**Cooperative banks and the real economy:**
**A long-standing and close connection**

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## Introduction and summary

This think piece focuses on two qualitative assertions about European cooperative banking groups (henceforth: ECBGs) stemming from existing reports and documents: the proclaimed focus of ECBGs on customer value and the real economy. The think piece deliberately looks at the aggregated development of cooperative banks, and not at individual cooperative banks. Our approach therefore allows for general conclusions and observations. We begin with a brief description of the backgrounds and evolution of ECBGs since their establishment a century ago. This clarification provides useful insights for understanding their current business orientation. The think piece ends with some serious food for future thought.

Newly constructed data on fifteen ECBGs show that they are still mainly focused on retail banking. This type of banking is closely linked to the real economy. Their business orientation can be largely ascribed to their specific governance with member influence and authority. The data also reveal that ECBGs behave differently throughout various stages in recent business cycles than all other banks. They are robust pillars in the financial intermediation process and provide households and firms with loans and credits in economically good and difficult times. ECBGs also seem to behave in a counter-cyclical way and dampen economic cycles. ECBGs also exhibit a relatively smooth growth pattern over the last decade. They expanded considerably faster than all other banks in their respective banking sectors and strengthened their market position. ECBGs attracted more members and expanded their shares in key markets. This could reflect an increased enthusiasm for the cooperative model, disillusionment with other banks, or both.

To date, ECBGs are confronted with increased volatility in results, a surging number of bankruptcies of SME firms, a damaged reputation of the entire banking industry and an explosion of regulatory and compliance measures and costs. In fact, due to their close ties with the real economy, ECBGs probably suffer more from economic slack in local economies and declining

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industries in the regions where they operate. Consequently, they have to find ways to increase their efficiency to survive in the new market environment. In the past, ECBGs have demonstrated their capacity to adapt to changing circumstances. Of course, this is no guarantee for future success.

## The transformation of local credit cooperatives into ECBGs

The history and evolution of many ECBGs is extensively documented. In short, most cooperative banks were established more than a century ago in response to the problems that small urban and rural businesses had in accessing financial services. These groups could only obtain loans at exorbitant interest rates from money lenders. From the very first credit cooperatives promoted by Schulze-Delitzsch (1808-83) and Raiffeisen (1818-88), they adopted an organizational model based on democratic governance and mutualism. Beginning in Germany, the cooperative banking concept gradually dispersed to the rest of the continent and to the Nordic countries. It was about offering opportunities for banking inclusion to large groups in society via dense branch networks. They could do so because members funded the institutions and were involved in the decision-making process. In line with their objectives, credit cooperatives did not aim at maximizing short term profits, but profits were necessary for further growth and were for the larger part retained and added to the capital base. This feature made them financially solid and well capitalized with a low risk profile. Credit cooperatives also inherently strived for long term relationships with their members, who were clients, owners and depositors at the same time.

Over time, the cooperative banking model evolved and differentiated into a multiplicity of European institutions with characteristics reflecting the needs of cooperative members on the one hand and the specificities of national legislative frameworks on the other. The majority of local credit cooperatives developed via national (network) organizations into internationally active banking groups. Striking differences include the extent of centralization and integration within the networks, the size and focus of international activities, and the design of the cooperative governance with member authority. These developments were also partly prompted by regulatory requirements or the necessary realisation of economies of scale and higher efficiency levels. Some ECBGs have sold a part of their business activities to investors or became partly listed. Hence, hybrid types of financial cooperatives have emerged. It is fair to say that not all cooperative banks managed to survive the ravages of time. Quite a few cooperatively organised banks were unable to adapt to technological, social or competitive changes and consequently disappeared or now just live a marginal existence.

## Two claims

The described transformation process raises the question whether the current ECBGs are still acting in accordance with the democratic and governance principles of the original credit cooperatives. Moreover, it can be questioned whether they have kept the same orientation. Interestingly, the aftertaste of many recent articles and reports is that ECBGs still have internal characteristics and a business orientation which can be traced back to the key features of the former credit cooperatives. However, these claims are hardly corroborated with empirical data. In short, member ownership is believed to contribute to continuity and a cautious course of ECBGs via specific internal governance mechanisms. Two important assertions pertaining to the link between ECBGs and the real economy can be inferred from existing documents and reports.

1. *ECBGs have a strong customer focus and client proximity*

It is hypothesized that member influence ensures a strong focus on delivering customer value, i.e. putting customer interests' first, and maintaining dense branch networks. It is also stated that this physical proximity to customers and members is further reinforced through the participation in numerous social networks and by actively supporting a sustainable development of local communities. This would be accompanied by a long-term view of relationships with local businesses and municipalities and an innate focus on customers. The alleged strong local ties and networks are assumed to lead to relatively stable lending to households and corporate customers in economically good and bad times.

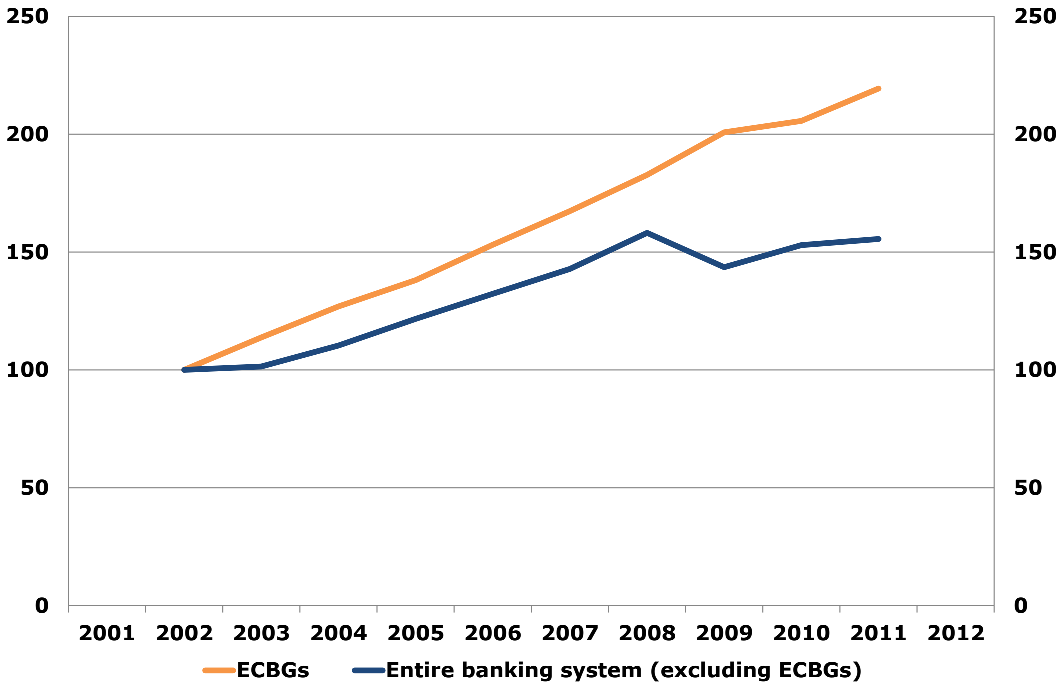
2. *ECBGs are relatively stable institutions with a focus on retail banking*

Because of member ownership, ECBGs are also believed to be mainly focused on retail, commercial and SME banking. Consequently, they would have a bias towards serving and financing 'real economy' activities. This area of banking is associated with relatively stable income streams across business cycles and a moderate risk profile, e.g. compared to wholesale or investment banking. Due to their specific governance, they cannot obtain capital by issuing shares. This limited access to third party capital should naturally lead to conservative behavior. This would mean that ECBGs steered away from riskier activities and practices and are operating at relatively high capital levels. This would enable them to keep on granting loans to members and customers for a longer period in times of financial and economic distress than other banks.

### Steady growth of ECBGs

Chart 1 visualizes the growth of ECBGs in terms of balance sheet total compared that of entire banking sectors in their respective countries. Since 2002, total assets of ECBGs grew by almost 120 per cent, whereas the assets of all other banks increased by around 55 per cent. The growth of ECBGs has continuously surpassed that of all other banks. Balance sheet growth of ECBGs was the result of both organic expansion and acquisitions of non-cooperative financial institutions.

### Chart 1 Asset growth of ECBGs and all other banks (2002 = 100)




*Source*: individual ECBGs and European Central Bank. Data pertain to ECBGs and all other banks in Austria, Denmark, Finland, France, Germany, Italy, the Netherlands, Portugal, Spain and Switzerland.

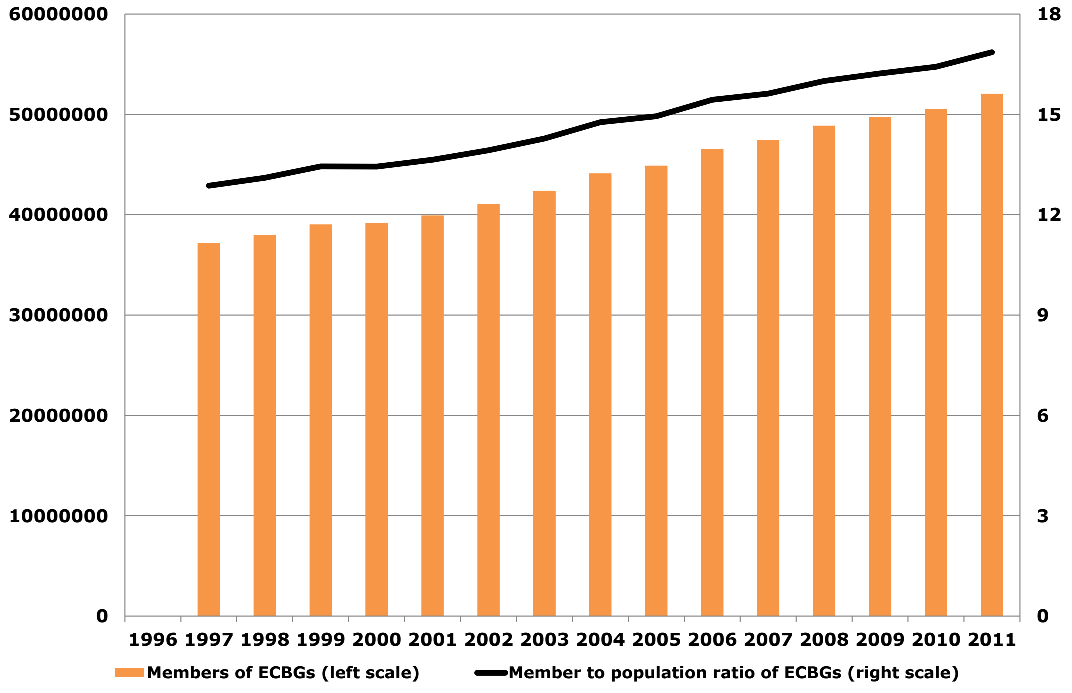
Total assets of all other banks showed a remarkable dip in 2009, whereas ECBG asset growth just decelerated slightly. The absolute drop in assets of all other banks reflects their considerable losses just after the break out of the initial credit crisis. Some of them needed considerable state support and had to reduce their balance sheet based on the conditions attached to obtaining government aid. The chart indicates that ECBGs were less hit by the subsequent crises and showed a fairly stable growth pattern.

### Strong customer focus and client proximity?

As stated before, ECBGs frequently publicly asserted that they do not aim at maximising profits but customer value. Ideally, one would like to verify this assertion with direct insights and opinions from customers. Unfortunately, information about the perception and appreciation of customers of this proclaimed customer focus and the maximalization of customer value is not available for many banks, including ECBGs.

Hence, we have to confine ourselves to indirect proxies for customer satisfaction and advocacy. We look at member to population ratios and market shares which contain implicit information about the attractiveness and popularity of ECBGs. Chart 2 shows the development of the number of members and member-population ratio of ECBGs in their domestic markets. Strikingly, the number of members has increased every individual year. Total number of members rose from around 37 million in 1997 to approximately 52 million in 2011, which equals a growth of about 40 per cent. On average, the member base grew at an annual growth rate of almost 2.5 per cent since 1997. In relative terms, the average member to population ratio showed an upward trend; the ratio rose from 12.9 in 1997 to 16.9 in 2011.

### Chart 2 Number of members and member to population ratio




*Source*: National demographic statistics and ECBGs. Data pertain to ECBGs in Austria, Denmark, Finland, France, Germany, Italy, the Netherlands, Portugal, Spain and Switzerland.

Implicitly, the absolute and relative rises in members point to an increasing popularity of the cooperative banking model. The underlying reasons for the absolute and relative surge in members are hard to isolate and will probably be of financial and non-financial. It merely indicates that ECBGs have succeeded in attracting new members with their price conditions, products, advisory services, client approach, business models or other features. The increase also signals confidence of customers in ECBGs and indirectly supports assertions mentioned above. Indeed, clients are presumably not very eager to become a member if the level of trust and satisfaction would be low and the price conditions would be significantly worse compared to those of other banks. Here, it should be stressed that membership is open and voluntary in most countries to date.

The increase in the number of members has translated into rising market shares in national retail banking markets. Since 1997, ECBGs increased their domestic market shares in mortgages and consumer loans as well as in private savings steadily and continuously throughout economic cycles. On average, both retail market shares rose by about 10 percentage points to 26 per cent in 2011. In the economically turbulent years 2007-11, ECBGs also strengthened their domestic market positions, but the increase did not differ significantly from that in the period before. Like the substantial increase in the number of members, rising market shares are just signs that customers felt relatively more attracted to ECBGs for a myriad of different reasons.

Financial cooperatives have historically maintained extensive branch networks to support strong links to their members and communities. Although ECBGs underscore the urgency to focus on efficiency improvements in their networks as a result of mobile banking, contactless payments and integrated cash management, they still operate with relatively dense networks and have strengthened their local presence over the last decade. Their average market share for branches is approximately 10 percentage points higher than that for loans and deposits. On balance, the number of branches of ECBGs increased from around 54,000 in 1997 to more than 60,000 in 2011, whereas total bank branches decreased from 191,000 to 170,000 over this period.

### Close ties between ECBGs and the real economy?

Total loan and deposit growth rates shed additional light on business orientation of ECBGs. Chart 3 and table 1 provide information about total (inter)national credit growth to the non-financial private sector since 1997 for ECBGs and entire banking sectors. Credit growth by ECBGs is fairly stable and equals 8.3 per cent in every sub-period considered. This expansion exceeds credit growth at all other banks. ECBGs are more stable loan providers to the real economy than all other banks.

### Table 1 Average loan and deposit growth

| Period | Loan growth ( standard deviation in parentheses) | | Deposit growth ( standard deviation in parentheses) | |
|---|---|---|---|---|
| | ***ECBGs*** | ***TBS*** | ***ECBGs*** | ***TBS*** |
| *1997-2004* | 8.3 (2.6 ) | 5.8 (2.6) | 5.7 (2.4) | 4.0 (2.9) |
| *2005-2011* | 8.3 (1.8) | 4.7 (5.3) | 6.1 (1.4) | 8.1 (6.1) |
| *1997-2011* | 8.3 (3.4) | 5.3 (4.0) | 5.9 (1.9) | 6.1 (5.0) |

*Source*: own calculations based on figures from ECBGs, ECB and national statistics.
*Note*: the data are adjusted for major breaks caused by mergers and acquisitions. ECBGs stand for European cooperative banking groups and TBS stand for total banking sectors. Fifteen ECBGs from ten countries are included in the sample (see note of Chart 1).

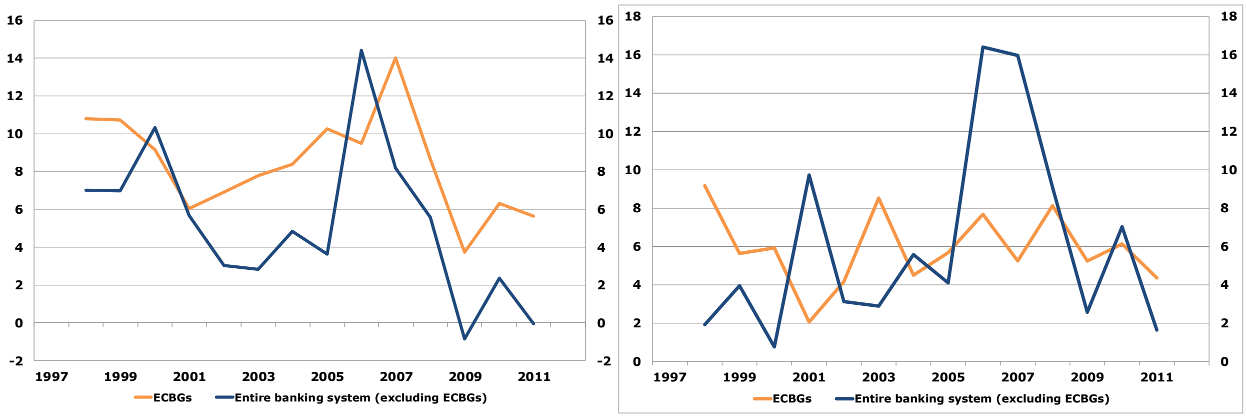
Credit growth of all other banks decelerated fiercely after 2006 and even dropped below zero in 2009 and 2011. ECBG credit growth also slowed down remarkably, but ECBGs were still able to expand their credit portfolios in 2005-11. The latter period encompasses economically difficult times. The persistently positive credit growth figures of ECBGs can be largely ascribed to their relatively good capitalization. This feature allowed them to meet the credit demand of their customers for a longer period of time. Hence, loan data illustrate the close ties of ECBGs to the real economy as well as their focus on retail lending.

Regarding deposit growth, one can also observe some striking developments. Like credit growth, deposit growth at ECBGs shows a stable pattern compared to that of all other banks. The large swings in deposit growth at other banks contrast sharply with the stable deposit growth at ECBGs. First, we can witness a sharp acceleration of deposit growth at other banks from around 4 per cent in 2005 to about 10 per cent in 2006-08. During this period, other banks presumably needed funding for the strong expansion of their loan portfolios as well as for other investments with higher returns, which appeared to be relatively risky afterwards. Immediately after the initial credit crisis broke out, deposit growth at other banks slowed down sharply. This deceleration continued in the subsequent years when a deep economic recession and banking crisis in Europe unfolded.

When we combine these credit and deposit growth data with economic growth figures, it appears that that non-cooperative banks grant relatively more loans and obtain comparatively more savings and deposits from households and enterprises in a favourable economic climate. In times of moderate economic growth, ECBGs attract relatively more savings and deposits and provide proportionally more loans than all other banks. This observation could stem from the fact that uncertainty about the health of other banks in difficult times provokes customers to choose the – perceived and acknowledged – more financially solid ECBGs. ECBGs appear to fulfil a stabilizing role in the financial intermediation process. These findings point to a safe haven effect and a risk averse attitude of ECBGs.

### Chart 3 Average credit and deposit growth

**Credit growth** **Deposit growth**




*Source*: ECBGs, ECB and national statistics.
*Note*: ECBGs and TBS stand for European cooperative banking groups and total banking sectors, respectively. The credit data refer to all (inter)national credits and loans to the non-financial private sector of ECBGs and all other banks. The deposit data refer to all (inter)national savings and deposits of the non-financial private sector at ECBGs and other banks. Data pertain to ECBGs and all other banks in Austria, Denmark, Finland, France, Germany, Italy, the Netherlands, Portugal, Spain and Switzerland.

### Food for thought

From a policy point of view, this think piece stresses the importance to acknowledge the relationship between the specific governance and ownership structure of ECBGs and their stabilizing role in the financial intermediation process. They exhibit a smooth growth pattern and dampen business cycles. ECBGs are still mainly satisfying basic financial needs of their members and customers. They have stayed relatively close to retail banking, meaning that they are careful with the savings of their depositors. These findings have important implications for academics and policy makers alike, since they indicate that ignoring this ownership structure can lead to erroneous banking regulations which may eventually undermine the positive impact of their specific governance on economic development in general. ECBGs should not be subject to a special treatment, but regulators and policy makers should be aware of their specifics when developing and implementing new policies.

Another important issue concerns the funding of ECBGs in order to satisfy future credit demand of members and customers. While these organizations have traditionally relied on retained earnings and member financing, they are now operating in a very different environment, like all other banks. Their reservation capacity has deteriorated, due to lower profits, thus increasing the necessity to tap new sources of funding to remain able to support the real economy in the future.

Finally, it goes without saying that every bank should primarily act in the interest of its clients. However, it is not possible to verify ECBGs' claim that they have always put customer interests' first in a direct way. Only indirect and implicit evidence for this assertion is available. Therefore, we suggest to perform a European wide survey among many bank customers to measure the level of customer satisfaction, value and advocacy in an objective way.

## Literature

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