CORPORATE GOVERNANCE IN COOPERATIVE BANKS

J.M. (Hans) Groeneveld and David T Llewellyn

1. Introduction

The aim of this paper is to give an overview of the corporate governance issues related to cooperative banks. We seek to place these governance issues in a broad analytical framework, and to consider their strengths and potential weaknesses in theory and reality. A distinction is made at the outset between Shareholder Value (SHV) banks and Stakeholder Value (STV) banks. Cooperative and savings banks form the largest part of STV banks. For the purposes of our discussion, SHV banks may be regarded as those whose business focus is maximising shareholder interests and the rate of return on equity capital, while STV banks have a broader focus, in particular on maximising consumer surplus for their owner-members.[1] It must be pointed out that a separation of decision-making and risk-taking exists in both SHV and STV banks, which leads to so-called agency issues (potential conflicts of interest between managers and owners). Ideally, the monitoring of both types of bank is performed by – representatives of – their owners, i.e. shareholders in the case of SHV banks and members in the case of cooperative STV banks. This facet appears to have caused a lot of confusion among policy makers, supervisors and academics over the last decades, which has led to an inaccurate and incomplete comparison of the mechanisms of corporate governance in both types of banks. The paper seeks to rebut these widespread misperceptions.

The paper is structured as follows. Section 2 addresses general theoretical notions about corporate governance and agency issues. Section 3 contains important governance facts relating to cooperative banks. Section 4 discusses relevant aspects when comparing the corporate governance of cooperative banks with SHV banks. Section 5 presents conclusions as well as some future corporate governance challenges for cooperative banks.

2. Corporate governance issues in STV and SHV banks

2.1 Definition of corporate governance

According to the OECD (2004), corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance

also provides the structure through which the objectives of the company are set out, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders, and it should facilitate effective monitoring. Given that all firms utilise economic resources in their activity, issues of corporate governance are economically important for three central reasons. Firstly, there is the question of what objectives companies pursue and, in which stakeholders' interests companies are run. Secondly, monitoring and control (and the market for corporate control) have an impact on the allocation of resources in the economy, and on which firms end up managing economic resources. Thirdly, corporate governance impacts on the efficiency in the use of resources within firms (Sinha, 1996). In this regard, the issues are about resource allocation and resource efficiency in the context of the business model and principles within SHV and STV firms.

2.2 Theoretical agency issues

Agency issues (potential conflicts of interest between managers and owners) arise in any organisation in which there is a separation of decision-making and risk-taking functions. In the case of cooperative banks, these conflicts may arise between the management and the members. In the case of SHV companies, the conflicts may exist between management and shareholders. This occurs particularly when important decision agents do not bear a substantial share of the wealth effects of their decisions (Fama and Jensen, 1983). A potential moral hazard may arise as managers may be induced to behave in their own interests rather than those of members or shareholders. The central idea is that the owners of a bank, whether they are shareholders or members of a cooperative, delegate to management the job of running the firm and operating it in their interests. In particular, management are supposed to pursue policies which maximise the benefit of the owners. In turn, the shareholders/members monitor and control management to prevent them from exploiting their advantageous position. However, there are important differences in the nature of "ownership" between different types of firm and this in itself gives rise to different optimal models for corporate governance.

Issues of corporate governance are to be considered in the wider context of the nexus of influence, control, protection, and sanction with respect to agency problems, and the various mechanisms that are available to address them. In what might be termed the *Agency Paradigm* (Hirschman, 1970; Llewellyn, 2004) several mechanisms have emerged to deal with agency problems:

- Voice: shareholders or members exert pressure on management to pursue correct policies.
- Exit: dissatisfied shareholders in a company sell their ownership stake which may have an impact on the share price; or members of a cooperative liquidate their stake by, for instance, withdrawing funds or cancelling contracts.
- Governance and accountability arrangements: the precise mechanisms for exercising accountability and the control of managers.
- Labour market: the labour market for executives can be a disciplining factor to the extent that managers seek to enhance their personal market value by creating a reputation for success (Fama, 1980).
- Market in corporate control: in the SHV sector, the take-over market allegedly exerts pressure on management to be efficient and pursue policies that maximise shareholder-value, (Jensen, 1988).
- Capital market pressure: price signals indicate shareholders' and creditors' views about the worth of the company and the quality of management and business strategy, and also determine the cost of capital and debt. This has been discussed with respect to the debt market and the threat of bankruptcy (Jensen, 1988) and monitoring by debt holders.
- Regulation: the behaviour of management is constrained by prudential and conduct of business regulation and supervision.
- Publicity: the behaviour of management and the business operations of the firm are scrutinised by, for instance, the media which enables stakeholders to make informed judgements about the bank.
- Competition in the market place for the products and services being offered (Nickell, 1996).

Different elements of the *agency paradigm* are relevant for various aspects of a bank's business and may operate differently in STV and SHV institutions. Thus, for instance, while capital market pressure may at times be powerful in disciplining SHVs, it is weaker (if relevant at all) in the case of STVs which do not have tradable ownership stakes. To some extent there is a trade-off between the different components of the *Agency Paradigm,* implying that weakness in one area may need to be compensated by stronger elements elsewhere. This means that if some elements are weak or non-existent in particular cases, compensation may be needed through other routes. Thus, for example, if for any reason the market in corporate control either does not exist at all or operates very inefficiently, there is a corresponding need for internal governance arrangements to be stronger.

A further issue is whether a bank's behaviour is determined more by ownership structure and corporate governance arrangements as opposed to competitive conditions in the markets in which it operates. It is argued elsewhere that cooperative banks also shape that competitive environment and contribute to financial stability precisely due to their specific corporate governance (Ayadi, *et.al*., 2010). Nevertheless, in many ways competitive conditions can be more powerful than the ownership structure in determining a bank's behaviour; and strong competitive conditions in final markets may at times alleviate any problems implicit in less than perfect corporate governance arrangements of whatever type of bank is being considered. In the hypothetical world of perfect competition in all markets, issues of corporate governance would be of second-order importance in terms of what really matters: efficiency in the allocation of resources, and efficiency in the use of resources. However, corporate governance issues are of significance because the ideal model of perfect competition does not exist in practice. Although corporate governance issues in cooperative banks are important, a sense of proportion is needed when these banks are operating in highly competitive markets.

The manner in which the mechanisms in the *Agency Paradigm* work (or are thought to work) is discussed here in so far as they are relevant for corporate governance issues in cooperative banks as explained in section 3. A particular issue is the exit-voice dichotomy: in the absence of effective *Voice* (i.e. ability to change the behaviour of a firm and its management) an agent has the option of withdrawing business from the firm such as by withdrawing deposits.[2] The mechanisms within the *Agency Paradigm* may be characterised as internal or external: the former includes *Voice*, governance arrangements, and accountability mechanisms, and the latter includes the market for corporate control, the role of rating agencies, and competition in product markets.

a. Voice

A major determinant of internal versus external monitoring and control is the structure of stakeholders' incentives and ability, as well as the feasibility of exercising *Voice*. This in turn is powerfully influenced by the degree of concentration or dispersion in ownership. It must also be borne in mind that monitoring is a costly activity and hence there must be a sufficiently strong incentive (potential reward) for stakeholders to incur these costs. When ownership is dispersed (with a large number of shareholders or members) incentives may in practice be weak, the ability to control may be low, and the feasibility of control may be poor. In the first case, no individual small shareholder has an incentive to monitor, because his or her stake is low. The individual

bears the full cost of monitoring but reaps few of the benefits. There would also be uneconomic duplication if all small shareholders/members were to conduct their own monitoring. This creates the standard free-rider problem: all seek to gain the benefit (but not incur the cost) of the monitoring activities of others. Expertise is also likely to be low as small stake-holdings make it uneconomic to acquire the necessary information and expertise to conduct effective monitoring. It may also not be feasible to exercise control as, in practice, *Voice* is not heard when the sanction that can be imposed by a small stakeholder is weak. The existence of a large number of small stakeholders in a company (with no dominant stakeholders) also makes it difficult to organise coalitions for the benefit of effective surveillance.

On the other hand, the problems of *Voice* do not arise so powerfully when ownership is concentrated: incentives are strong; expertise can be gained, and feasibility is high. Thus concentrated ownership has the potential to create efficient monitoring and control and alleviate potential agency problems and moral hazard. Active institutional shareholding in SHV banks becomes feasible (though not necessarily actual) when ownership is concentrated in a small number of large shareholders who are willing and able to commit resources to monitoring and control, and who have incentives to do so. This can create a powerful discipline and control ethos (Shleifer and Vishny, 1986).

The issue of *Voice* in SHV and STV banks is to some extent resolved or mitigated by rating agencies. If shareholders or members cannot exercise influence due to ignorance stemming from large costs associated with information gathering to monitor the bank, they can nowadays rely on the judgement of rating agencies, which are in a way performing this monitoring job for them. However, even here recent experience may raise questions about how effective ratings are in practice.

b. Exit

The theory is simple to state: a dissatisfied member in a cooperative bank or a depositor or shareholder in an SHV bank has the simple option of withdrawing from the bank, which is a potentially powerful mechanism in competitive markets. In the case of depositors, for instance, this can be done at low cost. Equally, a shareholder with a tradable ownership stake in a SHV bank has the option of selling the stake in the secondary market, which is much more difficult for a member of a cooperative bank, even supposing it is possible at all. However, in some areas (such as long-term contracts including life assurance or personal pensions), whilst this option

exists in theory, the exit cost (such as penalties, market-adjustment, etc.) may be prohibitive to the extent that it effectively removes the exit option as a realistic possibility.

c. Governance

Specific corporate governance arrangements can influence the performance of banks (whether they be STV or SHV) in several ways. Mayer (1996) identifies five channels: (1) through the incentives they create, and in particular the extent to which they align interests in the principal-agent relationship between shareholders/members and managers of firms, (2) through discipline effects (i.e. whether particular corporate governance arrangements facilitate the monitoring and disciplining of managers), (3) via re-structuring of companies through changes in ownership stakes (relevant in the case of SHV banks), (4) via finance and investment (e.g. the incentives for and the role of, debt and equity finance), and (5) the extent of commitment, i.e. whether stake-holders in the bank have an incentive or the ability to develop long-term commitments.

2.3 Imperfect corporate governance arrangements in SHV and STV banks

The theoretical notions about corporate governance issues apply to SHV as well as STV banks that have grown over the years into large (inter)national financial conglomerates. Both organisational forms are prone to agency problems in practice. In the literature, comparisons of the pros and cons of corporate governance structures between STV and SHV banks are sometimes misleading as they are based on incorrect starting points. The issue is that it is not always clear on what basis the comparison is being made: (i) the ideal SHV, (ii) the ideal cooperative bank (being the STV bank under discussion in this chapter), (iii) the actual SHV, and (iv) the actual cooperative bank model. In other words, it is necessary to distinguish between how institutions behave in some abstract, theoretical or ideal state, and the way they operate in practice.

During the last decades, the belief had widely grown that the ideal SHV model such as discussed in modern standard textbooks actually prevailed in practice. In fact, modern textbooks pay little attention to STV banking models (Kalmi, 2007). The ideal SHV model has clear-cut principles defining objectives, accountability and control. Therefore, the corporate governance of SHV banks was deemed to be superior to the observed STV model where many theoretical flaws of any corporate governance were thought to apply in practice. However, recent experience unambiguously points to ill-functioning aspects of corporate governance arrangements in SHV banks: the actual SHV model is not ideal in practice.[3] At the same time, the theoretical

shortcomings of corporate governance arrangements in STV banks were magnified and exaggerated for a long time. For instance, it has often been questioned whether cooperative banks really behave in the interests of their members. We now know that the management of SHV banks often failed to operate in the interests of their shareholders by following strategies to maximise shareholder value, which caused huge losses and write downs and necessitated large-scale government intervention. Northern Rock, Fortis, UBS and Royal Bank of Scotland are clear examples of this. Hence, it is tendentious to compare the actual behaviour of a cooperative bank model with some mythical ideal form of SHV model. It must be acknowledged that in practice, both forms operate imperfectly and, in the world of the second-best, no safe conclusions can be drawn regarding the superiority of one form over the other.

3. Perspectives on the corporate governance of cooperative banks

Across Europe, cooperative banks compete with institutions which have different ownership, governance and capital structures and different business models. The optimal governance arrangements for any firm or bank depend largely upon its structure, objectives and ownership. For this reason we outline the key features of cooperative banks in so far as they are relevant to governance arrangements. However, a particular feature of European cooperative banking is that there is no single universal model that, in all its detail, is common to every single cooperative bank. As this volume illustrates, there is a rich diversity in precise cooperative business models, structure and governance. Some cooperative banks in Europe also have non-cooperative subsidiaries and have, for a variety of reasons, opted for different business models when conducting business outside their home country. Furthermore, we may characterise the European cooperative banking sector as "commonality with diversity" in that there is a set of basic principles that are common to all cooperative banks while at the same time differences exist in the practical way of operation in many in other areas.

Because of this, it is not feasible to define a simple and unequivocal description that applies to all versions of the cooperative model and which encapsulates without challenge all the detailed versions of the basic business model. Nevertheless, this does not mean that it is not possible to identify unifying governance features. The key characteristics are identified which encapsulate the essence of the basic cooperative banking model and which serve as a background to a discussion of their specific corporate governance compared to SHV banks in section 4. The empirical and descriptive foundations of these characteristics are given in other chapters of this

book dealing with cooperative banks in individual countries, and which demonstrate our central theme of "commonality with diversity". The cooperative bank model is rich and robust enough to encompass diversity albeit in the context of a basic set of common features. In many ways this is one of the major strengths of the European cooperative bank sector. It has adapted to changing circumstances as they have evolved differently in various countries, thus exemplifying the theme of "commonality with diversity".

3.1 The advantages of member ownership and influence

Cooperative banks are owned by their members. Members have significance not only by virtue of being owners but also because they are an integral part of the governance structure, although the precise arrangements vary considerably between countries and, in some cases, within a country. In most cases, ownership is at the local and regional level, although there are notable exceptions (e.g. Crédit Agricole and Banche Popolari).

Voting rights conferred by membership are based on the principle of One-Member-One-Vote (OMOV) and are not proportional to the size of a member's stake in the bank. This also means that members cannot accumulate votes through purchases of shares in a market. The implication is that the ownership rights inherent in the OMOV model are necessarily widely dispersed, with no individual or group able to build up a controlling position. This does not pose serious problems, as for instance, members are represented in many commissions and consultative bodies. Besides, members elect the supervisory boards of local or regional banks and the central institutions when they exist.

Another noticeable advantage of member ownership is that it entails a more consensus-driven approach and prevents a strong fixation on just one stakeholder, which is the case in the SHV model. Members have different backgrounds and belong to different social groups or networks. This is usually accompanied by a longer-term and risk-averse view, which translates into a more stable banking approach primarily focussed on retail banking in their home country compared to most SHV banks, which are more involved in riskier wholesale and investment banking, both at home and abroad. Apart from the fact that retail banking is more about relationship banking, their focus can be geared towards a longer-term orientation just because they are not listed and do not have to realise short-term profits to satisfy external shareholders. The cooperative governance model offers the opportunity to put clients' and members' interests first. With their strong local ties and large networks, cooperative banks are in theory better equipped to assess the

creditworthiness and risks of customers at a local level. Member ownership produces a stable business model, focussed on sustainable retail banking. This leads to good liquidity and sound asset quality. The structure, knowledge of local customers and risk diversification all work in favour of cooperative banks.

3.2 Customers' interests first

The interests of members rather than external shareholders are at the centre of cooperative banks' business strategies. The Rabobank Group has articulated the role of cooperative banks as follows: "*The primary mission of cooperative banks is to promote the economic interests of its members who are their customers*" (Mooij, 2009). Cooperative banks often have an element of a "social mission" frequently, though not exclusively, focussed on the local community. Secondly, cooperative banks often publicly state that they do not aim to maximise profits but rather to maximise customer value (EACB, 2005). It is true that this assertion is difficult to substantiate with 'hard data' or empirical evidence. This means that the alleged perception that customers have about cooperative banks being more customer centric (and the value they attach to this) is something that cannot be proved unambiguously, though survey evidence in some countries offers some support (Niemeyer, 2010). It could also be argued that customer satisfaction is ultimately visible in member-to-population ratios, market shares or financial performance of cooperative banks, but obtaining direct insights and opinions from customers would provide more powerful evidence. It is all about the perception of customers whether cooperative banks 'walk the talk': or in other words, keep their promises and treat their customers fairly.

This issue has been particularly important during the recent financial crisis. Many banks were accused of corporate greed and of disregarding the needs and interests of many clients. In contrast, cooperative banks were hardly confronted with bad publicity or reputational and financial losses (Michie, 2010). On the contrary, they were considered as safe havens and did not incur large losses or write-downs due to irresponsible and hazardous behaviour (Groeneveld, 2011). Moreover, their focus on customer value has contributed to a strengthening of their positions in domestic deposit and loan markets. Compared to SHV banks, cooperative banks have a larger focus on relationship banking.

3.3 High capitalisation, high rating and low funding costs

Cooperative banks barely distribute their profits but add them to their reserves or the banks' own funds, although members may sometimes be able to vote for a limited distribution of profits.[4]

Consequently, cooperative banks are among the most highly capitalised banking institutions in Europe thanks to their unique model and ownership structure. Most cooperative banks accumulate capital by design, as their original purpose was to overcome a shortage of capital for their chosen activities. The knowledge that this carefully built-up capital cannot be easily replaced by external sources after considerable losses may have motivated cooperative bank managers towards a relatively low risk appetite. This implicit disciplining factor presumably partly explains the relatively good performance of financial cooperatives during and after the initial credit crisis.

Another important feature is that current members cannot extract the capital of the bank and gain for themselves an inter-generation transfer: capital belongs to the cooperative bank itself. Capital (reserves) is an endowment to be managed for the benefit of current and future generations of members. Managers of a cooperative bank are effectively managers of an inter-generation endowment. Unlike with SHV banks, ownership stakes are not marketable in that members cannot sell their ownership stakes in an open secondary market, but in some cases can sell them back to the bank. Of course, members can withdraw from the bank by withdrawing funds (deposits), but it is difficult if not impossible to withdraw equity.[5]

The cooperative banking part of most cooperative banking groups is only rarely quoted on a stock exchange, but some group subsidiaries are listed in a few instances. In most cases, there are no external shareholders/owners who are not themselves members of the cooperative. Because of this, as well as the absence of a stock exchange listing, there is no market for corporate control, in that it is virtually impossible for hostile bids for ownership to take place: a cooperative bank cannot be bought by new owners. This does not mean that there is no need for cooperative banks to operate efficiently. If they are not efficient, they will, sooner or later, be wiped out by competitors. As argued earlier, competition between cooperative banks and their SHV counterparts consitutes a major discipline on all banks competing in the same or similar markets and can certainly compensate for any alleged weaknesses in governance arrangements within both the STV and SHV sectors.

All other things being equal, the cost of capital for cooperative banks is lower than that for SHV banks because, unlike the latter, it is typically not required to remunerate externally-held equity capital. This gives the bank a potential margin advantage (Drake and Llewellyn, 2004) which can be used in various ways (good or bad) such as higher deposit and/or lower lending rates to

members.[6] In addition, mutual support mechanisms between cooperative banks within Central Network Institutions that exist in various countries contribute to high credit ratings. These collective guarantee schemes reduce, or even exclude, the risk of individual cooperative bank failure. Finally, high capital reserves and high ratings provide cooperative banks with opportunities to obtain relatively cheap capital market funding, because this entails less risk for other creditors and thus lower risk premiums.

3.4 Profit as a necessary condition

In contrast to SHV banks, maximising the rate of return on capital is not the exclusive or even dominant business objective of cooperative banks. The essence of the cooperative bank model is that there is no myopic focus on maximising shareholder value. The ideal cooperative bank seeks to maximise the benefit of its members (who are also customers) and to maximise consumer surplus. However, as with all banks (irrespective of their capital structure), healthy profitability is an important necessary condition for a cooperative bank to safeguard its continuity, to finance growth and credit, and to provide a buffer for inclement times. But, unlike SHV banks, profit is not a goal in itself but is necessary for continued growth. For STV banks, they are a “means to an end” rather than the “end” itself.

3.5 Proximity to customers: dense branch networks

As many cooperative banks are locally based (even though they may be part of a powerful national network) they typically exist in close proximity to their customers. This gives these banks certain information advantages. Large branch networks also provide cooperatives with an important, albeit declining, comparative advantage in retail markets. Cooperative banks are literally and figuratively closer to their customers and know those customers, which are often (but not always) also members, relatively well through participation in numerous social networks. This is because the cooperative banking model centres above all on ‘relationship banking’ via local presence. Proximity to their customers is reinforced by these banks through actively supporting local communities. Finally, large branch networks facilitate mobilising and retaining a relatively cheap and important funding source, provided that their deposit rates are competitive vis à vis those offered by competitors.

However, local or regional cooperative banks are often part of a network with an integrated structure based on extensive vertical and horizontal cooperation: defined elsewhere as Central Network Institutions (CNIs) (Ayadi, *et. al*., 2010). Prime examples include the Dutch Rabobank,

the Finnish OP-Pohjola and, to some extent, the French Crédit Agricole and Crédit Mutuel. These institutions centralise the provision of certain services and production processes, especially where the benefits of economies of scale are significant. The services and processes provided include back-office and representation services as well as centralised product, liquidity and risk management and the role of supervisor. A unique feature is that some CNIs (such as Rabobank in the Netherlands) operate as internal central banks within the network of cooperative banks. The APEX institutions are not particularly close to the end-customers and are also more difficult to monitor by members of local banks due to their remoteness and complex organisation and activities. In most cases, members of local banks are not members of the CNIs, but local cooperative banks are members and owners of the CNIs (regional Crédit Agricole banks and local Rabobanks). However, members of local banks can exercise influence on CNIs if they are represented in central decision-making bodies inside cooperative banking groups (as, for instance, in Rabobank).

4. Superior elements in the corporate governance of cooperative banks

Whilst there are differences in detail between cooperative bank models in various countries, what they have in common is more important, and there are marked differences between the generality of cooperative banks and their SHV bank competitors. From the preceding sections, it also becomes clear that some characteristics of cooperative banks have been misunderstood for a long time, leading automatically to biased conclusions. When comparing the pros and cons of the corporate governance of SHV and cooperative banks, one should not just concentrate on elegant theoretical notions, which have led to a preference for the SHV model in the literature and in the markets in the last decades. For an accurate and adequate comparison, one should also analyse the performance and functioning of both corporate governance models in practice. Such an all-embracing investigation reveals that several specific issues must be considered when comparison is made of optimal governance arrangements between cooperative and other firms. Accordingly, we argue that cooperative banks clearly stand out from SHV banks.

4.1 Cooperative banks serve the interests of their members/customers

There are three particular features with respect to "maximising value" in the case of cooperative banks: (1) crucially there is no formal separation between members (owners) and customers although it is usually possible to be a customer without formally being a member, (2) the concept of "ownership" is less clearly defined, and (3) the concept of "maximising owner value" in a

cooperative bank is somewhat indeterminate. On the face of it, it is more straightforward in SHV banks although, as noted above, theory and practice often diverge in important ways in the SHV sector. The ultimate business objectives of the cooperative banks (such as "maximising member interests") may not be as easily defined as is "maximising shareholder value" in SHV banks. If business objectives are difficult to define, then optimal governance arrangements may appear equally ambiguous.

However, these considerations ignore important features of how cooperative banks operate in practice. In some ways, the practice is more persuasive than the theory! The dual structure of governance arrangements (members have ownership and voting rights over their banks which in turn have ownership rights over the central institution) has the effect of reinforcing the efficiency and effectiveness of governance arrangements within cooperative banks. The extent to which customer value is or has been the leading principle is the subject of frequent and serious discussion in all kinds of committees and consultative bodies in every layer of the cooperative organisation where members are directly or indirectly represented.

4.2 Nature of agency problems

A key element in this debate typically centres on the differences in ownership structure and the often-alleged greater scope for managers of cooperative banks to engage in rent-seeking or expense-preference behaviour. It is typically asserted that agency costs are potentially heavier in cooperative banks than in SHV institutions because the owners (investors and borrowers) of the former have less influence on managers than do their equity shareholding counterparts. This is partly because they are larger in number, have smaller ownership stakes, and are more dispersed.

This theoretical notion and line of reasoning can, however, be challenged by recent experience. It is true that moral hazard associated with the split between ownership and control is common to all forms of economic firms. However, this moral hazard has been more prevalent in some large SHV banks which have taken excessive risks, became 'too big to fail', and therefore needed large-scale government support during the latest financial crisis. Hardly any cooperative bank needed taxpayer recapitalization as a result of the global financial crisis. Furthermore, members can mostly exert some form of direct influence on their local and regional banks, and to a lesser extent on the central institution where the strategic decision-making of the entire cooperative banking group takes place. In most cooperative banks, members also have an indirect say in the strategic course of the entire organisation, i.e. at local banks and in the central network institution

which is owned by the banks in the group. Members elect the supervisory boards of local banks and of the central institution.

Thus, the nature of principal-agency problems in cooperative banks is less severe than is frequently argued. Depositors can become members who own the organisation and (in)directly determine the course of the entire group. The interests of members as depositors coincide with the interests of members as 'owners or shareholders': good quality products at fair prices on the basis of continuity and low risk. In SHV banks, the interests of – retail – depositors are not automatically aligned with those of shareholders. In fact, all forms of risk are 'good' for a profit-seeking shareholder (credit risk, interest rate risk, off-balance sheet and other positions). The control of this conflict is the main reason to regulate and supervise banks. Hence, one form of the principal-agent problem from the literature (shareholder-depositor) is absent in most cooperative banks (Cuevas and Fischer, 2006).

4.3 The nature and form of internal governance mechanisms

Governance arrangements in cooperative banks have necessarily evolved over time most especially as they have become considerably bigger, more complex, and national rather than purely local. As member banks own the central network institutions (APEX), a typical cooperative bank has a dual structure of governance: between members and their local bank, and between member banks and the APEX. Consequently, cooperative banks are significantly different from SHV banks, which in turn has implications for optimal governance arrangements and most especially with regard to incentives, ability and feasibility of owner influence.

Another regularly voiced criticism is that members of cooperative banks are not generally expert in the complex affairs of the firm or cooperative financial conglomerate (and this may limit the effectiveness of traditional governance mechanisms). This is again a biased representation, since the same can be argued with respect to shareholders of SHV banks. Nevertheless, in most cooperative banks the local and central supervisory boards consist of members with a financial background. This is often formally required by the banking regulators and supervisors. These 'expert' members can function as a sparring partner for the banking professionals. Besides, banking professionals must be able to explain to their non-banking supervisors in an understandable way what and why strategic decisions have been taken.

In practice, cooperative banks seek to overcome the absence of some external disciplining arrangements by applying alternative mechanisms for internal governance. These include, for instance, a higher proportion of Non-Executives on the Board of Directors; greater use of Board committees compared with the norm for SHV banks; the creation of Member Parliaments, an active communications strategy with members; and education programmes to equip members with the skills necessary to make the exercising of their ownership rights effective.

Furthermore, in some cases the central institution has an important supervisory role over its local bank members: in the Netherlands, for example, the Dutch central bank (DNB) – being also the prudential banking supervisor – has delegated to Rabobank Nederland formal supervisory powers over its member banks. Rabobank Nederland itself is supervised by DNB. Peer pressure within the group can exert as powerful a discipline (if not more so) on member banks to reduce severe problems of moral hazard and adverse selection. In most cooperative banks, best-practice within the group in itself acts as a discipline. This aspect is reinforced by the existence of cross-guarantee systems in most cooperative banks which minimize the probability of default by an individual cooperative bank (Groeneveld and De Vries, 2009).

4.4 Incentives, abilities and feasibility of effective monitoring of STV and SHV banks

This aspect raises issues about the incentive structures for owners (members and shareholders, respectively) to monitor and discipline banks; about their technical capacity to do so (access to information and the ability to use relevant information, etc.); and whether it is feasible in practice for owners to exercise monitoring and control. Irrespective of the type of bank, it can be stated that monitoring is costly and the effectiveness of monitoring and disciplining firms is difficult to assess.

In this respect, it is peculiar that a long list of theoretical considerations has been formulated over the years as to why members cannot or would not have incentives or the means to discipline executives of cooperative banks to operate in line with owners' interests.[7] For instance, the effectiveness of *Voice* is questioned on the basis of lack of expertise in the diffused membership. However, the same qualifications can be made for the shareholders of SHV banks. In the past few years, SHV banks have been confronted with huge moral hazard and adverse selection problems, as they were engaged in increasingly high-risk business in order to reach unrealistically high profit targets. At the same time, equity holders seemed to have an incentive to see the firm investing in high-risk projects even though these may be ultimately value-decreasing for the

firm.[8] This effect, referred to as the “asset substitution effect” (Leland, 1998), is an agency cost of debt financing that exists in SHV banks but not in cooperative banks. This implies that the presence of external shareholders in SHV financial institutions can add a further dimension to the agency problem by virtue of the potential conflict between the owners (equity shareholders) and depositors/customers. Equity shareholders (who share in both gains and losses) may prefer a higher risk profile for the institution than would debt holders (who have hardly any upward potential from risky adventures, but ultimately would have to share the risk). Clearly, in cooperative banks this particular aspect of the agency problem is absent as owners and customers are in many cases one and the same. As cooperative owners have no direct claim on profits they have no incentive to prefer risky activities.

It has also frequently been argued that there is no effective market in corporate control in the cooperative sector as there is no externally-held capital, nor are there tradable ownership rights that can be bought in a hostile bid. According to this line of reasoning, there is less external disciplining pressure for executives of cooperative banks. This conclusion must be substantially qualified in four respects. Firstly, the ‘external’ pressure on SHV banks to realize high profit targets in order to avoid the acquisition by other banks provoked unsustainable behaviour by many SHV banks, which is now considered to be one of the main causes underlying the credit crisis. Secondly, several surveys of how the market in corporate control operates in practice demonstrate a very mixed picture in terms of whether take-overs do in practice create value: clearly, many do not. Thirdly, inside cooperative banking groups, peer pressure exists to discipline local banks as well as the central network institution. Fourthly, in so far as cooperative banking groups or individual local banks want to maintain a relatively high credit rating, one could argue that this objective constitutes a strong external disciplinary factor for executives. The disciplinary role of credit ratings could in fact be stronger than the pressure exerted by external shareholders, who presumably attach less weight to a relatively high rating (Boonstra, 2010).

It must be realized that dissatisfied members have a powerful and easy option to discipline management in the form of withdrawing funds and business. *Exit* or voting with their feet by members diminishes the volume of deposits available to the business, and can consequently be a more powerful discipline on management than the sale of shares in a SHV institution. Although customers of SHV banks have similar options at their disposal to signal their discontent by, for instance, withdrawing deposits, the crucial distinction is that they are not owners of the bank. The exit route by members (who are also customers) is a particularly powerful disciplinary tool in the

case of cooperative banks, as it removes resources from the bank, whereas the sale of shares in an SHV bank does not. In other words, it is easier and less costly for a member simply to withdraw business (e.g. a deposit) and transfer it to a competitor than to seek to change the behaviour of the firm. It is true that a member cannot take away the capital from a cooperative bank because it is 'capital in dead hands', but its eventual capital loss would be fairly modest if its cooperative bank were to get into trouble. The reason is that members have at most a rather limited liability for their cooperative banks due to the fact that nowadays membership is voluntary in most instances. Withdrawing deposits thus exerts a powerful discipline on cooperative banks and constitutes, in some senses, a more direct threat to managers. This is because when a depositor withdraws funds, the capacity of the cooperative bank is immediately reduced. By contrast, the sale of an equity stake in a SHV bank does not in itself influence the capacity of the bank, though the share price might fall, which would have the effect of raising the cost of capital and might also create a confidence problem for the bank. Thus, if equity stakeholders in SHV banks sell their ownership stake on the stock market, this does not remove assets from the control of the management of the banks, whereas the withdrawal of members' deposits at both cooperative and SHV banks does (Adams and Mehran, 2003).

Another powerful disciplining mechanism inside cooperative banks stems from the fact that they traditionally do not have access to external equity finance (or at least not to the same extent as SHV banks) which makes them more reliant on retained profits for growth. The capital structure of cooperative banks is such that the almost exclusive source of capital is retained profits. This implies that business mistakes that have the effect of destroying capital cannot be offset by external injections of capital. This tends to make cooperative banks more risk-averse and focussed on a sustainable and stable business model.

5. Conclusions and future governance challenges

All in all, our judgement is that too much emphasis has been placed on potential weaknesses within the corporate governance of cooperative banks in most of the existing and earlier literature and policy documents (PA Consulting Group, 2003; Fonteyne, 2007). These assertions have been mostly based on one-sided theoretical considerations without taking into account the actual functioning and outcomes of corporate governance structures of SHV and cooperative banks. This contribution tries to nuance the picture by underscoring neglected and unknown positive elements of the cooperative governance model. We argue that STV banks are actually better

equipped to address some agency problems than are their SHV counterparts. In addition, there is absolutely no scope for cooperative banks to be inefficient or to adopt hazardous behaviour. Though members in a cooperative bank do not have the same ownership rights as do shareholders in a SHV bank, there is no systematic evidence that agency costs are significant. Cooperative banks have sufficiently active, involved and qualified members (Juvin, 2005) to limit these agency costs. Elsewhere in this volume, it will be demonstrated that cooperative banks often exhibit superior performance in terms of efficiency and stability and in general came through the financial crisis much better than did SHV banks. Hence, cooperative banks have an edge in portraying the trustworthiness of their corporate governance model explicitly directed towards maximising customer value instead of maximising short-term profits.

These positive comments on the corporate governance of cooperative banks are not intended to mask the fact that their governance poses various future challenges (Groeneveld and Sjauw-Koen-Fa, 2009). Firstly, cooperative banks should explain why the agency conflicts inherent in the mutual structure are much less pronounced than those in the SHV structure. These conflicts are largely controlled by relatively unknown existing governance mechanisms. Secondly, it will be a balancing act to reconcile the interests of domestic members, i.e. the cooperative part of the organisation, with the size and risks of their increasing international activities. If the operations abroad become substantially larger than the cooperative part, the dilution of the cooperative nature will be looming. Furthermore, adding international businesses may increase the overall risk of the organisation and destabilise the cooperative banking business. Thirdly, it is undeniable that it has become more difficult for members to monitor the organisation due to the increased organisational complexity of mature cooperative banks, where management is carried out by dedicated professionals. A transparent and enduring balance between local delivery and central management is needed to safeguard engagement and involvement of local banks' members. Fourthly, cooperative banks may be tempted to introduce external shareholders into a cooperative system, but this creates tensions regarding control. If capital is only provided by members, the voting power as a member of a cooperative bank and the voting power as capital provider coincide. On the other hand, when ownership is shared with external capital providers, voting power will also have to be shared.

If cooperative banks can effectively address these difficulties and find appropriate answers to these challenges, they will be well-positioned for the future. But one has to bear in mind that cooperative banking is not by definition better than other banking models and after all, past

performance is not a guarantee of future success. Irrespective of the merits and drawbacks of different governance arrangements in the cooperative and SHV sectors in banking, there is merit in diversity (Ayadi *et al*., 2010). No governance model is unambiguously superior and it needs to reflect the nature and ownership structure of different businesses. In general, and when considering consumer interests, comparing the merits of the two organisational forms is of second-order importance in the context of imperfect versions of each; when both operate in a competitive environment, and when the two forms compete in the same markets. In the final analysis it is competition that is a major discipline on cooperative banks most especially when cooperative and SHV banks are in direct competition with each other. Thus, the main conclusion is that cooperative banking is not a panacea for post-crisis banking in general, but should be viewed as a viable, enduring and parallel alternative to the SHV banking model that has been in the spotlight for most of the time in recent decades. There is no presumption that the SHV model is to be regarded as the norm, as SHV and cooperative banks have equal status as contributors to the services provided by the financial sector of the economy. The strength of competition lies in diversity with different models playing to their particular strengths.

REFERENCES

Adams, R. and H. Mehran (2003), ‘Is Corporate Governance Different for Bank Holding Companies?’, *Federal Reserve Bank of New York Economic Policy Review*, April , pp. 123-142.

Ayadi, R., D.T. Llewellyn, R. Schmidt, E. Arbak, and W. de Groen (2010), *Investigating Diversity in the Banking Sector in Europe: Key developments, Performance and Role of Cooperative Banks*, Centre for European Policy Studies, Brussels.

Baysinger, B. and H. Butler (1985), ‘Corporate Governance and the Board of Directors’, *Journal of Law, Economics and Organisation,* Vol. 1, pp. 101-124.

Birchall, J. (2001), ‘Introduction’, in: J. Birchall, ed., *The New Mutualism in Public Policy*, Routledge, London, pp. 1-13.

Blair, M. (1995), *Ownership and Control: Rethinking Corporate Governance for the 21st Century*, Brookings Institution, Washington.

Boonstra, W.W. (2010), ‘*Banking in times of crisis: the case of Rabobank*’, SUERF Study 2010/3, pp. 31-56.

Cuevas, C.E., and K.P. Fischer (2006), ‘Cooperative Financial Institutions: Issues in Governance, Regulation and Supervision’, *World Bank*, Working Paper No. 82, Washington. D.C..

Drake, L. and D.T. Llewellyn (2004), ‘The Economics of Mutuality: A: Perspective on UK Building Societies’, in: J. Birchall, ed., *The New Mutualism in Public Policy,* Routledge, London, pp. 14-40.

EACB (2005), ‘*Cooperative banks in Europe: values and practices to promote development’*, Brussels.

Fama, E. and M. Jensen (1983), ‘Agency Problems and Residual Claims’, *Journal of Law and Economics*, 26(2), pp. 327-352.

Fama, E. (1980), ‘Agency Problems and the Theory of the Firm’, *Journal of Political Economy*, 28(2), pp. 288-307.

Fonteyne, W. (2007), ‘Cooperative Banks in Europe – Policy issues’, *IMF Working Papers,* WP 07/159, , Washington. D.C.

Groeneveld, J.M. (2011), ‘Morality and Integrity in Cooperative Banking’, *Ethical Perspectives,* Vol. 18, No. 4, pp. 515-540.

Groeneveld, J.M. and A. Sjauw-Koen-Fa (2009), *'Co-operative banks in the new financial system'*, report prepared by Rabobank for the IMF/World Bank meeting in Istanbul, Turkey, October 2009.

Groeneveld, J.M. and Y.B. de Vries (2009), 'European co-operative banks: First lessons of the subprime crisis', *The International Journal of Co-operative Management*, Vol. 4, No. 2, September , pp. 8-21.

Hirschman, A. O. (1970), *Exit, Voice and Loyalty: Responses to Decline in Firms, Organisations and States,* Mass. Harvard University Press, Cambridge.

Jensen, M.C. (1988), 'Takeovers: Their Causes and Consequences', *Journal of Economic Perspectives,* Winter, Vol. 2, No. 1, pp. 21-48.

Juvin, H. (2005), 'Les Restructurations Bancaires en Europe: Les Banques Cooperatives', *Revue d'Economie Financiere*, 78, pp. 14-18.

Kalmi, P. (2007), 'The disappearance of Cooperatives from economics textbooks', *Cambridge Journal of Economics*, 31, pp. 625–647.

Leland, H (1998), 'Agency Costs, Risk Management and Optimal Capital Structure', *Journal of Finance*, 53, pp. 1213-1243.

Llewellyn, D.T. (2004), 'Issues in the Governance of Life Mutuals', Paper commissioned for the Myners enquiry into the Governance of Life Mutuals, H M Treasury, London.

Mayer, C. (1996), 'Corporate Governance, Competition and Performance', OECD *Economic Studies*, No 27 (11), Paris pp. 7-34.

Michie, J. (2010), *Promoting corporate diversity in the financial services sector*', Kellogg College, University of Oxford, Oxford.

Mooij, J. ed. (2009), *Rabobank Matters,* Rabobank, Utrecht.

Nickell, S. (1996), *The Performance of Companies: Relationship between the External Environment, Management Strategies, and Corporate Performance*, Blackwell, Oxford.

Niemeyer, V. (2010), *Customer Advocacy 2010: How Customers Rate European Banks*, Cambridge MA: Forrester Research.

OECD (2004), *Principles of Corporate Governance*, Paris.

PA Consulting Group (2003), '*Mutually assured destruction?'*, PA Consulting, London.

Shleifer, A. and R.W. Vishny (1986), 'Large Shareholders and Corporate Control', *Journal of Political Economy,* 94, No. 3, June, pp. 461-488.

Sinha, R. (1996), 'Corporate Control in Large Firms in the UK"', Warwick Business School Research Bureau, Warwick, pp. 1-40.

---

[1] For a more detailed discussion of this distinction, see Ayadi, *et. al.* (2010).

[2] In the case of SHV banks, agents also have the option of selling their stocks if they disagree with the policy of the executive board. This corrective mechanism is, however, less powerful than withdrawing business from a bank.

[3] Accountability to shareholders does not operate perfectly or according to the standard text-book regarding the actual drawbacks of the SHV model. Many institutional shareholders are arguing that, in practice, their ability to bring inefficient management to task is limited. Besides, institutional investors often do not believe they have significant control, and many believe it is not their function to exercise monitoring and control of the companies in which they hold shares. The discipline of the capital market works very imperfectly for SHV banks as well. Companies are not in practice motivated exclusively by the maximisation of share-holder value: they may follow a wide variety of objectives and are conscious of a multitude of different stake-holders' interests which at times may conflict with the interests of shareholders.

[4] However, some cooperative banks do pay limited dividends and have instituted loyalty schemes for members.

[5] In a few cases, however, members may trade membership shares or certificates in a closed market available only to members. This is another example of the "commonality with diversity" description of the European cooperative bank sector.

[6] Mutual building societies in the United Kingdom tend to offer marginally better savings and mortgage rates.

[7] It is argued that members have a non-exclusive and non-marketable claim to residual net worth (in the sense that new members can typically join on equal terms or that it would not be meaningful to establish a secondary market for non-exclusive claims, respectively). Moreover, it is assumed that members are not a specialist group of shareholders and risk-takers who are remunerated separately from the generality of members (customers). Incentives for members to exercise monitoring and control may also be weak as the costs of doing so are prohibitive and out of proportion to the value received: in effect, a 'free-rider' argument applies.

[8] The debate about the relative agency costs in cooperative and SHV banks tends to focus on standard agency problems, i.e. problems associated with the separation of decision making and risk-bearing functions and manifested in problems such as management slacking and perquisite taking. A further agency problem, however, relates to the potential conflict between the holders of debt contracts and the holders of equity. Specifically, the nature of the debt contract dictates that if a risky (*ex ante*) investment produces high (*ex post*) returns well above the face value of the debt, equity holders will capture the gains

while debt holders receive only their fixed contractual payments. If, however, the investment fails then, due to their limited liability, equity holders will face only limited downside risk while debt holders will face the same downside risk without any compensating upside potential. This means that, as shareholders have all the upside potential of risk behaviour but only a limited downside loss, they may have greater incentives to encourage the firm to take more risk than do debt holders in the firm.