Supervision Department in the China Banking and Insurance Regulatory Commission (CBIRC). In Ireland, FCs are supervised by the Registry of Credit Unions – a division within the Central Bank of Ireland – in accordance with a specific statutory mandate. In Brazil, a specific unit is responsible for the supervision of FCs and non-bank financial institutions, regardless of size. In other cases, such as in Kenya and the United States, a specific agency is responsible for the supervision of FCs, again regardless of size.[36] However, in all these models, risk-based supervision principles are used to tailor the intensity of supervision and deploy resources more efficiently.

80. **Supervisory powers with regard to FCs and commercial banks are similar.** These typically include powers to require a capital restoration plan, to constrain activities, and fines and sanctions for violations of laws and regulations. Most supervisors have the power to remove one or all members of the board and senior managers and to nominate a temporary administrator when certain conditions are met. Few countries seem to have powers enabling a forced merger of FCs. In the United States, according to the Federal Credit Union Act, NCUA may exercise this power if the merging FC is insolvent, or in danger of insolvency. In Ireland, the Credit Institutions (Resolution) Act 2011 (the "2011 Act") provides for the directed transfer of assets and liabilities of authorised credit institutions.[37]

81. **Given the small size and simplicity of most FCs, supervisory cycles tend to be longer.** On-site supervision takes place less frequently. In some jurisdictions, larger FCs will have at least one annual on-site examination whereas for the smaller entities, the on-site supervision cycle can extend to three years, or even not be used at all unless a specific regulatory threshold is breached. In Ireland, for example, there are three different supervisory approaches for FCs, depending on asset size. For the larger FCs, an enhanced supervisory approach is applicable. Under this approach, on-site inspections take place at a frequency dependent on risk and impact metrics. At the other extreme, the smaller FCs are subject to the "differentiated proportionate approach", whereby the engagement is primarily desk-based with on-site inspections taking place exceptionally, when deemed necessary according to the risk profile.

82. **In these cases, off-site supervision plays a crucial role, as most decisions and actions are based on the outcomes of this kind of analysis.** In most jurisdictions, the output of this assessment feeds into a CAMEL[38] or CAMEL-like rating system to assess the risk of individual FCs. In most cases, such models are similar to the ones used for other regulated institutions, although there might be differences in the weighting of the risk categories and also in indicators used to reflect differences in FCs' structures and business models.

83. **That process, in turn, depends very much on the quantity and quality of data available to supervisors.** In this context, striking the right balance between comprehensiveness and regulatory burden is a key challenge to supervisors. On the one hand, supervisors would like to base their off-site/desk-based analyses of FCs on complete and high-quality information. On the other hand, imposing heavy reporting and auditing requirements on small financial institutions may create an excessive regulatory burden.

[36] See eg Poprawa (2009) and Cuevas and Fischer (2006) for more on the discussion about the existing supervisory models for FCs.

[37] Since 2015 and the transposition of the Bank Recovery and Resolution Directive (BRRD) by the European Union (Bank Recovery and Resolution) Regulations (S.I. No. 289 of 2015), the "2011 Act" applies to credit unions only, except Part 7 of the 2011 Act which applies to the winding-up of credit institutions as well as credit unions.

[38] The acronym CAMEL stands for the following factors that supervisors use to rate financial institutions: capital, assets, management, earnings and liquidity.

84. **Accordingly, supervisory reporting requirements usually focus on information that is more relevant to FCs.** In some cases, most of the data come from quarterly audited balance sheets. In this case, they are typically supplemented by simplified quantitative reports on capital and liquidity ratios. Given the significance of credit and concentration risk to small FCs, information from credit bureaus also plays an important role in the off-site monitoring framework in some jurisdictions. In Ireland, for example, as well as submitting quarterly data to the Registry of Credit Unions, FCs must also submit data on all consumer loans of EUR 500 or more to the Central Credit Register. In Brazil, all financial institutions including FCs must submit data on all loans above BRL 200 (about USD 50).

85. **Another way to enhance the intensity of supervision is by building upon the work of a higher-tier entity within the network.** In France, central bodies have the legal responsibility of ensuring the solvency of affiliated FCs. In order to do that, central bodies oversee the application of the laws and regulations by affiliated institutions and have the power to issue instructions and apply penalties if necessary. Subject to meeting specific requirements, regional subgroups receive collective licenses for themselves and for the local banks. These licenses allow them to partially or fully waive the application of prudential requirements (such as large exposures, liquidity requirements or solvency requirements) at the level of the local banks. In this model, integration is maximised and individual FCs are somewhat less autonomous.

86. **In other jurisdictions, different structures are also used to leverage the intensity and coverage of supervision.** In Germany, all licensed FCs must become members of an audit federation. The reports received from the audit federation are used by the supervisory authority as inputs in the assessment of individual FCs. In Brazil, second-tier cooperatives are responsible for supervising affiliate FCs and may perform specific on-site examinations on the instructions of the central bank.[39] Both of these frameworks help optimise supervisory resources, while keeping the ultimate legal responsibility for FC supervision with the supervisory authority.

Crisis management

87. **FC's characteristics give rise to particular challenges with respect to crisis management.** First, contagion as a result of the failure of one institution might be more pronounced for FCs, given the characteristics of their capital instruments. Tensions arising from the difficulties of members to redeem their member shares in times of stress might give rise to a more widespread contagion within the FC sector. Second, according to IADI (2018), some resolution tools cannot be applied to FCs in the way they are applied to banks, because of their different ownership structure. As such, for some of these tools to be applied, demutualisation might be required beforehand. This would be the case, for example, where the solution involves either recapitalisation, bail-in or contingent capital instruments, unless the conversion includes a write down feature. Also, as discussed, raising capital during times of stress is typically more of a challenge for an FC in that its model is based on long-term accumulation of retained earnings and because it is less likely to be able to access external sources. Finally, for smaller institutions that operate in remote rural areas, there are often other challenges such as a small pool of potential acquirers and the fact that FCs are sometimes the only financial service provider within a specific region. For all these reasons, the preferred option is typically a merger between FCs, and this is often a feasible solution in most jurisdictions when the weak FC is a part of a network with solidarity mechanisms.

88. **Cooperation among FCs is an essential ingredient for the crisis management framework.** In some jurisdictions, FCs have pooled resources to organise one or more of the following solidarity arrangements: deposit guarantee scheme (DGS), emergency liquidity assistance (ELA) and stabilisation

[39] Cuevas and Fischer (2006) call this process "indirect supervision" and make a distinction between auxiliary and delegated supervision. Auxiliary supervision would encompass the execution of function of data collection, processing and information/recommendation production. Delegated supervision goes further, in that the delegated supervisor has the power to enforce corrective action.

funds. In other cases, supervisory and resolution authorities have made use of the same framework applicable to commercial banks, including granting FCs access to central bank liquidity facilities and having a common DGS. In both models, membership to a DGS is typically mandatory. However, the DGS models used vary considerably in terms of their administration, scope and funding (see Table 6).

Deposit guarantee scheme* — Table 6

	Administration	Scope	Funding
Australia**	Public	One DGS for all deposit-takers	Ex post levy on all deposit-takers
Brazil	Private	Separate DGS for FCs	Ex ante flat premium
China	Public	One DGS for all deposit-takers	Ex ante risk sensitive premium
France	Private	One DGS for all deposit-takers	Ex ante risk sensitive premium
Germany	Private	Separate DGS for FCs	Ex ante risk sensitive premium
Ireland	Public	One DGS for all deposit-takers	Ex ante risk sensitive premium
United States	Public	Separate DGS for FCs	Ex ante flat premium

* Kenya and South Africa are, respectively, in the process of implementing a deposit guarantee scheme for FCs and for cooperative banks.

** Australia does not have an explicit deposit insurance regime with a separate deposit insurer and deposit-taking institutions are not charged insurance premiums. Rather, Australia has in place a financial claims scheme that applies to all deposit-taking institutions whereby the Australian government guarantees deposits up to AUD 250,000. Any shortfall after repayment of all guaranteed deposits of a failed institution is covered by the government and the amount is recovered through a levy across all deposit-taking institutions.

Source: FSI survey.

89. **In some cases, cooperation among FCs is encouraged by incentives provided by the regulator in the form of derogations or exceptions.** In Brazil, for example, the minimum capital adequacy ratio for standalone FCs is 17% while the minimum for FCs which are members of a network is 12%. In Germany, FCs have established an institutional protection scheme (IPS)[40] in accordance with Article 113(7) of the CRR with the goals of providing mutual support and a deposit guarantee scheme. Members of the IPS benefit from exemptions and/or derogations in relation to intra-IPS exposures such as not being subject to a large exposure limit or being able to apply a risk weight of 0% to these exposures. However, unlike the treatment for conventional banking groups, accounting and/or prudential consolidation is not possible.[41] In order to be entitled to these benefits, the IPS must meet several conditions as established in the regulation such as being able to conduct its own review of member FCs. It must also have a suite of tools to ensure that its members individually meet capital and liquidity requirements.

90. **These solidarity mechanisms promote scrutiny among affiliated FCs.** Arrangements are commonly funded by contributions from individual member FCs that also have a seat or a representative at the governance body which decides the use of those resources. As such, when an individual FC encounters liquidity or solvency problems, it is ultimately up to the other FCs to decide on the least costly solution. Also, to be able to make an informed decision, members need to learn about potential problems in advance and have access to data from the weak FC. Finally, because any shortfall of resources is covered by ordinary or extraordinary contributions, the failure of one FC may have an impact on other member FCs.

[40] See Box 3 on IPS.

[41] See Choulet (2017) for a comparison of IPS with other kinds of organisations such as a conventional banking groups and integrated networks of FCs with a central body.

Box 3

Institutional Protection Scheme (IPS)

According to the ECB, as of July 2016,① about half the credit institutions in Austria, Germany and Spain, representing around 10% of the total euro area banking system assets, are members of an IPS.

Article 113(7) of CRR defines an institutional protection scheme as a contractual or statutory liability arrangement which protects member institutions and in particular ensures their liquidity and solvency to avoid bankruptcy where necessary.

Recognition as an IPS results in the relaxation of some of the prudential requirements normally applied to individual banks, because a member of an IPS is treated in a way that is similar to the approach taken for banking groups. For eligible arrangements, for example, a 0% risk weight may be assigned to all intra-IPS exposures, with the exception of those giving rise to Common Equity Tier 1, Additional Tier 1 and Tier 2 items.

To qualify for the IPS treatment, the scheme and its member institutions must fulfil several conditions. Member institutions, for example, are required to be established in the same member state as the IPS and must have a homogeneous business profile.

In addition, the IPS must be able to support any member in difficulty. Also, it must have risk monitoring and classification systems in place that give a complete overview of the risk positions of all the individual members and the institutional protection scheme as a whole. The scheme must also conduct its own risk review which is then communicated to the individual members and must have the powers to take measures if necessary.

① See ECB (2016).

Section 6 – Concluding remarks

91. **Distinctive features of the traditional FC business model generate specific challenges.** The local operations, common bond requirements and small size typically lead to higher concentration risks. An FC's capacity to expand its business is limited, since its growth relies mainly on accumulating retained earnings and adding new members. In FCs, owners are also customers and, in some cases, members of the governance bodies, thus creating multiple conflicts of interest. Finally, members of an FC may not have the professional skills needed to direct, manage and control the FC's activities.

92. **New and stringent regulatory requirements and technological innovations are eroding some of their competitive advantages.** FCs 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 competitors to reduce or eliminate these advantages by cutting fixed costs and gaining better access to remote areas. In addition, some competitors can deliver a broader range of financial services using virtual channels and can do so more swiftly.

93. **In order to maintain their relevance and deal with these challenges, FCs need additional human and financial resources.** These pressures are particularly relevant for small standalone FCs. Responding to these challenges requires heavy investment to improve processes, systems and staff qualifications, which probably exceeds the resources available to small FCs. However, without such investment, FCs could fail to attract new members or lose existing ones, thus eroding their franchise.

94. **For most FCs, all alternatives seem to lead to enhanced cooperation arrangements.** Financial cooperatives are well positioned to pool resources, since most of them operate locally and therefore do not compete against each other. As such, FCs could intensify their cooperation in many ways to benefit from scale economies. The scope for cooperation ranges from ad hoc projects to the establishment of an integrated network or a consolidated group providing a wide range of shared services and facilities and

exercising oversight and issuing recommendations or instructions to affiliates. Consolidation between healthy FCs through mergers can also provide relevant economies of scale, and this has already occurred extensively.

95. **Cooperation should aim at generating economies of scale, cutting fixed costs and increasing the ability to make strategic investments.** This typically takes the form of a central entity, which might be regulated or unregulated depending on its activities. Common services provided by this type of entity include improving staff and member skills, as well as advocacy and support in different areas such as accounting, compliance, risk management, internal control, product development and marketing and information technology. In addition, structures can be put in place within these networks to improve liquidity management within the group and to facilitate payments system access.

96. **More intensive cooperation can lead to new business opportunities, help diversify business activities and improve access to capital markets.** FCs become able to provide a wider range of products to their customers, including asset management services and different types of insurance. This allows them to attract new types of customer, diversifying their activities and revenue sources, reducing asset concentration risk and reducing reliance on interest margins while boosting service-based revenues. In addition, the formation of consolidated groups may improve access to capital markets and diversify funding sources, thus reducing the concentration risk on the liability side and improving growth prospects.

97. **More cooperation could also help to enhance risk and crisis management.** In long-standing networks, FCs have created solidarity and mutual guarantee arrangements that encompass emergency liquidity facilities, deposit guarantee schemes and stabilisation funds. Under such arrangements, FCs must follow the minimum risk management requirements established for the whole group by a central entity, which is also tasked with enforcement. Failures of FCs operating under this sort of arrangement are rare or non-existent. While the central entity has the tools to provide emergency liquidity and solvency assistance to weak FCs, it rarely has to exercise them because its interventions take place earlier and may lead it to promote mergers between affiliates.

98. **Policy intervention might be necessary if FCs are to meet current challenges.** Risk concentrations, lack of scale, difficulties in raising new capital, deficient governance and the complexity of crisis management could be mitigated through cooperation and risk mutualisation among FCs. These desiderata could be encouraged by regulators and might help promote the safety and soundness of the financial system by ensuring that FCs achieve critical mass through growth.

99. **Policy action may be also needed to better protect buyers of member shares.** FCs typically issue member shares to small retail customers, who may be investing their savings in instruments that are sold as alternatives to low-yielding savings accounts. This could result in mis-selling, as FC customers may be unaware of the loss-absorption characteristics of such instruments. Thus, specific customer protection requirements related to issue documentation, marketing materials and disclosures may be necessary.

100. **Regulators should promote a level playing field.** In principle, small 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 grounds. At the same time, some differentiation in the rules specific for FCs could be justified by the need to tailor requirements to accommodate FCs' ownership structures and solidarity mechanisms. At the same time, no proportionality regime or any other regulatory differentiation for cooperatives should have the effect of shielding specific types of institution against competition.

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Annex 1 – Financial cooperatives in Australia

Historical background and legal framework

The first financial cooperative registered in Australia was the Homeowner's Co-operative Credit Society Limited, established in May 1945, four years after the passage of the New South Wales Small Loans Facilities Act. The number of cooperatives increased overtime and exceeded 500 in the 1980s, helped by tax incentives and specific legal requirements.

Regulatory changes that have taken place since the 1980s have encouraged financial cooperatives to consolidate, with such changes including the deregulation of financial services, the end of tax incentives and the publication of the Corporations Act in 2001, which treats share-capital companies and member-owned mutual companies without distinction. As a result, the number of financial cooperatives operating in Australia, which reached 549 in December 1983, stands at 76 as of June 2017.[42]

In March 2017, the Australian Treasury commissioned a review of cooperatives, mutuals and member-owned firms' business environment (The Hammond Review). The purpose was to make proposals that would enable Commonwealth-registered cooperatives and mutuals to have access to a broader range of capital raising opportunities.[43]

Financial cooperatives' architecture and their importance within the banking system

In Australia, all financial firms that take deposits are defined as Authorised Deposit-Taking Institutions (ADIs) and licensed and regulated by the Australian Prudential Regulation Authority (APRA) whether or not they are corporations owned through shares or member-owned mutual companies. The latter, in turn, can take the form of credit unions, building societies or mutual banks, all of which qualify as "mutual ADIs".

Mutual ADIs can operate with their natural-person members (and with companies owned by their natural-person members). No common bond is required for the majority of mutual ADIs, not even a geographical one, although in practice most mutual ADIs operate locally. Another distinctive feature is that recent legislative changes allow mutual ADIs to freely use the name "bank" and to do so for marketing reasons. Despite being authorised to provide their members with the range of services and products that an ADI can provide, mutual ADIs' activities are mostly limited to granting personal loans, home loans and credit cards and taking demand and term deposits.

There is little formal cooperation among the standalone mutual ADIs in Australia. However, mutual ADIs have established three Special Service Providers (SSPs). These providers mainly facilitate access to the payments system by "pooling" the transactions of the associates' members and settling these transactions in the market on behalf of the respective mutual ADIs. Since the SSP's are themselves ADIs, they are regulated and supervised by APRA.

Most mutual ADIs in Australia are part of the Customer Owned Banking Association (COBA); some are also part of the Business Council of Co-operatives and Mutuals (BCCM). Both are unregulated entities that act as lobby groups and provide their respective members with policy advice and training forums.

As of 30 June 2017, the total assets of all mutual ADIs (including credit unions, building societies and mutual banks) was USD 83.2 billion of assets (2.3% of all assets of the Australian banking system). Mutual ADIs collected USD 70.9 billion of deposits (2.8% of all deposits) and had an aggregated loan

42 Source: https://thenews.coop/wp-content/uploads/s4-Cutcher-122.pdf (section: The Impact of Regulatory Change, p 24).

43 The Hammond Report (from the name of its author) is officially known as the *Report on Reforms for Cooperatives, Mutuals and Member-owned Firms*, https://static.treasury.gov.au/uploads/sites/1/2017/11/Independent_Facilitator_Review_Report.pdf. See also the section on sources of capital.

portfolio of USD 67.4 billion (3.4% of the system). The three largest financial cooperatives hold together almost 30% of all mutual ADIs' assets.

Governance arrangements

From a legal entity perspective, mutual ADIs must have a corporate structure that meets the definition of a mutual in the Australian Securities and Investment Commission's (ASIC) Regulatory Guide 147, with each member having one share and entitled to one vote at a General Meeting.

As in the case of all other ADIs, mutual ADIs are required to have a board of directors and various separate board committees – including risk, audit, and remuneration. Boards, directors, and senior executives must meet various prudential requirements – including independence and fit and proper criteria. Members of the board of directors of a mutual ADI may be volunteers or paid professionals depending on the entity's statutes. Board membership does not require APRA's approval. In addition, mutual ADIs must have a senior management team. The head of this team (typically the Chief Executive Officer) can also be a board member but cannot chair the board of directors. The directors of the board of a mutual ADI are elected by the General Assembly of the mutual ADI's members. The board is empowered to appoint and remove executives at its discretion just like any other regulated entity.

Internal and external auditing requirements are the same for all ADIs. ADIs must have an internal audit function that complies with APRA's prudential requirements. Some mutual ADIs have their own staff perform internal audit functions while others, often the smaller entities, hire an independent audit firm for this purpose.

All companies (including FCs) must have their annual financial statements audited by an independent party under the Corporation Act. APRA imposes additional requirements on ADIs that require an external auditor to undertake additional work. This includes assessing the veracity of statistical data that the entity is required to submit to APRA.

One issue for a number of mutual ADIs is the high level of apathy within the membership base, with most members not knowing that they are owners of the financial cooperative and seeing it merely as a financial institution of which they are a customer. This can result in such low levels of member participation in general annual meetings that some FCs may need to require their staff to attend such meetings to ensure a quorum of members.

Another concern relates to board members' skill sets, relevant expertise and qualifications, with those being often limited. APRA has therefore actively encouraged the "upskilling" of FC boards through its governance standards applicable to all ADIs and which include fit and proper requirements. These have improved the effectiveness of the appointment process of boards of directors.

Regarding tenure as board members, APRA requires all ADI boards to have a renewal policy in place, but does not mandate a maximum tenure. The majority of ADI directors now serve a maximum term on the board of between nine and 12 years; noting, however, that there are longer-standing directors on some boards.

Most boards of mutual ADIs effectively select their own directors, with such appointments being generally required to be ratified (or not, as the case may be) as part of annual meeting processes. More generally, governance of financial services entities is subject to rising public and government scrutiny, with ever-increasing expectations that boards should act in the best interests of their customers.

Regulatory and supervisory frameworks

Mutual ADIs are subject to APRA's prudential oversight and to the oversight of ASIC for market conduct. As is the case for all ADIs, mutual ADIs are licensed and regulated by APRA and have to meet the rules and prudential requirements set by this authority. They therefore have to comply with the Australian version of the Basel standards.

The risk rating system that APRA uses to assess and supervise mutual ADIs, PAIRS,[44] is the same for all regulated institutions, although there are some differences in the weighting of the different risk categories to reflect differences in structure and business models between FCs and commercial banks. Supervisory powers are the same as for commercial banks.

As part of its risk-based approach to supervision, APRA takes into consideration the size, complexity of operations and risk profile of the regulated entity and has higher expectations with respect to the prudential framework regarding the larger and more sophisticated institutions. Proportionality is applied for both commercial banks and mutual ADIs. Smaller ADIs, whether commercial banks or mutual ADIs, may operate under simpler rules and are supervised by a separate division of APRA.

Elements of proportionality exist for both the definition of capital and for liquidity standards. FCs must comply with a Minimum Liquid Asset Holdings (MLH) requirement. The later mandates that at least 9% of adjusted liabilities must be held by the FC in specified types of highly liquid assets.

Regarding the capital ratio, its calculation is much simpler for standardised ADIs – particularly with regard to risk-weighted assets which are either prescribed or formulaic. The Basel minimum capital ratios apply to all ADIs. In practice, most ADIs are also subject to a Pillar 2 add-on, such that individual prudential capital ratios are in excess of Basel minima. All ADIs are subject to the buffer requirements, with there being different buffer requirements for different classes of ADIs – eg mutual ADIs versus those that are listed companies. APRA has not to date imposed a countercyclical buffer on ADIs in Australia.

Mutual ADIs are also subject to a prescribed provisioning approach whereby the level of provisions required is calculated through a formula based on the number of days past due, whether the exposure is secured, the type of security and the age of the valuation of the secured exposure.

In terms of periodic reporting to the supervisory authority, the returns that ADIs are required to submit to APRA will also vary according to whether the ADI is a standardised or advanced ADI.

All ADIs are currently required to meet Pillar 3 disclosure requirements, with different disclosure requirements for standardised and advanced ADIs. APRA is envisaging to simplify the disclosure requirements for "less sophisticated" or smaller ADIs and this would therefore apply to most mutual ADIs, but the proposal has yet to be finalised.

Capital sources

Retained earnings are the primary source of capital for mutual ADIs. A few mutual ADIs have issued subordinated debt instruments qualifying as Tier 2 capital. The implementation of Basel III in 2013 saw the development of a "new" form of capital – Mutual Equity Interest (MEI) – which meets the Basel III criteria for conversion of subordinated debt or Additional Tier 1 capital instruments into CET1 upon a non-viability trigger event. In practice, however, only a couple of FCs have used this option.

Further amendments to the prudential framework have been made[45] to provide mutual ADIs with the option of directly issuing a capital instrument (the MEIs) that qualifies as CET1 capital, therefore addressing one of the key recommendations of the Hammond Report. MEIs issued by mutual ADIs can be sold to investors and/or member clients. Mutual ADIs have to comply with the disclosure regimes

[44] PAIRS stands for "Probability and Impact Rating System".

[45] The technical requirements for the issuance of capital instruments are provided in Prudential Standard APS111 Measurement of Capital. The specific additional requirements relevant for financial cooperatives are detailed in Attachment K of this standard.

applicable to all institutions as detailed in the Corporations Act when marketing and issuing them and would be regulated by the market authority (ASIC) when doing so.

In addition to being expensive to issue, APRA has subjected MEIs to limits and constraints. Issuance is limited to 25% of the mutual ADI's CET1 capital. Any issuance is subject to APRA's prior approval and must be submitted with an independent legal opinion. Distributions cannot exceed 50% of an issuing ADI's net profit after tax in the financial year to which the distributions relate. ADIs must also comply with specific disclosures requirements. Both the need to obtain APRA's prior written approval for redemption and the methodology for determining the value of the instruments in case of such redemptions must be clearly specified in the prospectus or other issuing document. There has been no direct issuance to date, largely because issuing such an instrument is expensive.

Member shares, with nominal values of a few dollars, are only a notional contribution of capital. For accounting purposes, they are treated as any other deposit. For regulatory purposes, they are not eligible for inclusion as regulatory capital and are not considered to be deposits for financial claim scheme purposes. They can only be redeemed at their nominal value when a member closes all accounts with the FC and cancels her/his membership.

Evolution of business models and competitive challenges

On the basis of information gathered from mutual ADIs, the Hammond Report identified their main challenges as having to overcome the lack of recognition and understanding of their business model by the general public and their limited access to capital and funding. Besides being considered a significant barrier to growth, the first issue was also identified as being linked to their difficulties in raising additional capital.

In practice, mutual ADIs grow their capital overwhelmingly through retained earnings rather than by issuing capital instruments. This is seen as constraining their growth, inhibiting both their competitiveness and their ability to increase scale and market share rapidly. Recent changes to the prudential framework that facilitate the direct issuance of capital may alleviate the concern over time, but this is subject to investors developing a market appetite to hold such instruments and to mutual ADIs feeling the need to using them despite their cost.

The small scale of most mutual ADIs further limits their access to funding and capital, especially since they are generally not rated by external credit rating agencies. This small scale also inhibits their ability to compete in the technological space since it limits the amount of investments that they can deploy. This, in turn, makes it more difficult to attract new and younger members at a time when most mutual ADIs are confronted with an ageing membership.

Concentration and mergers is a way found by the smaller FCs to take advantage of new technologies and remain competitive with the major banking institutions.

Another alternative would be for FCs to demutualise. In practice, however, most FCs are committed to mutuality. There has been only one recent case of demutualisation, with the transaction taking place as part of the acquisition and transfer of the FC's business to a listed entity. Such a transaction requires the approval of members. The benefits are generally pitched as providing a payout of capital to the FC members followed by the ability to increase scale and widen the range of products and services provided.

Safety net and deposit protection

Australia does not have an explicit deposit insurance regime with a separate deposit insurer and deposit-taking institutions are not charged insurance premiums. Rather, Australia has in place a Financial Claims Scheme (FCS) that applies to all ADIs and whereby the Australian government guarantees deposits up to

AUD 250.000 at individual ADIs. Through the FCS framework, any shortfall after repayment of all guaranteed deposits of a failed institution is covered by the government and the amount is recovered through a levy across all ADIs.

Credit unions have collectively established an emergency liquidity support scheme that members can draw on in a crisis. The Credit Union Financial Support Scheme (CUFSS), which is an APRA-approved liquidity scheme in place since 1999, is mostly supported by smaller FCs, ie those with assets less than AUD 1 billion, which make up most of its members. It has been used only once since its inception.

Larger credit unions – typically those with total assets in excess of a billion – have access to emergency funding with the Reserve Bank of Australia (RBA) through repurchase arrangements. As these operations are based on self-securitisation, the larger FCs are expected to establish an internal securitisation facility that is repo-eligible with the RBA for emergency liquidity purposes.

Liquidation and insolvency arrangements

The process of resolution of FCs is not different from that in place for the commercial banks and APRA is responsible for conducting it. The authority, however, does not wait until non-viability to take action. Rather, it intervenes much earlier as part of its Supervisory Oversight and Response System (SOARS).[46] Interventions typically take place through "moral suasion" with the aim of removing an underperforming ADI from the sector; rather than relying on formal powers.

The tools available to resolve a weak mutual ADI are also the same as those applicable to other ADIs with these including a compulsory transfer of business (a court order which forces the transfer of business), the removal of individual senior managers or board members, and the dismissal of the senior management or the board of directors followed by the appointment of a statutory manager. In practice, APRA has neither needed to make use of a compulsory transfer of business nor has had to appoint a statutory manager to date.

Triggers to force FCs to merge include a breach of the Banking Act but also take into consideration that the entity is likely to become unable to meet its obligations in the near future. Associated powers include mandating a compulsory transfer of business, but these powers have never been enacted so far.

Annex 2 – Financial cooperatives in Brazil

Historical background and the legal framework

The Brazilian version of a financial cooperative (FC) is called a "credit cooperative" This is a society of persons (individuals or legal entities) constituted to provide its members with financial services. The first one was created in 1902, one year after the introduction of the cooperative regime in Brazil. After the closure of the BNCC (the National Cooperative Credit Bank) in 1990, a state-owned entity created roughly 40 years before to provide financial support to all kinds of cooperatives, the FCs went through a severe restructuring process.

Brazil's Federal Constitution states that the law will support and stimulate cooperatives and other forms of associations to promote financial inclusion and provide access to credit for communities. Credit cooperatives in Brazil are ruled by the law 5.764/1971, the general cooperatives' law; and the

[46] A description of APRA's supervisory response system together with its stances and types of intervention can be found at www.apra.gov.au/sites/default/files/attachments/0417-soars-guide.pdf.

complementary special law 130/2009 on credit cooperatives. The legal framework defines them as not-for-profit entities whose primary objective is to ensure access to financial services for their members.

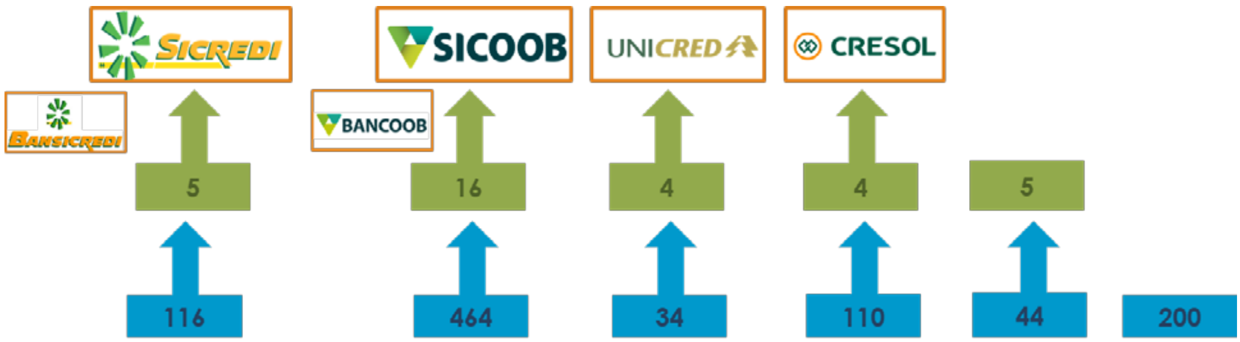
Financial cooperatives' architecture and their importance within the banking system

As of 2017, there were 1,006 cooperatives of different sizes and levels of complexity operating in Brazil. On their own or through agreements with cooperative banks, they provide their members with a broad range of financial services such as demand and term deposits, consumer loans, business lending, credit and debit cards, and online banking. Cooperatives can only operate with their members (and, exceptionally, with the respective municipality). No common bond among members is required by law although it may be required in the bylaws of each FC. However, financial cooperatives are subject to geographical limitations.

There is substantial diversity across financial cooperatives in Brazil. This is reflected both in the types and sizes of credit cooperatives (see section on the regulatory and supervisory framework) and in the ways they are organised (standalone or part of networks with varying levels of concentration and complexity).

FCs in Brazil are classified into three different levels: standalone or single financial cooperative, federations of cooperatives, and confederations, as summarised below. There are 200 standalone credit cooperatives. Forty-nine FCs are organised into five two-level groups under a central facility (federation), and the other 759 entities are distributed throughout four three-level systems, under the control of four confederations. Two of these three-level systems, Sicredi and Sicoob, include a commercial bank.

Figure 2: Levels of financial cooperatives in Brazil



Source: Central Bank of Brazil.

First-tier cooperatives are classified and authorised within three categories, with each being associated with a specific set of regulations depending on the levels of complexity and risk that their operations may reflect. The three levels are Capital & Loans (less complex entities), Classic, and Full-Service (the most complex entities). While the simpler category is prohibited from taking deposits of any kind, the more complex ones may carry out the same activities as commercial banks. In practice, most cooperatives are small, their operations are simple and they have a low-risk profile. These characteristics allow them to be subject to and to comply with simpler prudential requirements.

Over the past decade, a significant amount of consolidation has taken place, although most FCs remain small. In December 2008, there were 1,439 operating cooperatives whereas in December 2017 there were slightly more than a thousand FCs. This concentration has helped FCs face increased competition in financial markets through economies of scale. Competition comes in particular from commercial banks and, more recently, from credit fintechs.

Although the market share of financial cooperatives in the domestic financial system is relatively low, their importance has grown in recent years as a result of their own efforts and because of the evolution of the regulatory and legal frameworks. Between December of 2008 and December of 2017, their consolidated assets increased more than five times, from BRL 34 billion to BRL 178 billion. During the same period, their relative importance in the financial system has more than doubled.

Despite a significant increase over the last years, the overall market share of FCs in the domestic market remains small. Currently, the sector accounts for 2.5% of the total assets of the financial system or about USD 54 billion; 2.8% of total loans, roughly USD 29 billion; and 4.4% of the total deposits or around USD 32 billion. Given an estimated population of 210 million in Brazil as of December 2017 and 9.6 million members, FCs provide financial services to 4.6% of the population. However, these overall numbers mask their importance in specific regions or products. For instance, the market share of FCs in the southern region of Brazil is 16.7%.

Governance arrangements

One of the main characteristics of FCs is that each member has an equal and single voting right regardless of the number of shares held. FCs are required to have a board of directors, a senior management team and a supervisory committee (called "supervisory council").

In addition to the supervision carried out by the Central Bank of Brazil (CBB), FCs are subject to four different types of auditing. Besides internal and external auditing, cooperatives that are part of a two- or three-level system are subject to the "auxiliary" supervision of their respective second tier cooperative.[47] More recently, a complementary kind of auditing – cooperative auditing – has been established for all FCs.

Cooperative auditing focuses on the processes of the institution. It is performed by a specific audit confederation or by an independent auditing firm. These are licensed by the CBB, with such authorisations being renewable every five years. The CBB is considering how to rationalise and enhance the auditing framework. FCs organised in two or three-level groups are already exempt from internal audit functions when they opt for a simplified prudential regime and limit their business to less complex activities. Capital & Loans FCs – those with the simplest business model – are not required to undergo external audits due to their risk limitations. Over time, it is expected that the auxiliary supervision, which is currently performed by federations, will be supplied and complemented by cooperative auditing procedures.

FCs are often confronted with low member participation in general annual meetings and with the difficulty of finding enough members with the appropriate qualifications to be directors of the board, members of the supervisory councils or senior managers. Although none of these issues can be solved over the short term, a number of initiatives seek to address some of them. Efforts to increase member participation include linking the annual general meeting (AGM) with festive events, campaigns targeting younger people to raise their awareness, or electronic voting. The main supervisory targets are currently to improve the effectiveness of governance structures (board of directors, supervisory councils and senior management), as well as the quality of the auxiliary supervision functions. Another objective is to foster further cooperation among cooperatives.

[47] "Auxiliary" supervision in Brazil is performed by the second-tier cooperatives, known as "central cooperatives" to facilitate, but not to replace, supervision by the supervisory authority. This framework is set to reduce the need for intensive ongoing supervision of individual institutions by the central bank which keeps the ultimate legal responsibility for supervision and enforcement of all financial cooperatives. The regulation rules the main aspects of the auxiliary supervision such as the auditing procedures, reporting process, the limits of the central cooperative mandate and responsibilities. Moreover, it allows the central bank to require the central facilities to perform inspections on specific situations.

Regulatory and supervisory frameworks

Under the legal framework, the National Monetary Council, comprising the Minister of Finance, the Minister of Planning and the Governor of the central bank, issues "resolutions" which regulate credit cooperatives. The CBB is the sole supervisory authority and, inside the CBB, supervision is conducted by a specific department exercising oversight over all financial cooperatives and non-banking institutions. Another department supervises customer protection and anti-money laundering issues. The CBB has full powers to conduct supervision at all stages, from licensing up to issuing the decree that initiates the resolution of a financial cooperative.

FCs, banks and other financial institutions are subject to regulatory requirements that are similar, at least in their over-arching principles, and which are based on proportionality. These take into account their size, complexity of operations and risk profile. These requirements are in line with a pre-established regulatory segmentation and the respective activities that are allowed for each type of institution. Examples of exemptions regarding small and simple financial institutions include the calculation of the LCR and the NSFR and also Pillar 3 requirements. In addition, a simpler capital adequacy ratio solely based on balance sheet figures replaces the Basel III standard for these institutions.

As the FCs have specific legal features, specific rules govern some of their organisational or operational aspects. These relate in particular to the granting and withdrawal of licenses, auditing procedures and corporate governance. The main differences with commercial banks with regard to licensing requirements are that FCs are required to have a minimum number of associates and that federations, confederations and cooperative banks must meet specific requirements, such as performing auxiliary supervision or providing support to affiliated first level cooperatives with regard to internal controls and risk management. Overall, the recently established regulatory segmentation framework is expected to smooth the differences between the two types of institution over time.

Other financial requirements such as rules regarding loan classification, credit quality assessment reviews, and loan loss provisioning apply to all financial institutions regardless of type, size, complexity or risk profile.

There is a monitoring and early warning system and a rating system in place that is specific to FCs. Some aspects of off-site supervision (the monitoring of liquidity and market risks in particular) are less extensive than those regarding banks. Also, the assessment methodology for FCs has five risk categories as opposed to eight for commercial banks and the supervision cycle is in general longer for FCs and non-banks than it is for banks.

Capital sources

Member shares and retained earnings constitute the sources of capital for credit cooperatives. In general, member shares qualify as regulatory capital and can only be redeemed when the member leaves the cooperative, whether voluntarily or not. However, voluntary departures and capital redemptions are subject to regulatory conditions. The FC must comply with capital requirements and large exposure limits. Additional conditions may be included in the cooperative's bylaws, such as the need to obtain the board's authorisation, the absence of any debt balance at the cooperative when withdrawing and the fact that withdrawals may only be authorised after the approval of the annual financial statements by the general assembly.

Financial cooperatives can also issue "Letra Financeira" or Financial Bills (LFs). These are fixed income subordinated instruments with a minimum maturity of two years and no possibility of redemption when maturity is less than four years. Redemptions can only take place if the redeemed amount does not exceed 5% of the total balance of all LFs issued by the financial cooperative. The Financial Bill can be used by FCs as subordinated debt, as for other financial institutions. FCs (and groups of FCs) cannot sell debt securities in capital markets and can only raise funds from their members. They may, however, sell LFs to their members, and these could, in turn, resell them to investors in secondary markets. In both instances, the amounts issued are currently not significant (a few thousand dollars in total).

Evolution of business models and competitive challenges

Regulators expect Brazilian FCs to play an essential role in financial inclusion, especially in rural areas, and, as the cooperatives expand their presence in major cities, to increasingly compete with banks and contribute to the provision of more affordable banking services to all customers.

To help credit cooperatives to accomplish these goals, and as entities that do not seek to maximise profitability, they are exempt from federal taxes (corporate income tax and social contributions) on the operations they carry out with their members.

The main challenge for Brazilian FCs is about sustaining growth and increasing their share in a market which is concentrated in the hands of a few large commercial banking groups. An additional challenge is that most of the population is still unaware of the characteristics of a financial cooperative business model. More generally, FCs, like all incumbent credit institutions, are confronted with increasing competition arising from new entrants such as credit fintech companies.

Safety net and deposit protection

Two distinct mechanisms insure the deposits taken by financial institutions in Brazil. One mechanism applies to commercial banking deposits and another applies to cooperative deposits. The latter are insured by the Cooperative Credit Guarantee Fund (FGCoop), the mandatory and the solely authorised deposit insurance fund for all FCs.

The FGCoop, created in 2013, is a non-profit civil association, under private law, whose board members are appointed by its associates (ie first-tier credit cooperatives and the two cooperative banks, which are the entities which can take deposits from individuals). Deposits at FCs are guaranteed up to a limit of BRL 250,000. The limit is the same for customers' funds deposited at commercial banks. The affiliation to the FGCoop exempts cooperatives from having to contribute to any additional mutual guarantee fund, although some cooperative groups still have such a guarantee fund in addition.

The fund is capitalised primarily with the contributions of the affiliated entities. These contributions are calculated based on the amount of the deposits to be insured and a flat monthly rate, regardless of the risk posed to the FGCoop by the respective cooperative. The fund is also able to provide liquidity assistance in addition to that provided within cooperative groups since the CBB does not act as a lender of last resort to FCs.

Liquidation and insolvency arrangements

The process for resolving financial cooperatives is similar to that in place for commercial banks. The central bank is the authority responsible for conducting it.

Supervisory enforcement powers are essentially the same for all financial institutions. These include the power to fine or remove from office, as a precautionary measure, a senior manager or a board member responsible for material misconduct, regulatory breach or fraud, with over a thousand cases having occurred so far. It also has the power to dismiss senior management and board members to the extent that all can be held collectively responsible for a material breach in regulation. The CBB may also replace them and appoint a specialised council of managers for a limited period in such cases, with this power having also been applied in practice.

Triggers for resolution include breaches of minimum prudential requirements or regulation and negative net worth due to economic deterioration or asset write-offs arising from supervisory actions. If efforts to restore a cooperative's soundness are unsuccessful, the central bank can use one of two resolution instruments: withdrawal of the license or a decree of extra-judicial liquidation. The use of one or the other instrument is at the discretion of the CBB. In practice, it is common for a weak financial cooperative to find a market solution prior to any resolution action taken by the central bank. This generally leads to a merger that is independently agreed by the cooperatives involved.

Annex 3 – Financial cooperatives in China

Historical background and legal framework

Financial cooperatives in China include rural credit cooperatives (RCCs), rural credit unions (RCUs), rural cooperative banks (RCBs) and rural mutual cooperatives (RMCs). The rules on RCCs were published by the People's Bank of China (PBC) in 1997. They define an RCC as a financial institution consisting of farmers and rural economic organisations with legal person qualification, managed democratically by members (one man, one vote) and providing financial services to members.

RCCs were originally established in the 1950s according to the basic principles of cooperatives. From the late 1950s and up to the 1990s, RCCs gradually lost their cooperative nature, becoming de facto subsidiaries of either People's Communes or the Agricultural Bank of China (ABC). In 1996, RCCs decoupled from the ABC in order to restore their cooperative nature. In the early 2000s, most RCCs were consolidated into RCUs or RCBs and then gradually transformed into rural commercial banks (shareholding companies). The remaining RCCs, RCUs and RCBs were encouraged by the China Banking Regulatory Commission (CBRC)[48] to convert themselves into rural commercial banks, or else to take the form of a shareholding company (sometimes called rural credit companies).

This change took place because the CBRC concluded that the Chinese FCs had not been real cooperatives for a long time, and that transforming them into shareholding companies would be preferable in order to clarify property rights and improve governance, sustainable development and the capacity for serving the rural area. As of end-2016, there were 1,222 RCBs, and nine provinces (municipalities) – Beijing, Tianjin, Shanghai, Chongqing, Jiangsu, Anhui, Hubei, Shandong, and Shanxi – had completed the transformation of all RCCs, RCUs and RCBs into rural commercial banks.

Compared with RCCs, RCUs and RCBs, RMCs are relatively new, with the first RMC established in 2007. According to the *Provisional Rules Governing Rural Mutual Cooperatives* issued by CBRC in January 2007, an RMC is defined as a community mutual banking institution consisting of voluntary equity participation by farmers or rural small enterprises, aiming to serve members and seek their common interests and exclusively providing members with the service of deposits, loans, settlement etc. As RCCs, RCUs and RCBs came under the shareholding company-oriented reform, RMCs were designed to be the real financial cooperatives. However, there have been no newly established RMCs since 2012.

The main problems impeding the development of RMCs included inadequate internal governance and their small size. Besides, there were several cases of improper fund-raising or use of deposits from the general public by organisations using the guise of financial cooperatives, something that damaged the reputation of the whole sector.

In addition to RCCs, RCUs, RCBs and RMCs, there was formerly another type of FC, the urban credit cooperatives (UCCs), which existed in China between 1979 and 2012. According to the rules issued

48 On 8 April 2018, the China Banking and Insurance Regulatory Commission (CBIRC) was formally created through the merger of the China Banking Regulatory Commission (CBRC) and the China Insurance Regulatory Commission (CIRC).

in 1997 by the PBC, a UCC was defined as an FC established in urban areas to provide services mainly to members who were urban residents, individual businesses or small and medium-sized enterprises. All UCCs have been transformed into city commercial banks or had otherwise exited the market by the early part of the current decade.

Financial cooperatives' architecture and their importance within the banking system

Back in the 1980s and 1990s, the RCCs could establish secondary FCs and these could establish tertiary FCs. The secondary and the tertiary FCs were called, without distinction, corporate credit unions (CCUs). All of these arrangements were subjected to a geographical criterion following the administrative divisions of China, which can be categorised into four levels (from the lower to the higher): township, county, regional (or prefectural) and provincial. RCCs almost always operated at a township level. The CCUs were allowed to operate at a county or a regional level. The county-level CCUs were established by the RCCs, and the regional-level CCUs by the county-level CCUs.

Since the early 2000s, two major transformations have led to the current architecture: the establishment of rural credit unions/rural cooperative banks and the establishment of provincial-level corporate credit unions. The former were created through a massive merger process, when the majority of the CCUs, whether they were county or regional-level, were merged, with their RCC members becoming again mere primary FCs. The latter were established by the RCUs/RCBs and the county-level or regional-level CCUs.

As of end-2016, there were 1,125 CCUs, RCCs and RCUs, 40 RCBs and 48 RMCs. Total assets of CCUs, RCCs and RCUs amounted to USD 1,200 billion, accounting for 3.5% of the total assets of all depository financial institutions. They hold USD 868 billion or 3.8% of all deposits collected by depository financial institutions. Total assets of the 40 RCBs amounted to USD 66 billion.

The total claims of CCUs, RCCs and RCUs on non-financial corporations and other resident sectors amounted to USD 568 billion (3.2% of all depository financial institutions), with these essentially made up of loans; and their total claims on financial institutions amounted to USD 375 billion (4.3% of depository financial institutions).

In contrast, RMCs' business volume is very small, as the total deposits of RMCs as of end-2016 were just USD 405 million, with a total of 60,000 members and total loan balances of nearly USD 285 million. All RMCs are standalone cooperatives.

Governance arrangements

The corporate governance of RCCs and RCUs/RCBs is unique because it combines elements typically found in the governance of independent cooperatives with government control and supervision. As cooperatives, these entities are owned by members, so there are certain governance bodies, such as general assemblies with the rule of one vote for each member (for RCUs/RCBs, there were additional voting rights for capital shares), and a board of directors and supervisory board, which have duties and powers similar to those of commercial banks.

However, provincial-level governments are also required by the central government to oversee the administration and be responsible for the resolution of the RCCs/RCUs/RCBs. In practice, this means that provincial-level governments are responsible for making decisions on most major issues affecting these FCs. This is achieved by setting up a provincial-level administrative entity (or provincial-level CCU) to manage, guide, coordinate and serve RCUs/RCCs and RCBs.[49] The provincial-level CCU also coordinates and manages relations with the relevant local offices of CBRC and PBC. This provincial-level administrative entity also deals with any unexpected payment risks of RCUs/RCCs/RCBs and with their restructuring or their exit from business should this be necessary. The provincial-level governments are charged with ensuring that RCUs/RCCs/RCBs within their province comply with all rules and regulations.

For each RCC/RCU/CCU, the General Assembly elects the board of directors and the supervisory board. The senior management are appointed by the board of directors. The senior manager and the chair of the board need to be approved by the regulator (CBIRC).

For provincial-level CCUs, senior management candidates are first nominated by the provincial-level government. They then need to be appointed by the FC's board of directors and approved by CBRC. For other RCCs/RCUs/CCUs, the provincial-level CCU oversees and instructs them to elect the board of directors and the supervisory board and to appoint senior managers. In most cases, the candidate of the senior management, as well as the chairmen of the two boards, are de facto nominated by the provincial-level CCU.

This prudential arrangement may evolve over time since the quality of provincial-level framework controls may be uneven and the regime itself is relatively recent, with time being needed for gradual improvements to take place. Nevertheless, the direction and objective of the existing policy are clear, with the intention being to phase out over time the administrative role of provincial-level CCUs, as RCCs/RCUs/RCBs' financial condition and corporate governance improve.

The governance of RMCs is relatively simple. According to the "Provisional rules for the management of rural mutual cooperatives", each member has in principle one vote when attending the general assembly. Members that contribute more capital may have additional voting rights if this is provided for in the RMC's articles of association.

RMCs generally do not have a board of directors. If the articles of association allow for and establish such a board, it should consist of no less than three directors, with one as the chairman. The responsibilities and rules of the board should be provided in the articles of association.

Each RMC should have only one senior manager who runs the RMC according to the articles of association and by delegation from the general assembly. Each RMC should also have a supervisory board, which supervises the RMC's operations according to the articles of association and to the general assembly's association. The senior manager should obtain approval from the supervisory board and the board of directors (if any) when hiring staff.

Regulatory and supervisory frameworks

RCCs/RCUs/RCBs are regulated and supervised by CBRC largely in the same way as commercial banks. In the CBRC's terminology, RCCs/RCUs/RCBs, together with rural commercial banks, are referred to as rural small and medium-sized financial institutions, which fall under the responsibility of the Rural Financial Institution Supervision Department in CBRC.

[49] The role of a provincial-level CCU in managing, guiding, coordinating and serving RCUs/RCCs/CCUs is a very broad one. It issues regulations and guidelines for RCUs/RCCs/CCUs on business operations, financial accounting, labour and employment, risk control systems and governance. It supervises and urges RCUs/RCCs/CCUs to elect board of directors and board of supervisors and to elect and hire senior managers. It conducts training but also audits of RCUs/RCCs/CCUs regarding business operations, employment, social security and internal management. It helps the RCUs/RCCs/CCUs improve the technical support system such as providing fund clearing and settlement services. It also provides business guidance and information consulting services.

The law of the People's Republic of China on the regulation of and supervision over the banking industry, which provides the basic regulatory and supervisory framework, pertains equally to RCCs/RCUs/RCBs and commercial banks. This includes monitoring, off-site and on-site supervision, early warning systems etc.

For regulatory purposes, RCCs/RCUs/RCBs are treated like commercial banks in most cases. For instance, they implement and comply with the same capital and liquidity rules as those applicable to commercial banks. As a case of proportionality, simplified versions of requirements may apply to smaller institutions, whether or not they are commercial banks or cooperatives. For example, banks or RCCs/RCUs/RCBs with total assets below RMB 200 billion (about USD 30 billion) are exempted from NSFR and LCR requirements. Instead, a simpler liquidity ratio termed the HQLAAR (high-quality liquidity asset adequacy ratio) applies to them.

RMCs are also licensed, regulated and supervised by CBRC, with a specific rule applicable to all the RMCs. This includes tight limitations on the activity of RMCs. For instance, RMCs are not allowed to operate with non-members or to open branches.

The prudential requirements for RMCs are simplified. These include the following:

- capital adequacy ratios should be at least 8%;
- loans made to a single member should not exceed 15% of total regulatory capital;
- loans made to a single member and his affiliated party should not exceed 20% of regulatory capital;
- loans made to the top 10 members should not exceed 50% of regulatory capital; and
- impaired assets should be adequately provisioned according to accounting rules.

Capital sources

The main sources of capital for RCCs/RCUs/RCBs include member shares, capital shares and retained earnings. Member shares are the basic shares which must be paid-in by members to obtain membership. Capital shares are shares held by members in addition to their member shares. Voting rights for member shares is one vote for one member, and the voting rights for capital shares are determined by the amount of capital share. Capital shares cannot be redeemed, while the member share may be redeemed at original value if certain conditions are satisfied and with the approval of the RCCs/RCUs/RCBs' board.

In 2010, CBRC issued official guidance to accelerate the transformation of RCCs/RCUs/RCBs into shareholding companies termed rural commercial banks. RCCs/RCUs that do not fulfil the conditions for being transformed into commercial banks are expected to convert member shares into capital shares as soon as possible and to be transformed into a shareholding company form (sometimes called rural credit cooperative companies).

According to implementation rules on administrative licensing of small- and medium-sized financial institutions in rural areas issued by CBRC, RCCs/RCUs/RCBs may also issue Tier 2 capital instruments through the OTC interbank bond market which is supervised by PBC. In practice only a few RCBs have issued such capital instruments. No RCC/RCU has done so to date.

In addition to capital instruments, some wholesale funds are also available for RCCs/RCUs/RCBs since PBC allows qualified deposit-taking institutions including RCCs/RCUs/RCBs to issue certificates of deposit (CDs) and interbank CDs.[50] However, CDs and interbank CDs remain a secondary source of

[50] CD (certificate of deposit) refers to a large deposit certificate issued to non-financial institutions (wholesale) customers. An interbank CD refers to a money market instrument issued to members of the national interbank offering market and mutual funds.

funding. Customer-member deposits predominate and make up around three quarters of RCCs/RCUs/RCBs' liabilities on average. Other liabilities are mainly to other financial institutions.

The main sources of capital for RMCs are member shares and retained earnings. A member can only redeem its member share subject to a number of conditions. None of the loans obtained must be past due. Redemption can only take place if the RMC has profits in the current year and the redemption does not cause the capital adequacy ratio to fall below 8%. The request must be approved by the board of directors or the senior manager.

Evolution of business models and competitive challenges

The business model of RCCs/RCUs/RCBs is simple compared with those of large commercial banks, with the principle of operation within a specific region both required and encouraged by the government. Rural commercial banks which are former RCCs/RCUs are also required to be geographically focused (ie based in a single county or region). While they may have some branches or subsidiaries located in other regions, the number of these is strictly limited.

The regional specialisation of RCCs/RCUs/RCBs and of rural commercial banks helps ensure that they are the main players in certain local markets, as opposed to the local branches of large commercial banks. At the same time, provincial-level CCUs provide important support and services to the RCCs/RCUs/RCBs, for instance with regard to IT systems and to the development of financial products.

However, competitive challenges exist, with an increase in the number of new entrants as more banking institutions have obtained licenses to operate in rural areas. Among the most important competitors are the village or township banks established since 2007. As of end-2016, there were 1,443 village or township banks across the country. Village or township banks are mainly controlled by other banks, so they may compete with RCCs/RCUs and are used as tools by banks operating outside the specific region.

For RMCs, business sustainability is a very sensitive issue. After 10 years of development, only 48 RMCs have been established and their volume of operations remains very small. A report jointly written by the staff of the PBC and the World Bank Group[51] stated that, by 2012, it had become clear that the RMC model was not achieving its objectives. The CBRC has accordingly stopped issuing new licenses to focus on other policy approaches.

The main problems impeding the development of RMCs include improper and inadequate governance and their small size. There have been several cases of improper fund-raising or fraudulent use of deposits raised from the general public by organisations using the guise of financial cooperatives. These highly publicised cases have hurt the reputation of the whole sector.

Safety net and deposit protection

The deposit protection scheme for RCCs/RCUs/RCBs was introduced in 2015. It is mandatory for all RCCs/RCUs/RCBs and for commercial banks. The coverage level is RMB 500,000 (about USD 75,000) for each depositor in each insured institution. This provides full protection for more than 99% of depositors.

[51] "Toward universal financial inclusion in China: models, challenges, and global lessons" is available at https://openknowledge.worldbank.org/handle/10986/29336.

The deposit insurance system has a risk-minimiser mandate, including a risk-based differential rate, a prompt corrective action mechanism[52] and a resolution function. RCCs/RCUs/RCBs and other insured institutions contribute to the deposit insurance fund with premiums paid in every six months, according to their insurable deposits and individual premium rate.

If an RCC/RCU/RCB faces a temporary liquidity shortage rather than an insolvency problem, liquidity support is available from PBC, under the same conditions applicable for commercial banks. When temporary liquidity support from PBC is needed during the resolution of an RCC/RCU/RCB, a guarantee from the provincial-level government is requested, with any losses to be borne by the provincial-level government given that the provincial-level governments oversee the administration and are responsible for the resolution of an RCC/RCU/RCB.

Liquidation and insolvency arrangements

The resolution framework is also largely the same for RCCs/RCUs/RCBs and for commercial banks. When a credit institution is likely to fail, thereby seriously jeopardising the lawful rights and interests of depositors and other customers, CBRC may, consulting PBC and the deposit insurance fund management agency, take over the entity or facilitate its restructuring. Where a credit institution operates in violation of the law, is not operating soundly or is not managed properly, and is thereby seriously threatening the financial order and undermining public interests, the CBRC may, after consulting PBC and the deposit insurance fund management agency, close the institution.

In both cases, the deposit insurance fund management agency is expected to be the receiver. It may use the deposit insurance fund to pay out insured deposits within coverage level, or to support a purchase and assumption deal,[53] with the principle of least cost to the deposit insurance fund applying.

The PBC is also involved in the resolution process as the lender of last resort and is tasked with the responsibility of maintaining financial stability. As already mentioned, RCCs/RCUs/RCBs do significantly differ from commercial banks since provincial-level governments are responsible for their resolution. In practice, problem RCC/RCU/RCBs have been resolved mainly through consolidation or mergers, with provincial-level governments playing an important role in these transactions.

In contrast, RMCs are not covered by the deposit insurance system nor do they have any special insolvency regime. Instead, they are subject to the same liquidation procedures as those applicable to non-financial corporates. Finally, no liquidity support from the PBC is available to support RMCs.

[52] According to the regulation on deposit insurance promulgated by the state council, when capital adequacy of an RCC or of another insured institution drops sharply, with this jeopardising the safety of deposits and putting the deposit insurance fund at risk, the RCC must adopt timely corrective measures. These include raising additional capital, limiting asset growth and/or reducing credit exposure, particularly larger loans, and reducing its leverage ratio, as required by its regulatory authorities (the deposit insurance management agency, PBC and CBRC).

[53] According to regulations on deposit insurance promulgated by the state council, the deposit insurance fund may be used to provide guarantee, loss-sharing arrangements or financial support for other insured institutions, which acquire or undertake part or all of the business, assets, and liabilities of an insured institution which is in receivership, has been dissolved or has filed for bankruptcy.

Annex 4 – Financial cooperatives in France

Historical background and legal framework

The first mutual credit institutions were created in France towards the end of the 19th century.[54] Under French law, a financial cooperative (FC) is a credit institution that takes deposits and other repayable funds from the public and/or grants credit for its own account. To be authorised to exercise these activities, it must be licensed as a "mutual or cooperative bank" by the ACPR[55] and the European Central Bank (ECB). Mutual and cooperative banks – like all other types of licensed credit institution – are required to belong to a professional body or a central body that is affiliated with the French Association of Credit Institutions and Investment firms. All financial cooperatives except one[56] are affiliated to a central entity. There are three major cooperative banking groups (Groupe Crédit Agricole, Groupe Banques Populaires-Caisses d'Epargne[57] and Groupe Crédit Mutuel) and four networks (Crédit Agricole, Banques Populaires and Caisses d'Epargne, which belong to the same group, and Crédit Mutuel).

As cooperative entities, mutual and cooperative banks are also subject to the 10 September 1947 Act which regulates and defines cooperative organisations.[58] Each of the four networks has received legal recognition through specific laws that define their purpose, with the state having historically encouraged their development to promote financial inclusion and finance the local economy and specific professional groups.[59] While FCs were supported in the past by specific government policies and tax advantages, this is no longer the case, with the last advantages removed in 2009. There are no specific public-sector expectations regarding FCs, and these are subject to essentially the same regulations as commercial banks.

Financial cooperatives' architecture and their importance within the banking system

All three major cooperative banking groups are structured as "inverted pyramids" whereby the financial cooperatives owned by members and at the base of the pyramid own (directly or indirectly in whole or in majority) the central institution (or central body) that constitutes the summit (see organisation charts of each group at the end of the annex). In two cases (Crédit Agricole and BPCE), the central institution has become a joint stock company. However, only Crédit Agricole SA is publicly listed. In the case of Crédit

54 The first local mutual bank for agricultural credit was created in 1885, while a law of 1894 authorised members of agricultural unions to create financial cooperatives (Crédit Agricole). The first Mutual Credit Institution (Crédit Mutuel) was created in 1882 and was inspired by the Raiffeisen. The first of the Banques Populaires was created in 1878. The first Savings Bank (Caisses d'Epargne) was created in 1818. Saving banks became mutual banks in 1999 and merged with the Banques Populaires, creating the BPCE Group, the second largest mutual banking group in France after the Crédit Agricole Group.

55 ACPR stands for Autorité de Contrôle Prudentiel et de Résolution. It is the licensing, supervisory and resolution authority in France for banking, insurance and regulated financial services activities (within the euro zone's Single Supervisory Mechanism framework with respect to the credit institutions).

56 The only standalone mutual bank is Banque Française Mutualiste, which is focused on civil servants and has 1.2 million members. With slightly more than EUR 1 billion in loans, it is very much smaller than the three main groups.

57 This group includes the networks of Banques Populaires and of Caisses d'Epargne.

58 These include, for instance, the requirement that each member can only have one vote at general meetings (though exceptions to this principle are possible) and a cap imposed on remuneration of capital which cannot exceed the average rate of return on corporate bonds as published by the ministry for the economy.

59 For instance, Crédit Agricole and Banques Populaires were expected to grant credit to, respectively, farmers and SMEs and individual entrepreneurs and craftsmen.

Mutuel, the central body is a not-for-profit association. Moreover, the French Financial and Monetary Code[60] provides that each of these central bodies:

- has an unconditional legal obligation to ensure jointly the liquidity and the solvency of each affiliated institution and of the entire network;
- oversees the application of laws and regulations that are specific to affiliated institutions and to the network and exercise administrative, technical and financial control over their organisation and management; and
- may apply the penalties provided for in the laws and regulations that are specific to them.

Further legal provisions and the bylaws and internal regulations specific to each network complement these requirements. They essentially ensure that the management of central bodies has the power to both issue instructions to the management of each of the affiliates and to enforce them should the need arise.

Together, the three cooperative groups account for 47% of all assets of the French banking system, 51% of all loans and 47% of deposits. Given their size and the range of their activities, two of the groups are designated as systemically important banking groups (G-SIBs) and all three groups are deemed to be significant banks and subject to the direct supervision of the ECB under the Single Supervisory Mechanism (SSM), which is carried out by Joint Supervisory Teams (JSTs) formed of staff of the ECB and the relevant national supervisors (ACPR for France).

Table 7 summarises the relative importance of the three groups within the French banking system. Membership of an FC is obtained by subscribing to membership shares, which is nowadays open (ie no common bond required), with such shares often offered to customers as savings products. In practice, FCs are no longer limited to operating with members, as reflected by the discrepancy between the number of members and the number of customers for each of them (see Table 7).

Relative importance of French mutual and cooperative banking groups

In billions of euros for assets, loans and deposits and in millions of euros for members and customers

Table 7

Name of the group	Assets	Loans	Deposits	Members	Customers
Crédit Agricole	1,707 (20%)	1,174 (22%)	1,064 (21%)	9.7	24
Banques Populaires-Caisses d'Epargne	1,392 (17%)	957 (18%)	825 (16%)	4.3 and 4.8	9.2 and 20
Crédit Mutuel	797 (10)	570 (11%)	524 (10%)	7.8	11.6
Total	3,896 (47%)	2,701 (51%)	2,413 (47%)	26.6*	64.8

* The number of members and of customers is provided for each network. There is some double-counting because some clients may be customers and/or members in more than one network.

Source: FSI survey.

The three cooperative groups are consolidated for both accounting and prudential purposes since they meet the relevant EU definition. The financial cooperatives must all have their head office in the same member state. They are permanently affiliated to a central body that supervises them and this central body is established in the same member state.[61]

[60] The reference is Article L511-31 of the Monetary and Financial Code which was originally part of the 24 January 1984 Banking Act.

[61] The legal reference for these requirements is Article 2 paragraph 21(c) of the SSM Framework Regulation (Regulation EU No 468/2014).

Governance arrangements

The governance arrangements of the three cooperative banking groups combine provisions derived from their legal nature (Act of 1947 for financial cooperatives and commercial code for joint stock companies), from their activities as credit institutions and from statutes specific to each group. Given the crucial role of these entities, the supervision of governance focuses on the arrangements at central bodies. These central bodies have an internal audit function that covers the whole group, including all direct or indirect subsidiaries. In addition, all financial cooperatives that have a banking license have their own internal control function, as required by law.

The composition of supervisory boards (some of which may be called boards of directors) at the central body level tends to associate a majority of directors representing the respective networks (and in particular the local and regional financial cooperatives) with external/independent directors and some directors representing employees. Accordingly, the governance of each central body is specific.

There is no legal requirement in France for board members, risk committee members or senior executives to be formally independent and therefore not drawn from the financial cooperatives' customers/membership. Most members (and often almost all of them) of management boards in supervisory function are also clients of the financial cooperative and hold membership shares. With regard to the composition of the supervisory boards of each central body, a majority of directors are also board members or chief executive officers of regional financial cooperatives belonging to the group. In practice, however, the supervisory bodies of the central entities of each of the three groups include varying numbers of external directors.

While the lack of renewal of board members used to be a common issue across mutual entities, regional and national boards were renewed in recent years through a combination of pressure applied by supervisory authorities as part of their ongoing supervision (eg appointment of independent board members) and of legal requirements pertaining to gender diversity.[62] As is the case for commercial banks, the CEO of a licensed cooperative institution cannot chair the board, unless expressly authorised to do so by the supervisory authority. Some senior managers are part of the boards of FCs. However, most board members at regional levels are members/customers with no executive position.

Attendance at the AGMs of local FCs tends to be low. However, this does not lead to operational problems in practice, as the statutes of local FCs either do not include a quorum at all, or provide for the convening of a second general meeting with no quorum when the quorum was not met the first time. At higher levels, attendance is not an issue, because only institutions are members.

Decision-making processes and selection and succession processes are established by each group and each financial cooperative. However, central bodies are required to approve the appointment of the senior executives of all entities that have a banking license. In addition, the voting rights at the general assemblies of the respective central bodies are nowadays no longer aligned to the one member-one vote cooperative principle. For all three groups, weighting systems are used in practice.[63]

With regard to accounting and risk management, the local entities of each network collect deposits, extend loans and book them in their respective balance sheets. In the case of Groupe Crédit Agricole and Groupe Crédit Mutuel, all local assets and liabilities are consolidated by each regional entity where the financial statements and regulatory reporting are established and take place as a consequence

62 In particular, the 2011 Copé-Zimmermann Act currently requires that at least 40% of members of supervisory boards or boards of directors of companies with a balance sheet higher than EUR 50 million should be women. Increasing the number of women at higher levels implies having a sufficient number of women on the boards of local entities.

63 With regard to the Crédit Agricole Group, for instance, shares owned by regional banks are subject to a weighting system where one third of the votes are divided equally among all regional banks and two thirds are attributed based on the number of shares held by each regional bank. With regard to the BPCE group and according to the statutes, each network has 50% of the shares of BPCE SA so as to prevent any domination of one network over the other.

of having a collective license. Regulatory requirements apply for each licensed entity so that regulatory reporting takes place both at the regional and at the consolidated level.

Liquidity risk management is group-specific and largely centralised at all three groups. At Crédit Agricole, the central body issues most fixed income securities on behalf of the group. By law, all local entities (caisses locales) are obliged to immediately transfer all deposits to the regional affiliate that manages them. The regional affiliate, in turn, has to transfer to the central body any excess deposit that it might hold. At BPCE, liquidity management is largely centralised at the central body, which is mandated by law to determine the rules for managing group-wide liquidity and determining funding terms and conditions. In practice, short-term funding needs are addressed through two issuers on a group-wide basis (BPCE and Natixis – the group's corporate and investment bank), while BPCE is the main long-term issuer. At Crédit Mutuel, liquidity management depends upon the internal rules of the six regional groups. Some require that all deposits collected by the local branches must be placed at the federal entity, while others require only the transfer of excess funds to the federal entity.

With regard to credit risk management, provisioning and loss absorption are done by the entities that extend the loans. Each group has its own solidarity arrangements that guarantee the liquidity and solvency of all members, as required by law. At Crédit Agricole, the regional entities define the terms and conditions for extending loans and the central entity manages a fund for liquidity and solvency risk to provide support to weak entities within the group. At BPCE, loans are extended by each of the networks (Banques Populaires and Caisses d'Epargne), which are each responsible for their own provisioning and loss absorption. Each network has its own guarantee fund with a third fund common to both networks. Should one of the affiliates run into problems, the fund of its network is solicited first, then the common fund and then the fund of the other network. At Crédit Mutuel, loans are extended by the local branches, which are also responsible for provisioning (even if provisioning guidelines are established at a higher level). Each regional federation has its own solidarity mechanisms to mutualise credit losses, with a national fund being also in place should regional support prove to be insufficient.

Regulatory and supervisory frameworks

Since the establishment of the SSM in 2014, the licensing authority for all commercial and cooperative banks is the ECB with the application being proposed by the national competent authority. Licensing requirements are basically the same as for commercial banks except in the case of a collective license. The ECB, upon proposal of the national authority, can grant a collective license to a regional or federal institution for both itself and its affiliated financial cooperatives, after consulting the central body of the cooperative group. In practice, the regional subgroups of Crédit Agricole and Crédit Mutuel benefit from collective licenses. These allow the application of prudential requirements (such as large exposures, liquidity requirements or solvency requirements) to be partially or fully waived on an individual basis at the level of the local entities. However, these requirements still apply at the regional level on a sub consolidated basis (ie the perimeter of the collective license).

The three cooperative groups are under the ECB's supervision with the assistance and cooperation of the national competent authorities – the ACPR with respect to France – with these remaining responsible for anti-money laundering and customer protection issues in their respective jurisdictions. The three groups are subject to similar supervision and monitoring as commercial banks, to the same regulatory thresholds and requirements and to the SSM's SREP supervisory rating system. Enforcement powers, including the ability to require the removal of senior managers and board members, of the senior management or management body in its entirety and the power to appoint one or more temporary administrator(s), are essentially the same as for commercial banks.

While some financial cooperatives have merged on their own initiative, French legislation authorises central bodies to merge two or more of the legal entities affiliated with them with a total or partial sale of their assets and their dissolution. There is no specific legal provision allowing the supervisory authority to force financial cooperatives to merge. However, legal European and national provisions[64] applicable to both commercial banks and financial cooperatives allow supervisory authorities to require changes to the legal or to the operational structures of an institution. Just like shareholders for commercial banks, financial cooperative members retain control of a cooperative during recovery and early intervention stages until it enters resolution or liquidation, unless a temporary administrator is appointed.

Capital sources

The capital of financial cooperatives essentially includes membership shares (called capital shares) and financial reserves, with the distribution of these being limited by legislation. Membership shares can qualify as CET1 capital subject to meeting the eligibility criteria of articles 28 and 29 of the Capital Requirements Regulation applicable to CET1 instruments and to capital instruments issued by cooperatives and savings institutions.

Membership (or capital) shares qualifying as CET1 capital can be redeemed under specific conditions. In particular, a financial cooperative must submit every year a request to the competent authority (the ECB in the case of the three cooperative groups) to grant them the authorisation to redeem on a solo basis up to 2% of their respective CET1 capital. The 1947 Act on financial cooperatives also specifies that redemption of capital takes place at nominal value, therefore further limiting the ability to redeem capital.

Fixed income instruments qualifying as regulatory capital can also be redeemed but the redemption has to be made at market value. Article 78 of the Capital Requirements Regulation of 2013 allows for such redemptions if one of the two following conditions is met:

- Before or at the same time that the redemption takes place, the institution replaces the instrument with own fund instruments that are of equal or higher quality and at terms that are sustainable for the institution; and
- The institution demonstrates that its own funds would still exceed the combined minimum requirements, buffer requirements plus a safety margin required by the supervisory authority following the redemption.

Cooperative/mutual banks can also issue debt securities on capital markets either at regional level or through the central body's treasury, including subordinated securities. There are no restrictions specific to cooperative/mutual banks limiting the issuance of capital instruments, including senior non-preferred bonds that qualify for TLAC/MREL loss absorbency requirements. As all other issuers, cooperative/mutual banks are required to fulfil a duty to inform and advise their customers to the best of their ability. To deliver this, they are required to assess their clients' financial knowledge and needs. In practice, the extent of this obligation varies depending on the type of instrument and the level of financial knowledge of the customer, as required under the MiFID and MiFIR Directives.

In all cases, offers of securities can only be made through a prospectus, an offering memorandum or other offering document describing the terms and conditions of the relevant securities. Any such prospectus must be controlled and approved by the market authority (Autorité des Marchés Financiers – AMF) prior to issuance. Both the ACPR and the AMF have a shared responsibility for regulating marketing

[64] These are Article 27.1 of the Bank Recovery and Resolution Directive (BRRD) that allows for early supervisory intervention and Article L511-41-5 of the Monetary and Financial Code.

and selling practices of financial cooperatives. Requirements regarding the marketing of mutual shares being were recently strengthened in 2016.[65]

Evolution of business models and competitive challenges

Three of the six largest banking groups in France are cooperative groups.[66] They face essentially the same competitive pressures as the three large commercial banking groups, which are their main competitors. French cooperative banking groups no longer benefit from any specific advantage (ie no tax benefit, government subsidy or monopoly in collecting or distributing certain products).

Common challenges include macroeconomic uncertainties related to Brexit or to changes in the interest rate environment and the emergence of new and non-regulated competitors (eg fintech).

Safety net and deposit protection

Since 1999, commercial and cooperative banks, which were previously part of different deposit protection schemes, belong to a common deposit guarantee scheme (Fonds de Garantie des Dépôts et de Résolution or FGDR). The fund receives mandatory contributions from its members, with such contributions being one of the prerequisites for being licensed as a credit institution. If needed, the FGDR can require additional contributions and borrow funds. Annual contributions are determined based on the size of each institution's guaranteed deposits and adjusted to reflect individual risk profiles.[67] The central body of each cooperative group is the contact point with FGDR for all members of the network.

Each cooperative group/network has set up its own liquidity support arrangements and solidarity mechanisms. None of the mutual banking groups has requested for its arrangements and mechanisms to be recognised as Institutional Protection Schemes (IPS) under EU regulation.[68]

Emergency liquidity assistance (ELA) from the central bank can be provided to financial cooperatives facing liquidity problems under the same terms and conditions as any other financial institution or group. The terms and conditions of the intervention must comply with the Eurosystem's agreement on emergency liquidity assistance and with the Bank of France's risk policy. In practice, ELA would be provided to entities that have an account at the central bank. In certain groups, the central body is the only mutual institution to have direct access to the central bank (BPCE in particular). Primary FCs (ie caisses locales, BP, CE) do not have direct access to the central bank.

Liquidation and insolvency arrangements

Given the strong solidarity requirements existing within cooperative groups between local and regional banks and central bodies, resolution is much more likely to occur when both the affiliated entities and the central body are likely to fail, which would then be considered as a single resolution entity. For this reason, and although the resolution authority would apply a single point of entry resolution on a legal entity basis

65 This refers to the provisions of the 9 December 2016 law – sometimes called Sapin 2 law – codified in article L. 512-1 of the French Monetary and Financial Code.

66 The three other banking groups are BNP Paribas, Société Générale and Banque Postale, the latter being a public sector bank.

67 The contribution is calculated in two steps. The total premium is first calculated at the consolidated level for the entire network. It is then allocated to each licensed affiliate depending on its contribution to the overall risk of the network. In practice, the central body collects all contributions across the entire network and pays them to the FGDR.

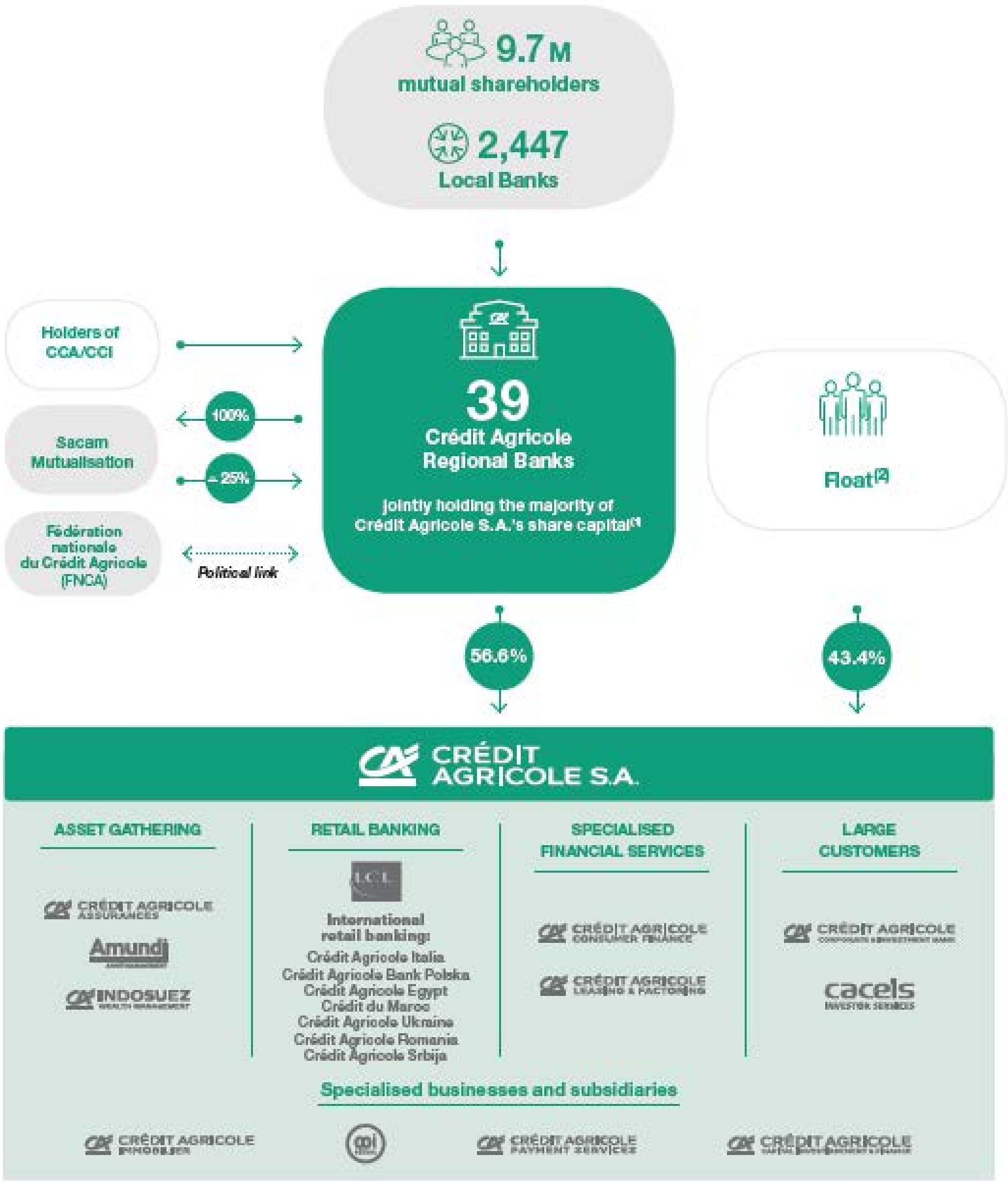
68 Rather than benefiting from an IPS scheme, the three large mutual groups are organised as banking groups with central bodies but with an inverted ownership structure. The scope of consolidation reflects the community of interests and the risk management control exercised by the central body on the affiliated institutions (local and regional banks) even if it owns no member shares in the banks.

for commercial banks, it would have to apply a "hybrid single point of entry strategy" in the case of a cooperative group, with resolution applying to both the affiliates and to the central body.

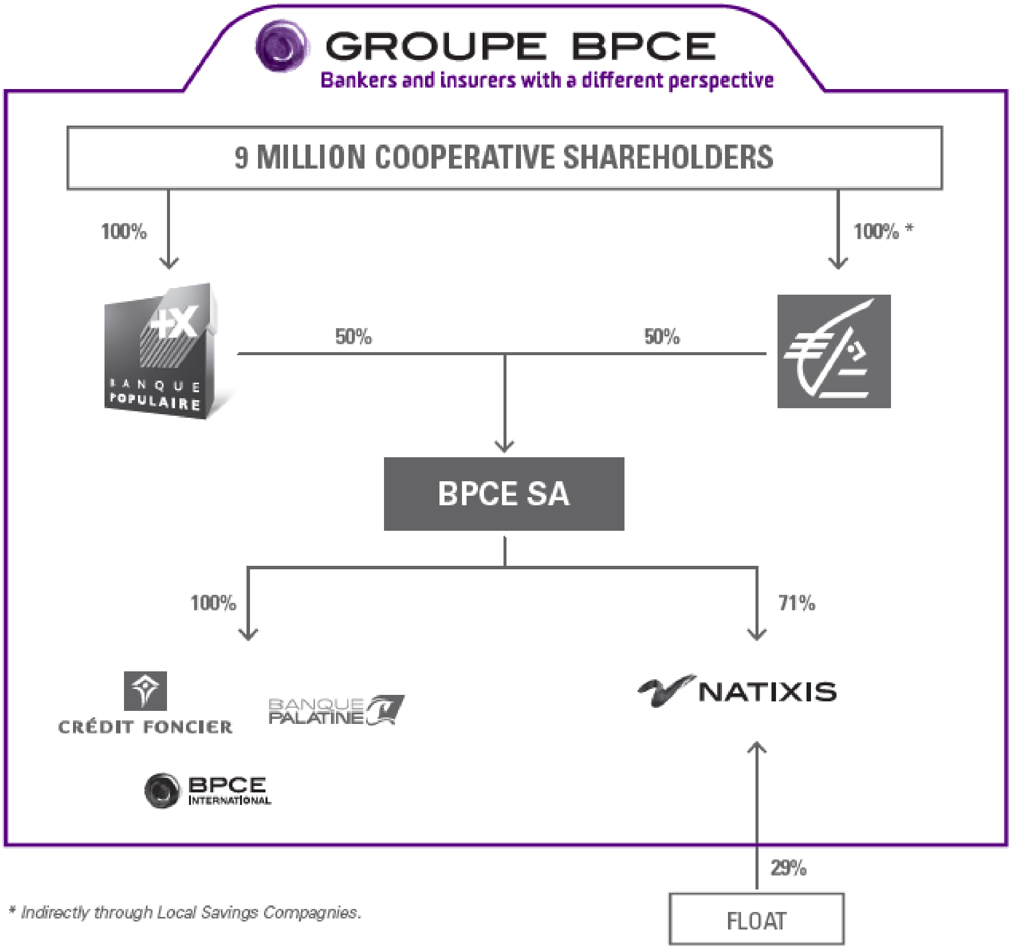
The preferred resolution strategy for cooperative banks would imply writing down capital instruments and activating bail-in clauses. As the central body is a corporate, writing down existing shareholders and replacing them with creditors whose claims have been converted into shares may result in demutualising the group.

Organisational charts of GCA, BPCE and GCM groups

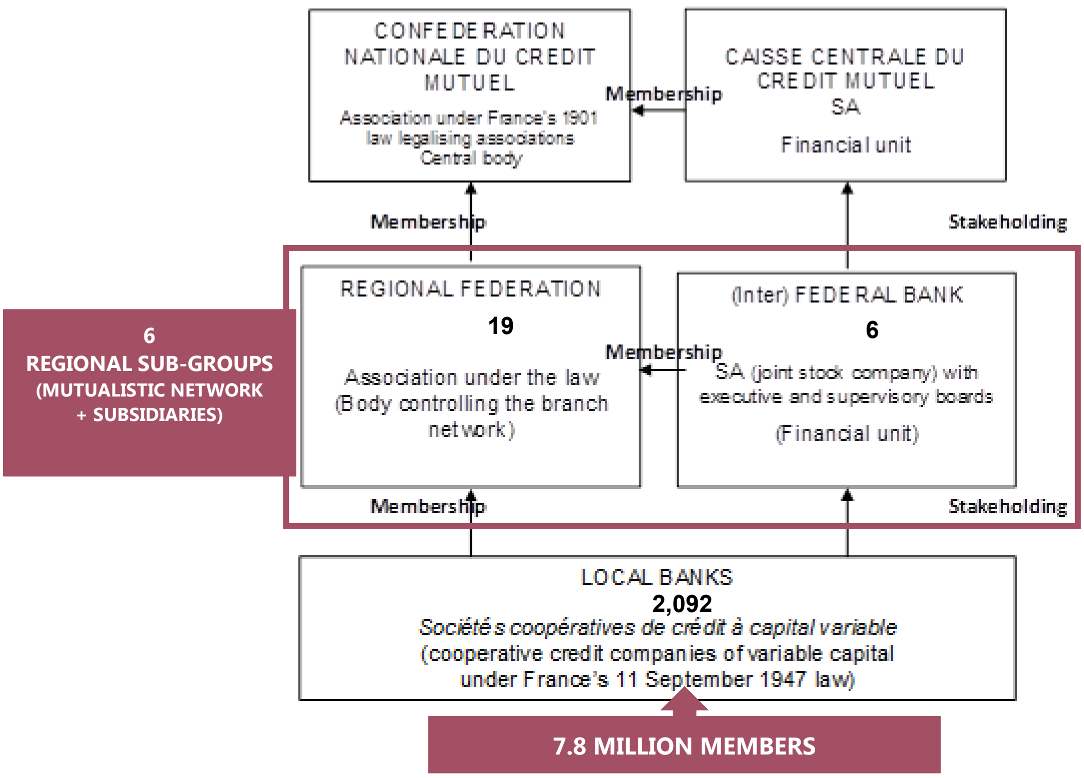
Groupe Crédit Agricole (GCA)



Groupe Banques Populaires–Caisses d'Epargne (BPCE)



Groupe Crédit Mutuel (GCM)



Annex 5 – Financial cooperatives in Germany

Historical background and legal framework

In Germany, financial cooperatives are called cooperative banks (CBs), which are credit institutions according to the German Banking Act. Cooperative banks date back to the middle of the 19th century, with the emergence of two groups of cooperative banks (Raiffeisenbanken and Volksbanken). The two cooperative networks merged in 1972. In 1974, after decades of debate, restrictions on business activities and the associated tax advantages were abolished to promote a level playing field between FCs and other credit institutions. Nowadays, there is no law or significant benefits that favor financial cooperatives over the rest of the banking system.

Financial cooperatives' architecture and their importance within the banking system

The main purpose of cooperative banks is the economic promotion of their members through standard bank transactions. Cooperative banks – just like saving banks – offer retail bank services and extend credit to small and medium-sized companies. These credit institutions take the form of registered cooperative societies. By law, they are required to belong to an audit association. Cooperative banks make up one of the "three pillars" of the German banking system, the two others being commercial banks and savings banks.

There are currently around 900 local cooperative banks (and 918 entities altogether) in Germany. They hold 12.2% of all assets (USD 1.05 trillion), extend 13.5% of all loans (USD 0.73 trillions), and collect 15.6% of all deposits (USD 0.93 trillion) of the German banking system. Together, they have some 18.5 million members and serve more than 30 million customers. There has been a decline in their overall market share from the mid-1990s up to 2012. However, and since then, cooperative banks have gained ground so that their market share in 2017 is back to the level it had reached in the early 1990s. The vast majority of cooperative banks are small. Only one of them, the Deutsche Apotheker- und Ärztebank eG (ApoBank), is deemed to be a "significant institution" (within the scope of the SSM) – with total assets of about USD 49 billion – and therefore subject to direct supervision from the European Central Bank.

All cooperative banks in Germany are members of the German Association of cooperative banks (BVR, Bundesverband der Deutschen Volksbanken und Raiffeisenbanken) and are therefore members of the BVR's institutional protection scheme (IPS). Statute regulates membership in the BVR's IPS. The network's central financial institution is DZ Bank AG, which is owned by the cooperative banks. DZ Bank AG provides its associates with a whole range of products and services including investment banking, lending to large corporates, funding and clearing bank services. With about EUR 500 billion in total assets, DZ Bank AG is currently the second largest bank in Germany.

Governance arrangements

The general assembly is the body in which the members jointly decide on the basic affairs of a cooperative. Apart from the general assembly, FCs have two governance bodies: the supervisory board which encompasses the oversight functions of a board of directors; and the management board, the executive entity which comes under various names in other jurisdictions (such as executive committee, senior management etc).

The general assembly is the body in which members decide on the most important affairs relating to the cooperative. According to the law, the general assembly approves and decides upon:

- the statutes and any amendments to them;

- the election (and dismissal) of the management board (unless the statutes have assigned this role to the supervisory board) and the election and discharge of members of the supervisory board;
- the adoption of the annual financial statements and the use of the financial surplus or the coverage of any annual deficit;
- the setting of credit limits;
- the approval (or not) of the audit report; and
- any decision regarding acquisitions, the merger or the dissolution of the cooperative.

Each member has a single vote in the general assembly, regardless of the number of shares subscribed. Most decisions only require a majority of votes cast to be approved although the most important ones, as defined under the cooperatives act or the articles of association, require a qualified majority. A qualified majority of three quarters is for instance required by the cooperatives act for the most important decisions such as amending the statutes, revoking individual members of the management board or the supervisory board or revoking the whole board and merging or dissolving the cooperative.

In practice, low participation in general assemblies is generally not a problem. FCs have the possibility, especially for the larger ones, of convening a representative assembly instead of a general assembly, with this being explicitly provided for in the Cooperative Act (Section 43a) and provided that this is organised by the institution's bylaws.[69] For smaller banks, there are usually enough members in attendance. For the larger FCs, it is the elected representatives who attend and ensure that there is sufficient representation.

The supervisory board is generally elected and dismissed by the general assembly. Its main duty is to advise, oversee and supervise the management board in the best interests of the members. It reviews the annual financial statements and the management report, and reports to the general assembly the results of the audit prior to the approval of the annual financial statements. All members must be non-executive and are expected to have sufficient legal and economic knowledge to fulfil their duties. According to the One-Third Participation Act, one third of supervisory board members must be representatives of the employees for all companies (including both stockholding companies and cooperatives) with more than 500 employees but fewer than 2,001. For companies that have more than 2,000 employees, half of the supervisory board members must represent the employees and half the owners of capital. The chair of the supervisory board (usually only appointed by the member representatives) has a double vote.

According to the German Cooperative Act, members of the management board are approved by the general assembly, unless the FC's statutes provide for a different mechanism. The statutes of most cooperative banks stipulate that the members of the management board are appointed and hired by the supervisory board. The management board is the legal representative of the cooperative both internally and externally and manages the cooperative bank under its own responsibility. The articles of association or the cooperative bank's rules of procedure define the duties and responsibilities of the management board. While the rules of procedure are laid down by the management board itself, this is often done in practice in consultation with the supervisory board. The articles of association may contain provisions requiring that members of the management board be hired and appointed by the supervisory board, with such appointments being then confirmed at the annual general assembly. The chair of the management board is typically appointed by the supervisory board.

The renewal of supervisory board members and members of the management board is, in principle, the responsibility of the respective bank, but is supported by the audit associations. The audit

[69] For example, the articles of association of a credit union state: "For every 40 members one representative has to be elected".

associations have specialised units offering personnel advice to board members. So far, there has been no problem in filling board positions, even though there is no obligation for a succession plan.

According to the minimum requirements for risk management provided by the banking supervisory authority, each cooperative bank must have a functioning internal audit (or a manager performing the tasks of the internal auditing department) with complete and unrestricted right of access to information. If the management of the internal audit department changes, the supervisory body must be informed in good time and in advance of the reasons for the change being provided.

In addition, all cooperatives are required by law to join an auditing federation that is part of the cooperative association as soon as it is created. An auditing federation is granted the right to audit by a state authority, subject to meeting specific requirements. The audit firm belonging to the federation is the cooperative's legal examiner and cannot be changed easily by the cooperative bank. The quality of its annual audits is regularly checked by other members of the Chamber of Public Accountants.

Regulatory and supervisory frameworks

The German Banking Act treats all credit institutions equally. There is no special treatment in the German Banking Act and little room for proportionality for small and non-complex institutions. However, according to the ECB Reporting Regulation, smaller institutions may provide less financial information than bigger and more complex institutions.

Cooperative banks are supervised in the same way as commercial banks. The ECB is the competent authority to grant and withdraw licenses for both commercial banks and cooperative banks on the basis of the German Banking Act. Cooperative banks are subject to the same licensing requirements as commercial banks.

The ECB is responsible for supervising 21 significant banks/banking groups in Germany through Joint Supervisory Teams (JSTs). Only one of these institutions is a cooperative bank. The vast majority of financial cooperatives are therefore smaller institutions that qualify as "Less Significant Institutions" (or LSIs).[70] These are jointly supervised by Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) and the Bundesbank. BaFin is the competent national supervisory authority. The annual on-site examination programme is determined by Bafin with input from the Bundesbank. The Bundesbank is responsible for conducting ongoing supervision at licensed credit institutions.[71] Cooperation and the division of tasks between BaFin and the Bundesbank are governed by Section 7 of the Banking Act. The Prudential Supervisory Guideline, issued by BaFin in agreement with the Bundesbank, describes supervisory practices.

[70] The Single Supervisory Mechanism (SSM), which comprises the ECB and the national competent authorities (NCAs) of participating member states, is currently responsible for the prudential supervision of all credit institutions in the euro area. The ECB directly supervises all institutions that are classified as significant (around 120 significant institutions) with the assistance of NCAs in Joint Supervisory Teams (JSTs). The NCAs continue to directly supervise the less significant institutions or 'LSIs' subject to the oversight of the ECB. Article 6 (4) of the SSM Regulation and Article 39 of the SSM Framework Regulation establish the criteria and rules for classifying a credit institution as significant or less significant.

[71] This is conducted in a decentralised manner through the Bundesbank's nine regional offices. The Bundesbank's central office performs a coordination function and is responsible for policy issues. Regional offices are the institutions' local point of contact. As part of a preventive, risk-based supervisory strategy, regional offices' primary responsibility is fact-finding, reviewing the documentation submitted by each institution, including the annual accounts and on-site inspection reports, and holding regular and ad hoc discussions with senior management. In addition, at least once a year, each credit institution is assessed as part of the supervisory review and evaluation process (SREP) to establish its supervisory risk profile. On this basis, proposals for supervisory action are determined. Ongoing supervision also encompasses on-site examinations at institutions pursuant to section 44 of the Banking Act. These are usually conducted by the Bundesbank's regional offices.

The audit federation under whose responsibility the cooperatives financial statements, risk management and risk provisioning have been audited has the obligation to send all audit reports to the supervisory authority.[72] Should the authority deem these reports unsatisfactory, it can ask for clarifications from the audit federation, require any documentation directly from the cooperative bank or order an independent on-site examination. The latter measure will typically take place immediately if there has been any serious breach, especially in cases of fraud or malpractice.

Capital sources

The subscribed capital of cooperative banks is made up of member shares. These are the only CET1 instruments issued by cooperative banks in Germany. They grant full voting rights and are fully eligible under Article 29 of the EU's Capital Requirements Regulation (CRR).

According to Articles 27–29 of the CRR and the Regulatory Technical Standard (RTS) on own funds in Article 4(2)(h), cooperative banks may issue capital instruments qualifying as Additional Tier 1 capital (AT1 capital). With regard to cooperatives however, these instruments can only be subscribed by investing members that are not also clients according to the Cooperative Societies Act. To date, no cooperative bank has issued or sold AT1 instruments such as contingent convertible capital instruments.

Cooperative banks may, however, issue debt securities. In practice, in most cases, FCs' capital requirements are satisfied with Common Equity Tier 1 only, with CET1 representing more than 85% of their total capital. The rest is made up of Tier 2 instruments. Over 80% of CET1 is made up of retained earnings, the rest being made up of member shares. No FC has issued AT1 capital to date although around 150 out of over 900 cooperatives have Tier 2 CRR-eligible capital instruments. The sizes of FCs that have issued Tier 2 instruments varies considerably and ranges between total assets of EUR 55 million and EUR 45 billion.

With regard to the marketing and sales of instruments qualifying for regulatory capital, the same regulations apply to all banks including cooperative banks. They are all subject to MiFID regulations, regardless of whether the instruments are publicly issued or distributed privately.

According to Articles 77 and 78 CRR, the competent authority shall grant permission for an institution to reduce, repurchase, call or redeem own funds instruments if either (a) earlier than or at the same time as the redemption, the institution replaces the instrument with own-funds instruments of equal or higher quality at terms that are sustainable for the income capacity of the institution; or (b) the institution has demonstrated to the satisfaction of the competent authority that the own funds of the institution would, following the redemption, exceed the capital requirements (minimum and buffers) by a margin that the competent authority may consider necessary.

The RTS on own funds in Articles 10 and 11 specifies limitations on the redemption of CET1 capital instruments issued by – inter alia – cooperative societies. Each year BaFin issues a general decree ("Allgemeinverfügung"), allowing CBs to redeem member shares, if certain limits are not exceeded and the institution fulfils all its capital requirements. Given the high number of FCs in Germany, this general decree applicable to all these banks offers administrative relief and flexibility for both institutions and BaFin.

[72] In Germany, a long form or extended report is required from all auditors of banks as a part of the statutory audit. The legal basis for this is the German Banking Act §29 and §30 in conjunction with the German Audit Report Regulation (PrüfbV). In addition to the statutory audit, this regulation covers a wide range of supervisory and prudential topics, such as risk management, corporate governance, compensation schemes, IT, restructuring plans, prudential reporting, internal controls, input for the SREP (in particular for the ICAAP and ILAAP), money laundering etc.

Evolution of business models and competitive challenges

Cooperative banks can conduct all activities mentioned in the German Banking Act, as long as they hold the required license. For instance, and like all other banks, they need to obtain a specific license to be allowed to issue covered bonds (Pfandbriefe).

The business of cooperative banks is usually dependent upon interest income-related operations. The current low interest rate environment poses a challenge to them especially in comparison to other competitors, which are reliant on interest-income related operations. The current environment therefore creates incentives for cooperative banks to diversify their sources of income and in particularly to increase the contribution of their fee-based activities in total income.

Second, there is strong competition between cooperative banks, savings banks and commercial banks especially in retail banking. This is somewhat alleviated by the regional principle for cooperative and savings banks, which can only conduct business within a specific area. In terms of size, cooperative banks are generally smaller and therefore at a relative disadvantage when compared with commercial banks but also to savings banks. This is also the case when considering the introduction of new regulations which tend to increase fixed costs, particularly with regard to IT systems.

The strongest competition from commercial banks, which generally have a larger presence in big cities, comes from their internet banking subsidiaries. Hence, not all institutions directly compete with each other. However, those that do compete with each other – for instance a cooperative bank and a savings bank operating in the same region – typically focus on a similar local area, a similar type of customer and offer very similar services.

Cooperative banks are also facing competition from new entrants, such as fintechs, with this creating both opportunities and challenges. So far, the impact of fintechs on the business model of cooperative banks has been limited. The main issue seems to be whether their strong local presence will continue to be as much of a strategic advantage within the context of digitalisation and changing customer behaviour as it has been up to now.

As in a number of other jurisdictions, the lack of recognition and understanding of the "mutual business model" by younger members of the public is one of the main challenges that FCs have to overcome. Initial steps have been taken in order to address this issue. With a vast majority, the BVR decided in June 2018 to heavily invest in IT. Financial services will be offered throughout the network through both channels. The purpose is to allow members and customers to determine their preferred channel themselves, ie visiting a bank physically or opting for online solutions, with the latter more likely to attract younger clients. BVR clearly states that digital solutions are meant to complement local branches.

In addition, cooperative banks are on average smaller than savings banks and commercial banks. This can lead to disadvantages. For example, the implementation of new (supervisory) regulation could be more of a burden for the smaller institutions. New supervisory regulation can increase fixed and compliance costs, leading for example to the procurement of new IT systems or to the need to hire staff to fulfil compliance functions.

As a result, cooperative banks have been reducing branch numbers and the smaller ones show more willingness to merge with other small institutions. In 2017 the number of cooperative banks dropped by 57 (–5.9% year on year) due to mergers, and about 900 branches (–5.8% year on year) were closed. Despite the existing low rate environment, cooperative banks' income is still relatively good but it could deteriorate if such an environment persists.

Safety net and deposit protection

Cooperative banks have established a separate deposit guarantee scheme (DGS) under the National Association of German Cooperative Banks. The BVR operates an institution protection scheme that is recognised as a deposit guarantee scheme according to the European directive on deposit guarantee schemes.

The IPS fulfils two goals. The first goal is to ensure the solvency and liquidity of the member's institution. To achieve that, the BVR protection scheme mainly implements preventive measures aimed at averting adverse trends at the affiliated institutions and, if necessary, takes measures to restructure the institutions concerned. It can use the guarantee fund to grant financial support (guarantees, loans etc) to the member. The second goal of IPS is to guarantee the covered deposits of the customers in the same way as an ordinary DGS. To fulfil this goal, the mutual guarantee fund has to have the same value in relation to the covered deposits as any other DGS.

Since 2015, when the new national deposit insurance legislation came into effect, the BVR protection scheme has been supplemented by BVR Institutssicherung GmbH (BVR-ISG), which is a statutory deposit guarantee system that provides customers' deposits with a form of dual protection. The rules for contributing to the fund are the same as for all DGS with deposit insurance premium rates depending upon the risk profiles assessed by the BVR-ISG.

Membership in the IPS of the BVR is recognised by the ECB, allowing these institutions not to deduct holdings of own funds instruments in institutions that fall within the same institutional protection scheme.[73] Membership also exempts cooperative banks from large exposure regulation since exposures to counterparties belonging to the same IPS can be risk-weighted at 0%. BaFin has supervised the IPS of the financial cooperatives since 1998. According to BVR, not a single FC has been liquidated since the founding of its IPS in 1934. The risk management systems of the IPS have proven to be highly effective. All FCs which were likely to fail have been saved ex ante by BVR and its IPS. No depositor has ever had to be compensated.

In addition to deposit insurance for the safety net, according to provisions of emergency liquidity assistance (ELA), Deutsche Bundesbank would provide ELA to both commercial and cooperative banks facing a temporary liquidity shortage but still considered solvent.

Liquidation and insolvency arrangements

The "point of non-viability" under German law generally refers to the point where conditions for resolution are met, as defined under the Bank Recovery and Resolution Directive (BRRD). This applies to both cooperative and commercial banks, with resolution triggered when:

- an institution is determined to be failing or likely to fail;
- there is no reasonable prospect that alternative private sector measures or supervisory action would prevent the failure of the institution within a reasonable timeframe; and
- a resolution is in the public interest in the sense that it is necessary for the achievement of, and is proportionate to, one or more of the resolution objectives and winding up under normal insolvency procedure would not meet those objectives to the same extent.

For significant institutions, the Single Resolution Board determines the resolution strategy. For less significant institutions, BaFin is the national resolution authority and has this responsibility. The

[73] To exempt cooperative banks from having to deduct holdings of own fund instruments in institutions that belong to the same IPS scheme and on the basis of CRR Article 49(3), the BVR regularly performs an aggregated calculation which is verified by an external auditor with the aim of ensuring that the exemption does not lead to any double-counting of capital. In practice, BVR runs a rating system that assesses the creditworthiness of all of the cooperative banks that it guarantees. Early intervention on the basis of this system is privileged, with BVR taking steps to contact weak cooperatives that run into problems at an early stage and agree to rehabilitation plans or the merger of the firm with another cooperative.

resolution objectives are: (a) to ensure the continuity of critical functions; (b) financial stability; (c) protect public funds; (d) protect depositors and investors; and (e) protect client funds and client assets.

The same range of tools is available for cooperative banks as for commercial banks. In practice, and since cooperative banks do not have stock, bailing in cannot take place without changing the legal form of the cooperative when it enters resolution, which is something that is authorised under Sec. 77(3) SAG/Art. 43(4) of the BRRD.

Annex 6 – Financial cooperatives in Ireland

Historical background and legal framework

"Credit unions" (CUs) are the main type of FC in Ireland.[74] The first ones were founded in 1958, followed, two years later, by the foundation of the Irish League of Credit Unions (ILCU). CUs are governed primarily by the Credit Union Act of 1997, which also established the Credit Union Advisory Committee (CUAC) to advise the Minister of Finance about the improvement of the management of credit unions and the protection of the interests of their members and creditors.

Since 2008, the Irish government has put in place measures aimed at strengthening CUs and the framework available to the regulatory authority, the Central Bank of Ireland (CBI). These include the establishment of the Commission on Credit Unions in 2011 (now disbanded after fulfilling its role[75]), the Credit Union and Co-operation with Overseas Regulators Act of 2012, which amends the Credit Union Act of 1997 and the Credit Union Restructuring Board (ReBo) in 2013 (which completed its restructuring operations in March 2017). Voluntary restructuring has continued in accordance with the legislative provisions under the Credit Union Act. Other measures include establishing the implementation group to oversee the implementation of CUAC's recommendations of 2016[76] (still active in 2018), and the introduction of a statutory stabilisation support scheme.

Financial cooperatives' architecture and their importance within the banking system

According to the law, Irish credit unions are societies of natural persons constituted to provide their members with financial services for their mutual benefit (in particular savings and credit), to provide the training and education of its members in the wise use of money, and in their economic, social and cultural well-being as members of the community.

As of September 2017, there were 272 standalone credit unions operating in Ireland. These provide their members with a broad range of financial services, primarily loans, deposits and savings with some credit unions also providing additional exempt services such as personal retirement accounts, home banking, financial counselling, and insurance, ATM, money transfer and payment services. Only members can operate with a CU and they are required to have a common bond (such as a particular occupation, location or employer) to do so. To provide additional services that are not exempt from additional services requirements and that are of mutual benefit to their members, CUs must apply to the central bank to seek approval.

[74] There are also for example a small number of friendly societies, some of which may have a financial aspect.

[75] The purpose of the Commission for CUs was to review the future of CUs and to make recommendations in relation to the most effective regulatory structure. Over 60 recommendations were made and implemented.

[76] Following a review of the implementation of the recommendations of the Commission on Credit Unions, CUAC published a report setting out a number of recommendations including a recommendation that an implementation group be established to oversee the implantation of the report's recommendations.

Total assets held by the CUs at the same date were USD 19.8 billion or 4.9% of the assets of the Irish banking system. They also hold USD 16.4 billion of deposits (5.8% of the system) and loan portfolios totalling USD 5.3 billion (2.0% of the system). The three largest CUs hold together USD 1.3 billion of assets, less than 7% of all assets held by credit unions. Despite their relatively low market share and small average size, credit unions have 3.3 million members while Ireland has a total population of about 4.8 million.

Almost all CUs are members of one of the two non-regulated representative bodies: the Irish League of Credit Unions, which has around 250 members; and the Credit Union Development Association, with 14 owner-member CUs, established in 2003. Both are industry bodies that provide a range of services to their members, including services related to business support, information and communication technology, human resources, product development, marketing, insurance services, and contract maintenance. The ILCU provides a range of insurance services through a number of insurance providers including its own insurance company.[77] It also owns and operates a savings protection scheme that it describes as being available to proactively intervene to help any CU experiencing financial difficulties.

Governance arrangements

Credit unions operate as independent and autonomous legal entities. The Report of the Commission on Credit Unions included recommendations regarding the strengthening of governance practices. Some of the corresponding requirements were already in place prior to 2013, while others were included in the revision of the Credit Union Act. The resulting regime currently includes detailed and comprehensive[78] requirements designed to improve governance practices. These emphasise the separation between executive and operational roles, which are to be performed by the CEO or manager, the management staff and staff and voluntary assistants, and the non-executive or governance roles which are performed by the board of directors. They also include detailed requirements with regard to internal audit, risk management and compliance.

CUs are required to constitute a volunteer board of directors, a senior management team, whose CEO cannot be a board member and, since 2013, a volunteer "board oversight committee" to assess whether the board of directors has been operating in accordance to its legal responsibilities and governance standards.

The board of directors determines strategy and policies while senior management executes them. An oversight role is performed by the board oversight committee, with the assistance of the risk management, compliance officers, internal and external auditors. Additionally, the board of directors can put in place up to three different committees: an audit, a risk and a remuneration committee. In practice, this is more likely to happen in larger entities.

The key decision-makers of a credit union are the directors of the board. These are in charge of setting and reviewing the strategic plan; appointing the high-level managers, the risk management officer and the compliance officer. They are also responsible for ensuring that management is effective, for succession planning, for conflict of interest mitigation policies and for ensuring compliance with all requirements imposed by law and regulation.

77 These include loan protection, repayment protection insurance, life savings insurance, home, car and travel insurance, private health insurance schemes and death benefit insurance.

78 For instance, the board of directors is required to meet at least 10 times a year and the interval between two meetings cannot exceed six weeks. Each meeting must have a detailed agenda established by the secretary of the CU and circulated sufficiently in advance together with supporting information where necessary. The secretary must keep minutes of all board of directors' meetings, with decisions, discussions and points for further action being documented.

The main supervisory concerns about the CUs are set out publicly on the CBI's website.[79] As underlined by this report, the issues identified can be found in CUs of all sizes, not only in the smaller entities. The most frequent ones relate to weaknesses in governance, risk management, and operational capabilities. Examples of operational risks identified include failure to test business continuity plans with some credit unions failing to implement a business continuity plan, weak anti-money laundering and combating the financing of terrorism frameworks, weak bank reconciliation processes and a lack of formal remediation plans to address findings of internal reports.

Regarding governance itself, the main concerns are the board of directors' lack of strategic focus with evidence of poor-quality discussion and a lack of challenge at board meetings and lack of awareness of and ineffective engagement with internal audit, risk management, and compliance functions. A related concern is the lack at many CUs of an adequate framework to review the performance of individual directors, senior managers and key staff members.

Lack of renewal of board members is an issue in some credit unions and this is the reason for the introduction of term limits for members of the board and members of the board oversight committee in the Credit Union Act in 2013. Credit unions are also required to have a nomination committee which is responsible for ensuring that there is an appropriate succession plan in place for the board of directors. Low attendance at AGMs is a big issue. A policy paper exploring alternative means of voting by members was published in December 2017 by CUAC. It proposed proxy voting and electronic voting as potential means of increasing member participation in CU AGMs.[80]

Regulatory and supervisory frameworks

The CBI regulates most of the firms that provide financial services in Ireland, including banks, insurance and reinsurance firms, investment firms, funds and payment institutions. While commercial banks are licensed by the European Central Bank (ECB)[81] and significant banks fall under the supervision of the Single Supervisory Mechanism (SSM), the CBI is the sole authority for registering, regulating and supervising all credit unions in Ireland. CUs are excluded from the scope of the Capital Regulation Directive by way of an exemption.

CUs are supervised by a dedicated unit of the Central Bank of Ireland – the Registry of Credit Unions (RCU).[82] They are subject to a separate regulatory framework which includes specific legislation (the Credit Union Act 1997) and regulations issued by the Central Bank through the RCU, setting out the

79 See the Central Bank of Ireland's website for more on these concerns and the corresponding governance requirements at www.centralbank.ie/docs/default-source/Regulation/industry-market-sectors/credit-unions/communications/supervisory-commentary/credit-union-prism-supervisory-commentary--march-2018.pdf?sfvrsn=4.

80 See the Policy Paper on "Alternative Means of Voting by Members" at www.finance.gov.ie/wp-content/uploads/2018/01/180119-Alternative-Means-of-Voting-by-Members-website.pdf.

81 The European Central Bank (ECB) is the competent authority in Ireland for the granting of banking licences in accordance with Section 9 of the Central Bank Act, 1971 (as amended). In relation to applications for authorisation under Section 9A of the Central Bank Act, 1971, by relevant credit institutions headquartered in a non-European Economic Area country or territory, referred to as "Third Country Branches", the Central Bank of Ireland (Central Bank) is the competent authority for granting such authorisations.

82 In May 2003, the Irish Financial Services Regulatory Authority (IFSRA) was established as the sole regulatory authority for all financial service providers in Ireland, including credit unions, and the registrar operated within the framework of IFSRA. This change saw the transition of the credit union sector from effective self-regulation to a regulatory regime consistent with other financial services providers including the introduction of new regulatory requirements, guidance notes, reporting requirements and inspection programmes for the credit union sector. In 2010, a new single unitary body – the Central Bank of Ireland – responsible for both central banking and financial regulation – was provided for in legislation, with credit unions now regulated and supervised by a registrar of credit unions, which is a statutory function within the Central Bank of Ireland.

registration and operational requirements of these entities regarding licensing (registration), governance, regulation and supervision. CUs are subject neither to the ECB SSM nor to the Capital Requirements Directive IV (CRD IV).

Accordingly, the main prudential requirements for CUs differ from those applicable to commercial banks. They are, however, similar, simpler and often more prescriptive, illustrating the case for proportionality. The main prudential requirements are set by simple ratios such as:

- Capital ratio of 10% of total assets. Capital is comprised entirely of retained earnings from current and previous years. CUs are also required to hold separate, distinct and additional reserves for operational risk, as assessed by each institution.[83]
- A minimum liquidity ratio whereby CUs are required to hold a proportion of their total assets in liquid form. The proportion of liquid assets varies according to the nature, scale and complexity of the CU and the composition and maturity of its assets and liabilities. The definition of liquid assets is strict.[84] CUs are required to maintain a minimum liquidity ratio of 20% of their unattached savings[85] in liquid assets. However, any CU wishing to increase its lending over a period of five years to more than 20% of total loans outstanding must meet additional and increasing liquidity requirements, therefore controlling the amount of leverage and of maturity transformation that CUs can engage in.[86]
- A related party and large exposures limit whereby a credit union may not make a loan to any borrower, or a group of borrowers who are connected, that would cause the credit union to have a total exposure of greater than EUR 39,000 or 10% of its regulatory reserve.

The CBI also makes use of the proportionality principle to tailor the intensity of its supervision, using both the risk profile and the systemic importance of individual CUs. The risk-based framework used to assess CUs is the "Probability Risk and Impact System" (PRISM), which is also used to assess the risks of commercial banks. PRISM assigns all regulated entities to one of four possible impact categories: high, medium high, medium low and low. Out of 254 FCs operating as of 30 September 2008, 53 are categorised as medium-low impact (asset size from EUR 101 million to EUR 499 million) and the others, 201 entities, as low-impact (asset size less than EUR 100 million). The largest CU in operation in Ireland has total assets of EUR 476 million. Impact category drives the frequency of minimum supervisory engagement with credit unions.

Supervisory reporting is standard for all credit unions. Reporting requirements for credit unions different to those of commercial banks, being tailored to the credit unions' business models and complexity. As credit unions are not subject to CRD IV, they are not subject to Pillar 3 disclosure. However, at each AGM, the board of directors must lay before the credit union the accounts for the financial year in respect of which the meeting is held and a copy of those accounts must be delivered, along with a notice of the meeting to every member.

83 Anecdotal evidence suggests that these additional reserves correspond on average to a further 0.54% of total assets.

84 In addition to cash, liquid assets are comprised of investments with a maturity of less than three months and Irish and EEA government bonds, bank bonds and supranational bonds which have a maturity of greater than three months. A haircut is applied to bonds with a maturity of greater than three months, depending on the remaining time to maturity of the bond, where such bonds qualify as liquid assets.

85 "Unattached savings" means the total amount of members' funds, however, described in the records of the credit union, which are not attached to loans or otherwise pledged as security and are withdrawable by members.

86 For instance, when lending over five years exceeds 20% of total gross loans outstanding and up to 25%, the minimum liquidity ratio is at least 25%.

Since June 2017, credit unions must submit data on all consumer loans of EUR 500 or more to the central credit register (CCR).[87] Credit unions must submit an enquiry to the CCR for all loan applications for EUR 2,000 or more. As this is a legal requirement, RCU supervisors will look for evidence that CCR checks have been carried out by credit unions when conducting loan reviews during on-site inspections.

Capital sources

Nearly all of the capital of Irish CUs is made up of retained earnings. CUs are not allowed to issue capital instruments. All the capital held by the financial cooperatives must be perpetual and fully available to absorb losses. Therefore, the reserves must be unrestricted, non-distributable, permanent, and rank below all other claims in the event of a liquidation.

Evolution of business models and competitive challenges

The aggregate loan portfolio of all CUs represents only 27% of total assets on average. The vast majority of loans (94%) is made up of unsecured personal lending with maturities of less than five years. This activity is under increasing competition from both commercial banks and new entrants. To succeed in this business environment, significant IT investments are required to meet the potential consumers' expectations about faster transactions, electronic marketing and digitised distribution channels.

The main competitive advantages of credit unions are their high level of personal customer contact and the fact that they are exempt from paying "corporation tax" as not-for-profit organisations and according to the Finance Act of 1998. On the other hand, the average age of CU members is increasing. Attracting new and younger members that seek to borrow from CUs requires large investments in digital services and product diversification, but many FCs may not have the size and resources to do so.

These challenges have led to a significant amount of voluntary restructuring through mergers and take-overs. This is reflected through the decline in the overall number of active CUs, from 406 in 2011 to 253 in November 2018 (–37%), with most of the transferred credit unions becoming branches of a larger one following the merger. In some cases, shared services are emerging among the CUs in an attempt to take advantage of economies of scale and to access IT and technical expertise that may be too expensive for a small CU on its own.

Safety net and deposit protection

There are two separate schemes in Ireland, one for deposit protection and one for providing emergency liquidity.

The deposit guarantee scheme (DGS) is regulated under the EU DGS Directive, which protects depositors in the event that a bank, building society or credit union authorised by the central bank is unable to repay deposits. The Irish DGS is administered by the CBI and funded by the institutions covered by the scheme. This deposit insurance protects eligible deposits up to EUR 100,000 per person per institution. The contributions are calculated by the Irish DGS for each insured institution based on its degree of risk and level of covered deposits, in line with the European Banking Authority (EBA) guidelines.

The second mechanism is the marginal lending facility, where CUs can obtain overnight liquidity from the central bank against eligible assets. To be qualified for open market operations, the financial institution has to hold minimum reserves for this purpose and must apply to become an eligible

[87] The central credit register has been established by the Central Bank of Ireland under the Credit Reporting Act of 2013. See www.centralcreditregister.ie/.

counterparty. Although the CUs hold the minimum reserves, to date no credit union has been approved as an eligible counterparty. Therefore, they are still not eligible to use this last resort scheme.

Liquidation and insolvency arrangements

In the years following the 2008 financial crisis, the CBI has acquired significant experience regarding liquidation and insolvency procedures. The Credit Institutions (Resolution) Act 2011 (the "2011 Act") aims to resolve authorised credit institutions that are failing or likely to fail and provides the Governor of the Central Bank (the "Governor") with significant resolution powers. Since 2015 and the transposition of the Bank Recovery and Resolution Directive (BRRD) by the European Union (Bank Recovery and Resolution) Regulations (S.I. No. 289 of 2015), the 2011 Act applies to credit unions only, except Part 7 of the 2011 Act, which applies to the winding up of credit institutions as well as credit unions.

The CBI also has in place a comprehensive supervisory framework for managing problem institutions. When supervision procedures detect an institution posing a significant risk, with this being characterised by a deterioration in its financial position or breach of minimum capital requirements, the troubled institution is put on a "watch list" and intensive supervision, conducted by the "intervention and restructuring team" of the RCU, takes place. As part of intensive supervision, a range of regulatory actions may then be taken with the objective of addressing the financial weaknesses in a credit union to include, as appropriate, restrictions on a credit union's business activities and the repayment of a portion of members' savings. If the specified measures fail to address the financial weaknesses, then the credit union will be required to seek external financial support to restore its capital.

A credit union seeking to restore its capital position can seek to avail itself of the statutory credit union stabilisation fund (SSF). The SSF allows the Minister for Finance to provide stabilisation support to credit unions, subject to the minister's consideration of a formal recommendation by the CBI that such support should be provided. The CBI's recommendation to provide support is based on an assessment that the credit union is viable and holds a minimum regulatory reserve ratio of between 7.5 and 10% of total assets. This mechanism, funded annually by the covered credit unions, is targeted at credit unions that are undercapitalised but still viable and is intended to be used at an early stage. The provision of such statutory stabilisation support constitutes state aid and, as a result, is repayable and subject to interest charges.

There is also a private sector funding option for credit unions affiliated to the ILCU from the ILCU's Savings Protection Scheme (SPS) in order to restore capital to meet regulatory requirements. This funding is typically provided in circumstances where the credit union completes a transfer of engagement to another credit union, with funding provided to restore the capital position immediately prior to the completion of the transfer. The CBI oversees this process from the point of view of ensuring that the capital support provided meets regulatory requirements.

Finally, the CBI will consider the use of resolution powers should the credit union fail to restore its reserve position through implementing supervisory actions, or obtaining external funding through the SSF or the SPS. The Credit Institutions Resolution Fund (CIRF), which was established by the 2011 Act and initially funded through an advance from the Minister of Finance, is currently funded by levies on credit unions. It is triggered to provide funds for the resolution procedures for failing or likely to fail entities. The resolution actions provided for under the 2011 Act are the creation of bridge banks, the directed transfer of assets and liabilities of a credit institution, and the appointment of a special manager. Powers on liquidation of a credit institution are also set out in Part 7 of the 2011 Act.

The Governor is responsible for the exercise of the functions of the central bank under the 2011 Act. In delegating any function, the Governor shall endeavour to ensure that the performance of that function is operationally separate from the regulatory and supervisory responsibilities of the Bank. In order to use the resolution powers contained in the 2011 Act, a number of "Intervention Conditions" covering in particular failure by a credit union to address significant regulatory breaches, serious threats to financial stability and determining that immediate winding up is not in the public interest, must be met and for a directed transfer that the proposed transfer must be "necessary in all the circumstances". One resolution power that can potentially apply to CUs is a directed transfer, which is a court-approved order transferring all or some of the CU's assets and liabilities to another financial institution. In practice, however, most of the restructuring of the credit union sector involving transfers between 2001 and 2017 has involved voluntary transfers of engagements, whereby a credit union voluntarily decides to transfer its engagements to another credit union.

Annex 7 – Financial cooperatives in Kenya

Historical background and legal framework

The first cooperative in Kenya was established in 1908 but membership was initially limited to colonial settlers. Africans were allowed to form and join cooperatives when the Co-operative Societies Ordinance was enacted in 1945. However, it was only in the early 1960s that the first financial cooperative was registered in Kenya.

The primary law that governs FCs is the Co-operative Societies Act CAP 490 (CSA), which applies to all kinds of cooperatives, was published in 1966 and revised in 1997. In addition to the CSA, the FCs are governed by a special law, the SACCO Society Act of 2008 (SSA).

In 2008, the Kenyan government launched a development programme entitled "Kenya vision 2030" to be implemented in successive five-year medium-term plans (MTP). It aims to promote a competitive, sound and efficient financial system. Means of achieving this include developing and implementing a strategy for consolidation of the FCs since they play a significant role in increasing financial access in an effective and cost-efficient manner.

Financial cooperatives' architecture and their importance within the banking system

There are nine types of cooperative society in Kenya. Three of them offer financial services to their members: these are savings and credit cooperative societies (SACCOs), the land/housing cooperatives societies and investment cooperative societies. Only cooperatives belonging to the first category have the option of collecting deposits from their members. The deposits collected by SACCOs fall into two categories: non-withdrawable deposits (or share deposits) and withdrawable or demand deposits. All SACCOs start by collecting share deposits. Where the FC elects to collect demand deposits, it becomes a "deposit-taking savings and credit cooperative society" (DT-SACCO). The total net assets held by the DT-SACCOs as of December 2017 were USD 4.4 billion (SASRA 2017 Annual Supervision Report), and this accounts for three quarters of the total assets for SACCOs in Kenya.

All cooperatives, regardless of their type, must be registered and incorporated under the general law, the CSA, but not all of them are supervised under this act. DT-SACCOs are licensed, regulated and supervised under a special law (the SACCO Societies Act – or SSA), and report to a specific regulatory agency, the SACCO societies regulatory authority (SASRA), created by this act. The rest of this annex focuses on DT-SACCOs only.

The CSA defines the general objectives of all cooperatives operating in Kenya, which is to promote the welfare and economic interests of its members. Cooperatives' members must have a common geographical bond although DT-SACCOs may operate nationally. This is especially the case for the larger ones. However, DT-SACCOs can only transact with members.

As of June of 2018, 174 standalone DT-SACCOs were operating in Kenya and providing their members with a range of traditional banking services such as deposit accounts, loans (consumer, mortgage, agriculture, business and education loans), transactional services (cash in/out), electronic payments processing in partnership with a bank (debit cards, mobile payments and cheques).

Although the law allows the establishment of secondary and tertiary cooperatives, there are only three secondary entities. The most prominent is the Kenya Union of Savings and Credit Cooperatives. This non-regulated entity mainly represents its members and offers advocacy and "central services" by being a central financial fund (to provide time loans to their associate DT-SACCOs), a credit insurance fund (by insuring the loan portfolios of its associates) and a housing fund to its associate members.

The other two, the Cooperative Bank of Kenya and the Cooperative Insurance Company of Kenya Ltd (CIC Group), are demutualised entities which are listed in the Nairobi Securities Exchange and supervised by the Central Bank of Kenya and the Insurance Regulatory Authority, respectively. Both entities provide financial services and consultancy to the affiliates and their members, and they share their platform with their affiliates for data processing purposes.

DT-SACCOs play a significant role in the Kenyan deposit-taking market. As of December 2017, they held about 11% of the system's assets (USD 4.3 billion), made 13.5% of the loans (USD 3.2 billion) and had collected more than 10% of the deposits (USD 2.9 billion). Concerning penetration, DT-SACCOs have some 3.6 million members for a total population of around 50 million. DT-SACCOs are relatively concentrated since 21 of them (12% of the total number) hold about 60% of all assets held by DT-SACCOs.

Governance arrangements

Governance structures include boards of directors and supervisory committees. Members of the boards of directors and of supervisory committees are elected during AGMs by members of each SACCO, with each member having only one vote irrespective of the number of shares or the amount of deposits that he/she might hold. The AGM also appoints the external auditor from a list of approved SASRA candidates.

Board and committee members are volunteers but they receive allowances to attend sessions besides reimbursements for costs. Board members can be paid if such a provision is allowed by the statutes and approved at the AGM. Once elected, the board of directors appoints the senior management team including the CEO. The supervisory committee exercises oversight on both the senior management team and the board of directors. The oversight exercised on the board seeks to ensure that it implements the wishes of the members as expressed in the bylaws, business plans and AGM resolutions. The supervisory committee reports to the members during the AGM.

The board is responsible for strategic decisions and the senior management is responsible for their implementation. To promote better coordination between these bodies, the CEO can attend the board meetings but has no voting rights. Internal auditing must be performed by an internal auditor who reports directly to the board on internal control systems and financial matters.

One of SASRA's main corporate governance concerns relates to the low level of awareness by boards of directors of the increasing business risks as SACCO business grows and evolves to retail banking. Thus, there is little sense of urgency in most DT-SACCOs to elect directors based on their competences, expertise and on their knowledge of the strategic needs of the SACCO business. Ageing and the lack of renewal of board members and members of senior management teams are related concerns. These undermine the ability of most DT-SACCOs to build human and technology capacity to adequately address industry-wide risks such as operational and IT risks, and imposes limits on their ability to manage their liquidity risks. Low attendance at AGMs is also an issue for FCs, regardless of their size.

Regulatory and supervisory frameworks

DT-SACCOs are created, registered and liquidated under the general Co-operative Societies Act. As of June 2010, they are also licensed, regulated and supervised under the SACCO Society Act when SASRA, the regulatory authority was established. The creation of SASRA was driven by the increasing risks to members, as SACCO businesses evolved and developed into retail banking activities. SASRA is responsible for the prudential and market conduct aspects of the regulation of DT-SACCOs. All other types of cooperative society operate under the CSA and are supervised by the State Department of Cooperatives, including the non-DT-SACCOs.

The regulatory framework for DT-SACCOs applies a proportionality principle. It differs from that applicable to commercial banks with simpler – but generally higher than those applicable to commercial banks – regulatory requirements that essentially recognise their specificities. The main requirements are the following:

- Minimum entry capital requirement: KES 10 million (around USD 100,000);
- Minimum capital requirement: 10% of total assets;
- Minimum "institutional capital ratio" (retained earnings)/(total assets) ≥ 8%;
- At least 15% of total assets must be held in liquid assets;
- No more than 5% of total assets can be held in fixed and non-income producing assets;
- The amount of money lent to a single member cannot exceed 10% of the core capital; and
- The risk classification of assets, based on the number of days in default, leads to required provisioning rates. Loans in arrears for 360 days or more are classified as a loss and must be provisioned at 100%.

Regarding its supervisory procedures, SASRA runs on-site and off-site examinations based on the CAMEL rating system. In practice, the risk-based supervisory framework – which is still under development – is a blend of compliance-based and risk-based supervision.

Both the federal government and county governments are involved in the oversight of DT-SACCOs. The State Department of Cooperatives nominates a commissioner for cooperative development. This commissioner is in charge of the registration, the creation and the liquidation of all cooperatives, including the DT-SACCOs. Therefore, when SASRA identifies a troubled DT-SACCOs which should be liquidated, the authority submits the situation to the commissioner. SASRA regularly reports its main supervisory findings to the State Department of Cooperatives.

SASRA has seven board members, three of whom represent public officers namely the commissioner for cooperative development, the principal secretary (or representative) for the Treasury and the Governor of the Central Bank of Kenya. The chairman is appointed by the Kenyan president while the other three members are appointed by the cabinet secretary responsible for cooperatives.

In addition, each of the 47 Kenyan counties has its own department in charge of developing and supervising cooperatives. These usually perform on-site work, including the attendance of general annual meetings, where the local authority provides the attending members of AGMs with guidance regarding the proper conduct of the session, electoral process, legal and statutory compliance.

Capital sources

Member shares and retained earnings are the primary source of capital but, in Kenya, unlike other jurisdictions, the first is the most important one. This is because FCs distribute a great part of their annual surpluses to the members impairing their ability to retain earnings. Member shares cannot be redeemed unless the DT-SACCO is liquidated and, in an operating cooperative, they can only be transferred to another member.

However, as retained earnings are considered the best way to increase an FC's capital base, the larger cooperatives are seeking to limit the annual distributions of surplus. The SASRA has a specific capital requirement, noted above, by which a DT-SACCO has to keep a ratio of "institutional capital" (retained earnings to total assets), above 8%. The authority has realised this requirement might be too high for the smaller entities and is running some additional studies to fine-tune this model.

DT-SACCOs are authorised by law to issue debt instruments that could count towards regulatory capital. However, the prudential authority has not to date issued the relevant regulation determining the terms and conditions that these instruments would need to fulfil to be eligible as regulatory capital. Therefore no capital instruments have been issued to date by FCs in Kenya.

Evolution of business models and competitive challenges

The FCs in Kenya operate according to a traditional "credit union" model. They do not offer sophisticated financial products. They provide their members with everyday banking services, primarily deposit services and loans. One unusual feature is that the aggregate loan portfolio (USD 3.2 billion) of all DT-SACCOs exceeds the aggregate size of their deposits (USD 2.9 billion), with the difference being funded with capital and external borrowings. Another feature that is particular to Kenya is that compared to most other countries FCs play a larger role in mortgage lending. .

The FCs are exempt from income tax on their interest income. This is taxed at a rate of 5% at the individual member level, something that is considered to be a significant tax benefit for members of FCs. In addition, since the middle of the 2000s and to take advantage of this, the larger DT-SACCOs have started to operate nationally, allowing any individual to join them.

However, FCs do not have access to deposit insurance nor do they have direct access to the payment system. The latter in particular limits their activities since they are obliged to partner with a bank to offer electronic transactions and more generally to offer access to payments systems to their members. In an attempt to offset this situation, the largest DT-SACCO recently acquired a commercial bank with the expectation of enhanced deposit collection from the acquisition.

FCs are under high competitive pressure in the local banking system. Over the last decade, commercial banks and fintechs have increased their role in financial inclusion. The relative importance of DT-SACCOs, which were previously the preferred choice for specific parts of the population, has declined as a result, especially among the younger population.

The average age of existing members is rising and FCs are facing increasing difficulties in renewing their membership and in attracting younger members. This is largely because commercial banks and new entrants offer a broader range of products and financial services. The use of technology by banks and fintechs has also enabled these institutions to become more reactive. They can deliver (almost) instant credit and open online accounts within a few hours, therefore making DT-SACCOs less attractive as loan providers and deposit-takers, especially to younger customers.

There is also significant competition between the FCs themselves, because the larger ones, by opening common bonds and branching out across the whole country, are putting pressure on the small ones. Even secondary cooperatives, when operating with their associates' members, compete with the associated DT-SACCOs in some respects[88] showing that, to some extent, there is predatory competition within the two-tier arrangements.

[88] DT-SACCOs provide retail banking services that are similar to those provided by Cooperative Bank of Kenya. It is not uncommon for SACCO members to have an account with both the SACCO and the Cooperative Bank.

Safety net and deposit protection

FCs do not have institutionalised deposit insurance, liquidity or resolution frameworks. However, there are ongoing initiatives to evaluate the creation of a specific framework for central liquidity and operationalising the deposit insurance fund.

Liquidation and insolvency arrangements

The prudential authority (SASRA) is responsible for resolving troubled DT-SACCOs. To this effect, it has the same enforcement powers as the banking supervisory authority. These include requiring capital restoration plans, constraining activities, imposing sanctions, removing individual managers/board members or the whole management team or the whole board of directors of the entity and revoking the license. Although responsible for determining the resolution strategy and for triggering the resolution process, the supervisory authority must petition the State Department of Cooperatives in the case of a liquidation, as this is the authority responsible for taking such a measure under the CSA.

SASRA cannot force DT-SACCOs to merge. However, it has the power to take control of a troubled FC at an early stage and putting it under statutory management. Triggers for such intervention include the institution failing to meet with the supervisory determinations, not operating in members' best interests, failing to overcoming financial problems or failing to comply with prudential requirements.

Triggers for using such a measure include excessive deterioration in the cooperative's performance or embezzlement of funds by the board or the senior management. The decree placing the institution under statutory management is a discretionary administrative act which has to be renewed every six months through a court order.

Annex 8 – Financial cooperatives in South Africa

Historical background and legal framework

In South Africa, financial cooperatives are fairly recent and relatively small. An FC usually starts its business as a "Co-operative financial institution" (CFI) operating under the Co-operative Act no. 14 of 2005 (Co-operatives Act) and an Exemption Notice to the Banks Act.[89] If its deposits rise above a pre-determined threshold, it has to apply to become a "cooperative bank" (COB) under the Co-operative Banks Act of 2007 (Co-operative Banks Act).

In 2011, the National Treasury published a document entitled "A safer financial sector to serve South Africa better" to outline four policy priorities, namely: financial stability, market conduct and consumer protection, financial inclusion and combating financial crime. After highlighting the vital role the financial sector plays in bringing a better life to all South Africans, also stating the financial industry needs to do more than safeguarding financial stability to support the real economy, the document emphasises the role of cooperative banks, through financial inclusion, to expand the access of the South African population to the financial services.

89 Since August 2018, CFIs have been regulated and supervised by the Prudential Authority in terms of the Co-operative Banks Act of 2007.

Financial cooperatives' architecture and their importance within the banking system

The Co-operatives Act defines a CFI as a "co-operative whose main objective is to provide financial services to its members". The Co-operative Banks Act, which applies to Co-operative banks, requires a common bond to be a member of a cooperative bank and defines the financial services these types of institutions can provide to their membership such as taking deposits, conducting money transfer, providing trust or custody services and lending.

As of 2017, 26 standalone FCs were operating in South Africa, including three cooperative banks. Although the law allows for the establishment of secondary and tertiary cooperatives to serve their members (primary and secondary cooperatives, respectively), there is currently only one relevant secondary entity, the National Association of Co-operative Financial Institution of South Africa (NACFISA).

NACFISA is registered in terms of the Co-operatives Bank Act as a representative body. It provides its members with representation and advocacy, also offering some demand-driven support services such as capacity-building and mentorship, technological and accounting support, advice and counselling, product development and marketing, management information systems, audit preparations and education and training for staff and board members of FCs.

The importance of FCs in the overall financial system is limited, although they play a crucial role at local levels. Their total aggregate assets are slightly less than USD 26 million, while the banking system holds around USD 400 billion as at December 2017. There is a total of 27,831 CFI members compared with a total population of around 57 million.

Governance arrangements

The FCs have to constitute a board of directors (governing function) and a supervisory committee (oversight function). The later must have at least three members that exercise oversight over the board and the senior management. These bodies are elected at the AGMs where each member has the same voting rights regardless of the number of shares he/she holds. Once elected, the board of directors appoints the senior management team.

Senior managers can participate in board meetings as directors but have no voting rights. Regarding compensation, the executive director can be an employee of the FC depending on the FC's constitution. All executive directors are currently unpaid volunteers, although they are reimbursed for expenses.

The supervisory committee selects the external auditor and proposes its nomination at the AGM for acceptance. Internal auditing is usually performed by the supervisory committee itself. However, depending on the size of the operations, an FC can hire consultants to conduct internal audits. To limit tenure, the law makes board rotations mandatory.

The main supervisory concerns regarding corporate governance relate to the capacity and qualifications of board members, senior management and members of the supervisory committee.

Regulatory and supervisory frameworks

The Financial Sector Regulation Act (FSRA) was published in August 2017 and it illustrates the scope of the transformation that the South African regulatory and supervisory environment is going through. The shift is a move from a system with multiple and specialised prudential and market conduct regulators to the twin peaks model with two regulators respectively responsible for prudential supervision and market conduct. According to this model, all of the deposit-taking institutions will be regulated and supervised by the Prudential Authority and a Financial Sector Conduct Authority. The Act also enables close collaboration between these two financial sector regulators and the South African Reserve Bank. The

Prudential Authority commenced with the supervision of all deposit-taking financial institutions in April 2018 and was empowered to commence supervising CFIs in August 2018.

As typically happens when legislation that redesigns the whole financial regulation framework is introduced, time is needed to determine how this new framework will fully apply in practice. This is especially the case for licensing, enforcement powers and troubled-entities resolution procedures. Until implementation issues related to these topics are clarified, the Co-operative Banks Act and most existing regulations and supervisory procedures remain applicable to FCs. However, FCs' deposit-taking operations are already regulated and supervised by the Prudential Authority (PA) and the Financial Sector Conduct Authority (FSCA).

The regulatory framework for FCs differs almost entirely from that applicable for commercial banks. It applies proportionality with simplified (but generally higher) regulatory requirements. The framework has two tiers: one for CFIs and another one for COBs. The main features of the regulation for FCs in South Africa are:

- Entry-level CFIs have to comply with simplified standards while the application for a COB will be accepted when certain operational, financial and human resource thresholds are met;
- Minimum entry capital for a CFI: USD 7,700, with at least 200 members, and the entity can operate as a CFI until it takes a maximum amount of deposits of USD 3.8 million. To continue operating once this amount is exceeded, it needs to apply for a COB's license;
- Minimum capital/leverage ratio: 6% of total non-risk weighted assets (net of provisions), plus an additional capital charge representing 2% of all loans outstanding (both performing and non-performing);
- Liquid assets ratio: at least 10% of total assets must be held in liquid assets (government and bank securities with a maximum maturity of one month);
- A maximum of 5% of total assets can be held in fixed and non-earning assets (such as buildings, furniture or equipment);
- Large exposures limit: the amount of money lent to a single member or a group of related members cannot exceed 10% of total loans; and
- A supervisory framework regarding loan reviews, their classification and their provisioning sets standard rates of provisioning for all past due loans. These are based on how long each loan has been delinquent. All loans which have been delinquent for more than 12 months need to be fully provisioned.

The supervision of FCs also reflects proportionality with specific procedures and some differentiation between CFIs and COBs. Some of the most relevant features of the supervisory framework are summarised below:

- The Prudential Authority uses a risk-based approach. The objective is to conduct on-site examinations for each FC on a yearly basis;
- FCs are currently supervised through a specific early warning scoring system. FCs with more than USD 77,000 of deposits will be rated through a CAMEL system which is still under development;
- COBs are required to submit monthly returns while CFIs report on a quarterly basis;
- Before the FSRA, supervisory enforcement powers with regard to FCs were limited to licence revocation. With all FCs being subject to the FSRA Act, a broader set of enforcement measures will be available, allowing the Prudential Authority and the Financial Sector Conduct Authority (market conduct authority) to go beyond moral suasion; and

- Legal provisions contained in the FSRA enables the Prudential Authority to remove individual senior manager or board members under specific circumstances.[90]

Capital sources

Currently, FCs' capital is mainly constituted by member shares since, in their current situation, these entities are recent and have not had enough time to retain sufficient earnings. Share redemption is only possible when the member resigns, in which situation, as a matter of course, members receive the nominal value of their shares plus accumulated undistributed earnings. However, an FC can withhold payouts for up to two years if it is facing liquidity or solvency problems. Financial cooperatives in South Africa are not allowed to issue any debt security or any capital instrument except for member shares.

Evolution of business models and competitive challenges

FCs in South Africa have a traditional "credit union" model with only one secondary representative body. They have not engaged in any de-mutualising. They are at an early stage of integration in an attempt to improve business support. Financial cooperatives offer traditional and basic banking services to their members. To offer additional services, such as foreign exchange services, they must apply for authorisation but none has done so to date. FCs do not have any tax exemption and do not have access to the payroll of the public employees. Nowadays, only banks and certain payment system operators have access to state payrolls.

In practice, FCs can be divided into urban and rural FCs. The first group competes against the larger commercial banks, fintech companies and loan finance companies. Interest rates charged by these entities to customers are generally high. Most financial cooperatives are currently too small and lack scale to be really competitive, especially with regard to technologically driven alternatives where they may lack the necessary financial resources to invest in digital services or lack a sufficiently large customer base to make such investments worthwhile.

In rural areas, where customers generally require more personal contact, especially amongst the elderly, FCs are more demand-led. However, rural FCs operating in these areas typically lack people with sufficient financial expertise and with the ability to customise services.

Safety net and deposit protection

There is currently no deposit insurance mechanism for FCs. The Co-operatives Banks Act provides for a specific scheme for cooperative banks. Regarding liquidity, recently FCs decided to set up a secondary cooperative bank to provide themselves with such assistance.

Liquidation and insolvency arrangements

The Prudential Authority is responsible for the resolution of financial institutions for which it is the responsible authority. A framework is being developed for the South African Reserve Bank to take on the role of the resolution authority with regard to systemically important financial institutions and banks. For a CFI, the point of non-viability is triggered when the solvency ratio (assets divided by liabilities) falls below

[90] Specifically, once they are registered, these powers will allow the prudential authority to:

- apply to a court that a cooperative financial institution be wound up;
- recommend to the minister responsible for cooperatives that a cooperative financial institution be wound up; and
- apply to a court for a judicial management order.

110%. For a cooperative bank, it is triggered when its capital adequacy ratio (capital divided by total assets) falls below 6%. In both cases, the Prudential Authority begins a process of resolution or liquidation according to the Co-operative Banks Act read with the Co-operatives Act while the resolution/liquidation of a commercial bank follows the Banks Act read with the Companies Act.

In practice, before resolution frameworks are activated, the supervisor typically uses moral suasion to encourage mergers or voluntary liquidation. Other options include requiring members to provide additional capital or limiting the entity's ability to expand by preventing it from enrolling new members or taking new deposits.

Annex 9 – Financial cooperatives in the United States

Historical background and legal framework

Financial cooperatives are called "credit unions" (CUs) in the United States.[91] The first one was created in 1908, the Saint Mary's bank of Manchester, New Hampshire, assisted personally by Alphonse Desjardins, the Canadian FC pioneer. These entities became regulated in 1934 when the US Congress adopted the Federal Credit Union Act (FCUA). Since then, the FCUA has been amended a number of times, with the latest version being enacted on 24 May 2018.

Financial cooperatives' architecture and their importance within the banking system

Credit unions in the United States are societies constituted to provide their members with a full range of financial services. With regard to loan types, these include real estate, small business lending, auto loans, credit cards, and general consumer loans. Financial services provided include online banking, chequing and retirement accounts, debit cards, among others. When first enacted, the FCUA expected CUs to serve people of "modest means", a requirement which remains in place today.

As of March 2018, there were 5,646 first-tier financial cooperatives, also known as "natural person" CUs, operating in US financial markets with a federal or state license. In aggregate, these attend some 113 million members corresponding to approximately 35% of the American population. In the vast majority of situations, only members can be served by a CU, which is limited to operating in defined bounds of a common bond formed by an association or local community.

Credit unions commonly partner with two types of second tier facility. The first type is the "corporate credit union" (CCU). The second type is made up of "credit union service organisations" (CUSO). A CCU, the "credit union of the credit unions," helps their associates to enhance their efficiency through economies of scale. Examples of activities offered by CCUs include back office activities, financial settlements and transactions such as cheque clearing, automated clearing house, electronic fund transfers and ATM transactions. As of March 2018, six federally-chartered CCUs and five state-chartered CCUs were operating in the United States.

A CUSO is created to offer commercial and IT solutions to its CU members. The purpose is to provide them with access to services and/or products that a CU may not be able to provide for or afford on its own. Typically, a CUSO provides chequing, currency, clerical, professional, management, access to electronic platforms, financial counselling, fixed asset, loan support, insurance agency, leasing, record retention, security and disaster recovery, brokerage, trust agency, payroll processing services; and business

[91] This annex and paper concentrates on credit unions only. There are also over 490 mutual savings banks in the United States, with these holding total assets of USD 374 billion as of 31 March 2018. Mutual savings banks have no capital stock, as opposed to credit unions. They are operated by trustees solely for the benefit of the depositors, who receive as interest-dividends the earnings that remain available after payment of expenses and establishment of reserves against loss and surplus.

loan, consumer mortgage, student loan and credit card loan originations. There were 946 CUSOs operating in the United States by mid-year 2018. Both CCUs and CUSOs can structure and offer syndicated loans to their affiliates, therefore helping them to diversify their exposures.

A CUSO can also join a non-regulated third-tier entity, the National Association of CUSOs (NACUSO). In contrast, the CCUs do not count anymore on a third-tier FC since the US Central Federal Credit Union, founded in 1974 as the "corporate credit union's credit union", had to be placed into conservatorship by the National Credit Union Administration (NCUA) in 2009, as a result of the financial crisis, and was officially shut down in 2012.

US credit unions also have formed an association that represents them and provides them with lobbying, regulatory advocacy, professional development and services management. This is the Credit Union National Association, which is headquartered in Washington DC. Its membership includes both state-chartered and federally chartered CUs. The federal CUs can also join the National Association of Federal Credit Unions which provides their associates similar services.

A number of credit unions in the United States still focus upon serving low-income members and poor communities, as defined under the CU Act. They are generally known as community development credit unions. They are often members of the National Federation of Community Development Credit Unions (Federation), based in New York City. This association provides its members with advocacy, investments, technical assistance, education and training.

As of March 2018, aggregate total assets of all credit unions was about USD 1.4 trillion or 8.1% of the total assets of the US financial system. They held deposits worth USD 1.2 trillion or 8.9% of all deposits collected in the system, and had an aggregated loan portfolio of USD 972 billion, or 10% of the system. The largest credit union in the United States is the Navy Federal Credit Union with total assets of almost USD 90 billion or more than 6% of the total aggregated assets of all credit unions.

Since 2007, a significant amount of consolidation has taken place. There were 5,573 federally insured CUs operating in 2017 as opposed to 8,101 a decade earlier, a reduction in numbers of 31%. Concentration has helped these entities to face increased competition in financial markets through economies of scale. In fact, most of the reduction in the number of CUs can be explained by voluntary mergers between healthy institutions. When compared with 2007, and with fewer entities, total aggregated assets held by credit unions has increased 83% (from USD 755 billion to USD 1,379 billion) while their collective share in the total of all financial assets also increased from 5.8% to 7.9%, within a decade.[92]

Governance arrangements

Usually, CUs have to constitute a board made up of volunteers and a supervisory committee. They also have the option of setting up a credit committee. Members of all three committees are elected during the AGM. All members of a CU can participate in the AGM and each has a single vote. The board is responsible for determining the FC's policies and strategy, for hiring the CEO and the senior management team and for reviewing and assessing their respective performances.

The supervisory committee, also made up of volunteers, has overall responsibility for internal and external audits and for internal control oversight of operations, including hiring and working with an external audit firm. Larger CUs are required to have an audit performed by a certified public accountant. Smaller CUs may have a third-party perform the external auditing function or even have the supervisory committee conducting the audit itself.

The main supervisory concerns in this area are the inability of smaller entities to have an adequate level of segregation of duties to ensure adequate internal control practices, and the lack of sufficient

[92] These numbers and percentages come from the NCUA report "CREDIT UNION DATA SUMMARY 2017 Q4" and banking system total assets, https://ycharts.com/indicators/us_banks_total_assets.

knowledge of internal controls and oversight/control functions among the supervisory committee members at many credit unions.

Regulatory and supervisory frameworks

The regulatory architecture of credit unions has two tiers since they may apply for a federal or for a state charter. It therefore includes a federal agency - the National Credit Union Administration – and state supervisory authorities. Each of the state authorities is responsible for licensing and supervising state-chartered CUs, although five states do not charter and supervise state-licensed CUs so that, in practice, there are 45 state regulators. In these five states, a credit union wanting to operate there has to apply to the NCUA for a federal charter.

In 1965, the state regulators created the National Association of State Credit Union Supervisors (NASCUS). The NCUA was created in 1970 by an amendment to FCU Act. In addition to its licensing and supervisory duties, it is also the resolution authority for federally chartered and federally insured credit unions and it manages the National Credit Union Share Insurance Fund (NCUSIF). As of March 2018, 62% of all standalone credit unions were federally chartered (3,477) and 38% (or 2,169) had state charters. The federally chartered and state-chartered CUs each held about half of all assets of the sector.

State-chartered CUs can be insured by the NCUSIF or draw private insurance. In practice, 98% of all credit unions are federally insured with only 116 being privately insured state-chartered credit unions. The NCUA is the sole supervisor of all federally licensed credit unions. As the manager of the NCUSIF, it also has supervisory responsibilities in addition to those of the prime supervisor (the state regulatory authority) on almost all of the state-chartered CUs, so that they are almost all federally insured.

The NCUA licenses federal CUs, determines their prudential requirements, enforces them and supervises their risk management. Regarding the supervision process, based on a CAMEL rating system, the NCUA is the sole supervisory authority with full powers to conduct supervision at all stages, from licensing up to shutting down for the federally chartered CUs and CCUs. State authorities generally have regulatory and supervisory powers that are similar to those that the NCUA can apply to federally-charted CUs. Supervisory authorities have more limited oversight when supervising CUSOs[93] although they can influence them by exercising moral suasion on their owners.

The NCUA has a separate office that supervises the largest CUs (those with over USD 10 billion in assets) and five regional offices across the country. Some specific regulations apply to those, including a more robust capital stress testing requirement. A CU holding higher concentrations of long-term loans is required to hold higher levels of capital. As a rule, all FCs are subject to regular on-site examinations by either the NCUA or the state authority. Exceptionally, and for the smaller entities, the on-site supervision cycle can extend to eighteen months.

The US supervisory framework typically requires some inter-agency coordination to rationalise resource allocation, eliminate duplicative efforts and limit the supervisory burden on the CUs. Federal and state supervisors use a range of tools to coordinate their actions. These include coordinating the respective examination schedules and/or running joint on-site examinations, promoting common training and attending several annual face-to-face meetings to coordinate policies and harmonise procedures.

To take into account the state regulatory and supervisory frameworks and assess how they articulate with the federal framework, five states have been selected. These are California, Florida, Michigan, Texas and Washington. Together, and as of March 2018, these supervise some 604 CUs (about 28% of the total number of state-chartered CUs) with total assets of USD 284 billion (around 40% of the total assets of state-chartered CUs). Each state has its own credit union law. Four out of five of them have

93 The reason for this more limited oversight is that the US Congress has not provided NCUA with any supervisory authority over them.

a dedicated unit for supervising CUs within a state agency responsible for the supervision of all state-chartered financial institutions. Texas, however, has a specific agency for supervising CUs.

All of the state authorities have a broad range of enforcement powers. Four of them also have the ability to enforce involuntary mergers and three can limit credit unions' distributions to their members. All of them use some version of a CAMEL supervisory assessment system. They also typically assess and examine third parties performing critical functions for CUs, such as technology providers and CUSOs. Most state regulators have signed information-sharing or other MOUs with other state or federal agencies such as NCUA, Federal Deposit Insurance Corporation, Federal Home Loan Bank and other agencies of other states. However, they do not share common procedures.

There can be some significant differences between states with regard to regulation. Investments in CUSOs, for instance, are subject to ratios that limit the size of these investments. However, both the ratios and the level of the limits can vary significantly from state to state. For instance, limits determined through a ratio on assets may vary between 1 and 10% while investment limits referring to capital vary between 2 and 10%. There is a similar range regarding limits on fixed assets. These limits may be defined as a percentage of total assets (for instance 5%), of capital (for instance 10%), of total deposits (such as 5%) or determined as capped by net worth.

There are also regulatory differences between state jurisdictions regarding other topics such as board members' compensation, which for instance is allowed in Washington and Texas, and proxy voting in general meetings, which is allowed in California and Florida but not in Texas. Some states also have requirements regarding board meeting frequency. Such is the case in Michigan, where board members are required to meet at least every 62 days. Michigan also requires candidates for board membership to satisfy qualification criteria while Texas imposes ongoing training requirements for existing board members.

Capital sources

Nearly all credit unions' capital is originated through retained earnings since they are generally not allowed to issue capital instruments. Membership shares have small denominations, usually ranging from USD 5 to USD 50. They are treated as regular deposits, including for accounting purposes, and insured by the NCUSIF so that they do not count as capital. Accordingly, the net worth of CUs is almost entirely made of retained earnings with these representing on average 10.88% of total assets, as of March 2018.

Evolution of business models and competitive challenges

As making a profit is not their main goal, credit unions are exempt from federal income taxes. However, they are also subject to various types of limitations on their activities. For instance, unlike banks, they are subject to restrictions on membership with these limiting the potential size of their customer basis.

Credit unions compete with commercial banks in retail banking and lending to small businesses. Commercial banks contend that they benefit from an unfair competitive advantage by being exempt from federal income tax. The emergence of internet banking services is a competitive challenge that credit unions are addressing through the offering of their own online services. However, because fintech firms are – unlike CUs – not limited by membership requirements and are essentially "borderless", they may create a competitive challenge that CUs find more difficult to address. In addition, the larger credit unions tend to attract the younger members, because their products and services are more diverse and attractive to younger people.

Safety net and deposit protection

The NCUSIF, which is managed by the NCUA, insures deposits of credit union members. Insuring deposits with the NCUSIF is mandatory for all federally chartered CUs and optional for state-chartered CUs. In practice, although optional, the vast majority of the state-chartered CUs (2,053 out of 2,169), are federally insured.

Credit union deposits are insured up to a limit of USD 250,000 per account and per institution, just like commercial banks. The NCUSIF capital, approximately USD 13 billion, is composed by contributed capital from CUs (roughly USD 10 billion) and retained earnings (nearly USD 3 billion). Regarding the former, the insured CUs are required to keep apart a portion of their liquid assets corresponding to a percentage of their insured deposits, and make the corresponding amounts available for the NCUSIF to use it when necessary. This percentage, typically around 1%, is set by the NCUA, which is required by law to maintain an equity ratio of between 1.2 and 1.5% of total insured deposits. It currently stands at 1.39%. Should these resources become insufficient, the NCUSIF is also backed by the full faith and credit of the US government. Since the creation of NCUSIF in 1970, no depositor at a federal insured credit union has had to suffer a loss on an insured deposit.

Since all CUs are required to adhere to a deposit guarantee scheme, those who are not covered by the NCUSIF are obliged to seek private insurance. Some 116 credit unions are therefore privately insured by the American share insurance (ASI),[94] the primary private deposit insurance provider in the United States, which claims to insure the deposits of over a million of credit union members.

The NCUA can provide liquidity assistance through the NCUSIF, or the central liquidity facility, which operates as a form of a central bank for CUs. Credit unions also have access to the Federal Reserve System.

Liquidation and insolvency arrangements

The NCUA and state regulators have a range of supervisory powers to resolve problem credit unions that are similar to those used by banking supervisors. These powers include conservatorship, cease and desist order, removal of officials, civil money penalties, liquidation, prohibition to individuals from working in industry, suspension of operations, and less formal actions such as signed agreements with the credit union's board for resolution, such as a memorandum of understanding.

The supervisory agencies have the power to nominate a temporary administrator when taking over a credit union's operations as part of a conservatorship. This may include dismissal of the existing management team and board. They can also force credit unions to merge in cases where the merging CU is illiquid or insolvent, or in danger of insolvency.

When the weak entity is federally chartered, the NCUA conducts the merger process on its own. However, when the problem entity is state-chartered the state authority first tries to find a solution and a credit union to merge with within its jurisdiction or with a neighbouring state and state regulator. The NCUA will become part of the negotiation when this is not possible or a payout from the NCUSIF is required. The NCUA, as the administrator of the deposit insurance fund, will also be involved when the proposed merger results in a federally insured credit union. The troubled CU is liquidated when none of these measures are successful or when it has passed the point of viability.

94 The ASI, founded in 1974, is a not-for-profit second tier credit union headquartered in Ohio where it was licensed by that state's department of insurance. It operates in 33 states and offers deposit coverage of up to USD 250,000 per account, not per individual. It also offers "excess insurance" to protect deposits up to USD 500,000. In the state of Massachusetts, the Massachusetts Share Insurance Corporation also offers excess insurance to protect the deposits of its associates' members but without limitation.