An analytical framework for regulation and supervision of agricultural finance

This brief summarizes findings from several studies conducted by FAO during the development of its agricultural finance revisited series.

The rationale for government regulation of financial systems

All governments have a regulatory framework governing the financial sector in order to ensure its stability and contribution to socio-economic development. Regulation aims to minimize the risk of welfare losses due to sub-optimal performance of the financial sector. For example, bank owners and/or fund managers may show opportunistic behaviour by taking excessive risks with people’s savings or investor funds. In addition, bank runs may destabilize the whole financial system, affecting its safety and soundness. Further, there is the need to assure a competitive market structure where a well-functioning financial system provides important capital allocation contributions to growing economic agents as well as payment transfer services to the real economy. Therefore, prudential regulation and supervision of financial institutions servicing the agricultural sector, as part of the whole economy, are required.
The most common regulatory bodies include central banks, ministries and parliaments, which enact legal norms that impact on the action and conduct of financial institutions (FIs). These norms are followed by bank owners and managers, the prime governors of FI actions. However, FIs can also self-regulate, when a group of FIs establishes a joint apex institution to accomplish definite regulatory tasks. These four subsets impact the action and conduct of FIs in significantly different ways.

**Supervisors**

Supervisors are the institutions that monitor the fulfillment of regulations. They are not necessarily the same institutions as the regulators. Self-regulatory supervisory institutions may be involved in potential conflicts of interests because their owners are the very institutions they have to sanction.

**External regulation and supervision**

Some of the criteria to apply regulatory norms to certain financial institutions are mentioned below.

**Funding sources:** It is common to externally regulate all FIs that take deposits from the public.

**Size of financial institutions:**

Regulation and supervision of small FIs are generally too costly and do not provide a substantial benefit to the overall financial system because systemic risk is small.

**Size of market niche:** It is advisable to specify the external regulatory and supervisory framework only once a critical mass of actors have ventured into a new type of financial business.

**Financial institutions in the higher tiers.** There are FIs that only serve other financial companies. These are categorized as operating in higher tiers. Regulation approaches based on tiers have been proposed for the regulation of microfinance operations in several countries, with stronger regulations for institutions in the higher tiers.

**Credit-only institutions.** These institutions such as finance companies are also commonly regulated, drawing funding from commercial fund providers and capital markets. Exerting some control over lending practices is justified for consumer protection.

**Requirements of external regulation and their implications for agricultural lending**

Only financially healthy FIs should be allowed to enter the market. Therefore, preventive regulation sets the criteria for a FI to enter agricultural markets. This regulation also determines how easy or difficult it is for FIs to service the agricultural sector. Some aspects to consider are mentioned below.

**Minimum capital requirements:**

Sufficient capital must be ensured to absorb financial shocks, which is committed by the owners’ own risk resources. For agricultural lending, a strong equity base should be required in order to create strong institutions that can withstand external shocks.

**Ownership:** Many regulators require a formal financial intermediary to have shareholders in order to ensure that there are owners with capital at stake, which serves as an incentive for active monitoring through a strong governance structure.

**Costs and benefits**

External regulation incurs low costs; however, ensuring efficient supervision is expensive. Managers and owners play the major role in ensuring safety, soundness and profitability of a FI; supervisory costs are funded by both public budgets and the FIs themselves.

**PRINCIPLES OF REGULATION**

**Competitive neutrality:** Institutions serving the same clientele should have the same rules.

**Efficiency:** Regulation should ensure: *allocative efficiency*, which refers to the optimal allocation of financial resources; *operational efficiency*, which minimizes transaction costs in financial intermediation; and *dynamic efficiency*, which concerns the adaptability of a financial institution to changing environments.

**Cost-benefit balance:** Overregulation can hamper the innovation of owners and management; thus, an optimum balance between control and the market is needed.
Feasibility studies: These are usually required to assess the suitability of new entrants; for agricultural lenders, they should include a clear strategy for addressing this market segment.

Once FIs are operating and servicing a market segment, there are specific requirements that should be followed in day-to-day operations. Some aspects include the following:

Capital-to-asset ratios and loan portfolio classification: Higher minimum capital requirements, higher capital-to-asset ratios, and higher minimum liquid asset ratios should be required for FIs with substantial agricultural loan portfolios in order to be able to cushion the risks of loss and to face challenges in the competitive environment.

Liquidity management: Liquidity problems are often early signals of bank failure. Banks usually have to maintain minimum liquid assets between 5 and 10 percent of total deposit liabilities in cash and bank deposits, and another 10 to 15 percent in treasury bills, short-term government securities or other assets sold. Rural FIs face particular liquidity issues that may impact on-lending and savings deposits. In order to mitigate these risks, agricultural lenders should be required to keep higher liquidity levels and have access to interregional liquidity pools.

Credit risk management: Documentation and collateral requirements are some of the prerequisites for appropriate credit risk management in FIs. In rural financial markets, collateral may be successfully substituted or complemented with co-signing, group joint liability arrangements and/or the pledging of non-traditional banking collateral such as movable assets.

Insider lending: Insider lending to owners, staff members, and directors of FI should be severely restricted, if not prohibited, to limit fraud and corruption.

Rigorous single borrower loan limits: These limits should be established and concentrated portfolios, avoided.

Product restrictions: Savings and credit cooperatives are not allowed to mobilize savings from non-members or offer checking accounts.

Credit information bureaus: These operate as an information source for lenders’ loan appraisal. The provision of information on the loan portfolio is often a regulatory requirement. In rural areas, informal and semi-formal lenders rarely share client information. In such contexts, meagre or inconsistent national identification systems may pose a serious problem to the effectiveness of this regulatory instrument.

Reporting requirements: Reporting requirements are the foundation for supervision, usually provided on a regular basis. Reports on loan portfolios are often required on a loan-by-loan basis.

Certain aspects of regulatory norms focus on preventing widespread harm when FIs face serious financial difficulties. Some of these aspects considered by regulation are mentioned below.

Deposit insurance and lender of last resort: These schemes only concentrate on insuring smaller savers; coverage can induce owners and management to engage in risky opportunistic lending behaviour since losses are either wholly or partially covered by insurance. Central banks typically serve as a lender of last resort for FIs facing insolvency through illiquidity.

Requirements for external supervisors: Supervisors require appropriate, accurate and timely information on financial status, accounting and internal procedures in order to identify FIs close to insolvency.

Audits as an information base: External audits can provide important insights into FIs; however, they are difficult and costly to obtain for supervisors. The evaluations of FIs are based on a static approach, which concentrates on historical and current data, and also on a dynamic approach, which includes an assessment of the FIs’ capability to manage risks in the present and in the near future.

On- and off-site analysis: Timely, accurate and regular reports form the basis for off-site analysis, which is rare. Due to a common lack of standardization and electronic data processing in developing countries, relevant information is difficult to trace in quantitative data sets, thus the relevance of on-site qualitative inspections.

Staff capacity: In agricultural lending, sector knowledge combined with banking experience are required in developing countries where low qualifications, inadequate staff training and non-competitive government pay-scales often prevail in bank supervision.

Operational independence, credibility and enforcement: Independent supervisory entities are still not in place in many countries, which creates credibility problems.

Delegation of supervisory tasks: Delegated supervisors can be specialized auditing companies, designated consultancy firms or member-based second-tier (apex) institutions. While subcontracting supervisory functions may reduce supervisory costs, it also loosens...
control and could lead to conflicts of interest because member-based institutions service downstream FIs with technical assistance and concessionary funding while also carrying out supervision.

**Internal regulation and supervision**

Internal supervision refers to the practices that the FI’s top management enforces to ensure internal control and compliance to all rules, including those set by external regulators.

**Owners** are the first line in regulating an FI’s actions; since they have capital at stake, they have a strong incentive to closely supervise the FI.

**The type of ownership** defines the mission and objective of an organization and sets out the framework for management accountability, thus the need for internal regulation and supervision.

**Main types of financial institutions**

In general terms, financial institutions may be categorized based on the ownership type, which determines their ability to provide internal regulation and supervision.

**Shareholder-based institutions:** These have the most capacity and self-interest to provide oversight, control, and deep pockets in emergencies, but can be compromised by insider lending issues.

**Member-based institutions:** In these institutions, owner control is weak, due to the “one person one vote”.

**Non-governmental organizations with no formal owner:** There is no equity provided by individuals or institutions held responsible when problems arise.

**Government-owned financial institutions:** These are subject to political intrusion and loan forgiveness pressures compromising their financial sustainability.

**Self-regulation and self-supervision**

Self-regulation refers to the self-bonding of a group of FIs to definite rules and regulations. The most common form is the contracting of an agency by a group of FIs to evaluate its compliance with its self-set rules and regulations.

**Recommended Readings**