

Why Cooperative Banks Are Particularly Important at a Time of Credit Crunch

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According to the definition put forth by the Council of Economic Advisors [1991], a “credit crunch” is “a situation in which the supply of credit is restricted below the range usually identified with prevailing market interest rates and the profitability of investment projects”.

The credit crunch damages the economy by reducing external finance available to “good” enterprises. Due to lack of credit, enterprises end up suffering illiquidity, which may lead them to curtailing output below potential (with job losses too) or to even go default. SMEs are typically the most damaged since they rely on bank credit as the exclusive source of external finance.

Perhaps the most well known recent event featuring an extensive credit crunch is the Asian crisis of 1997-98. Indeed, Domaç, Ferri and Kawai (2002) find evidence of a widespread credit crunch in the Asian crisis.¹ Based on that experience – but this may be generalized to other credit crunch events – one or more of the following features are observed during the credit crunch:

- Increase in real interest rate;
- Rising spread loan rate vs. risk free rate (e.g. T-bills);
- Drop in (rate of growth) of real loans;
- Flight to quality by depositors: i) across national banks; ii) from national to foreign banks;
- Flight to quality by banks (e.g. to central bank deposits and/or Treasury securities);
- Disproportionate drop in loans to SMEs;
- Increase in rejection rate of loan applications;
- Shortening maturity of loans;
- Drop in “pre-committed” credit lines.

As Table A – drawn from Domaç, Ferri and Kawai (2002) – documents, all of these features were observed to some extent during the Asian crisis.

Table A. Overview of Bank Behavior in Asian Crisis Countries: 1997-98

	Indonesia	Korea	Malaysia	Philippines	Thailand
<i>1. Degree of increase in real interest rates following the crisis</i>	Negative rates till summer '98; high real rates thereafter	High till summer '98 moderately high thereafter	Moderately high in the earlier part of '98; then declines	Moderately high in the latter part of '97; downward trend in '98	Moderately high in '97; downward trend in '98
<i>2. Increasing spread between loan rate and interest risk-free rate</i>	Yes (but moderate since summer '98)	Yes	Yes	Yes	Yes (at least temporary third quarter '97)
<i>3. Extent of decline in the growth of real loans</i>	Not in '97 but sharpest drop in '98	Sharp decline in first half of '98	Sharp decline in '98	Downward trend in '97; drop in '98	Slight upward trend in 1997 and sharp decline in 1998
<i>4. Flight to quality by depositors</i>	From private banks to state banks	From local banks to nationwide banks	Merchant banks & finance companies to commercial banks	From private banks and saving banks to commercial banks	From small banks to large banks
<i>4.1 Among Domestic Banks</i>					
<i>4.2 Domestic to Foreign Banks</i>	Yes	Yes	Yes	NA	Yes
<i>5. Evidence of flight to quality by banks (e.g. via larger purchase of securities)</i>	Yes	Yes	Yes	Yes	NA
<i>6. Evidence of disproportionate contraction in loans to SMEs</i>	Yes	Yes	Drop in share of small-size loans	Yes (drop in regions where SMEs concentrate)	NA
<i>7. Higher rejection rate</i>	NA	NA	Yes	NA	NA
<i>8. Shortening in the maturity of financial intermediation</i>	Yes, strongly so	Yes	Yes	No, contrary evidence	NA
<i>9. Evidence on contraction in pre-committed loans</i>	NA	Yes	Yes	NA	NA

¹ See also Ding, Domac and Ferri (1998); Ferri and Kang (1999), Domac and Ferri (1999).

There are essentially three ways in which – compared to ordinary commercial banks – credit cooperatives may be helpful at a time of credit crunch. All of the three potential effects of the credit cooperatives stem from their business model and productive specialization, which heavily relies on relationship-based retail banking. First, credit cooperatives may be less inclined to ration credit to customers. Second, credit cooperatives may be less prone to raise the loan rate during a time of financial stress. Third, thanks to better capitalization and more prudent lending, credit cooperatives may be less likely to be distressed themselves and, therefore, may be better able to continue assisting their customers in a time of financial stress.

Let us review some evidence, derived from the economic literature, which is – punctually, or at least broadly – consistent with the above claims.

1. Credit cooperatives exhibit less credit rationing

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The Italian case has been studied in depth. Angelini, Di Salvo and Ferri (1998) analyze the effects of bank-firm relationships on loan cost and availability at Italian SMEs investigating whether Banche di credito cooperativo (BCCs – Raiffeisen type cooperative banks in Italy) play any special role. They find that: i) members enjoy easier access to credit at BCCs (i.e., less credit rationing); ii) loan rates increase with relationship length for all customers, but at BCCs this is the case for non-member customers only (i.e., no bank capture as the duration of the bank-firm relationship lengthens); iii) the main distinctive features of BCCs relative to commercial banks stem from cooperative ownership. Analogously, Cannari and Signorini (1997) show that, vis-à-vis commercial banks, BCCs and also banche popolari – the other class of credit cooperatives, of the Volksbank type, present in Italy – enjoy a lower non-performing-loan ratio (i.e. they reach a superior efficiency in their loan allocation) and also a lower ratio of overdraft loans to pre-committed loans. Since the latter is a proxy of the extent of credit rationing, this suggests that – supposedly on the basis of longer-lived relationships – cooperative banks succeed in reducing the degree of asymmetries in information with respect to borrowers and, thereby, can make less recourse to credit rationing. More recent studies – focusing on the banche popolari – seem to broadly confirm those findings of the mid-1990s: Cau et al. (2005) concur that both the non-performing-loan ratio and the ratio of overdraft loans to pre-committed loans are lower for the banche popolari vis-à-vis commercial banks; Ferri et al. (2005) document that the probability of a firm declaring itself to be credit rationed is systematically lower when its main bank is a banca popolare and the effect is statistically significant for the SMEs and for all the firms located in the less-developed Southern Italy. Thus, there seems to be less credit rationing at the credit cooperatives.

The evidence to my knowledge for other European countries is less systematic than is the case for Italy. However, we can list some relevant contributions. For France, Ziane (2004) shows that: i) the probability of a firm being credit rationed increases in the number of banks it borrows from; ii) the number of banks a firm borrows from is systematically lower when the main bank is a cooperative bank. Thus, at least indirectly, Ziane finds that cooperative banks help reduce credit rationing. Moreover, similar results are reached by El Hajj Chehade and Vigneron (2007) who find that: i) there is a strong tie between the firm's informational opacity and the choice of a decentralized bank (where cooperative banks are the bulk); ii) opaque firms are more likely to be credit constrained if they choose a hierarchical bank (a national level or foreign bank) as their main bank. Furthermore, Bonnet, Cieply and Dejardin (2004) argue that the presence of mutual banks may reduce the extent of financial constraints for new and/or innovative firms. Regarding Germany, Harm (1992) documents the major role played by cooperative banks in financing the Mittlestand. More recently, Koetter and Wedow (2006) show that – contrary to what found for public sector

banks – improving the efficiency of cooperative banks leads to higher economic development in their respective economic planning regions (Raumordnungsregionen). Supposedly, this is consistent with the special role played by cooperative banks in reducing financing constraints for local small business. For Poland, Zawajska and Siudek (2005) report that despite growing competition from the commercial banking sector, cooperative banks are still of major importance for providing support to farmers and rural households.

All in all, there seems to be consistent evidence that cooperative banks decrease the extent of credit rationing, something which would prove extremely important during a period of credit crunch.

2. Credit cooperatives practice lower increase in loan rates at times of stress

This hypothesis is based on the idea that cooperative banks tend to limit the rise of loan rates since they engage in a longer-term relationship with their borrowers and also because these banks enjoy a funding which is both more stable and with a cost less responsive to market interest rates.

This hypothesis has been tested for some countries only. For Italy, Ferri and Pittaluga (1997) show that BCCs raise loan rates to a smaller extent than commercial banks during times of tight monetary policy. In addition, investigating the role of bank customer relationships during the intense monetary restriction of 1992, Conigiliani, Ferri and Generale (1997) use micro-data from the Central Credit Register to assess whether closer bank-firm relationships affected the probability that a firm suffers more. According to their findings, for firms with closer customer relationships the likelihood was lower that the borrowing rate strongly increases and/or credit limits become binding. Though this paper did not consider the difference across type of lending bank, it did show that the intensity of the bank-firm relationship – as measured by a lower number of lending banks or by a higher concentration of loan supply to the firm across banks – was by far larger for the cooperative banks. Hence, even this evidence is broadly consistent with the hypothesis.

For Germany, investigating the pass-through from policy rates to loan rates during the 1990s, Weth (2002) finds that: i) larger credit institutions adjust their lending rates to changes in market rates faster than smaller credit institutions; ii) those banks that are refinanced to a major extent by savings deposits adjust their lending rates to changes in market rates relatively slowly; iii) in the short run, the loan rates of those banks that have to refinance their long-term lending to non-banks on market-related terms respond more strongly to changes in market rates than those of banks that cover their long-term non-banks loans by corresponding non-banks deposits; iv) the lending rates of those banks with large volumes of long-term business with households and companies are stickier than those of banks where this business plays only a limited role. Obviously, even though Weth does not detail across bank type, the attributes he associates with a limited rise in loan rates are all strongly pertinent to the cooperative banks.

Though this aspect has not been investigated as deeply as the issue of credit rationing, there is some evidence that cooperative banks tend to increase their lending rates during times of monetary/financial stress less than the commercial banks do. Also this feature would be very important during a period of credit crunch.

3. Credit cooperatives are more stable during financial stress

Is there any difference across types of banks in terms of resilience to the crisis? If, with respect to the other banks, cooperative banks are traditionally better capitalized, are more prudent in

their lending and can also rely on more stable funding sources, then one could expect that cooperative banks are more resilient to the financial crisis.

Not much evidence is available in this respect, also because Europe did not experience truly major financial crises since the 1930s until the current one. I can quote some evidence derived from another country. According to a paper I wrote a few years ago, on mutual savings and finance companies (MSFCs) in Korea (Bongini, Ferri and Kang, 2000), studying the Korean 1998 systemic financial crisis, we contrasted the individual distress across a group of larger sized banks (commercial banks, merchant banking corps) and all the tiny-sized MSFCs. Our main findings were: i) contrary to Too-Big-To-Fail Doctrine and credit channel, the percentage of distress was smaller at MSFCs; ii) supporting "peer monitoring" hypothesis, the extent of distress was smaller for MSFCs that kept closer to their origins – e.g. collecting a larger share of deposits as "credit mutual installment savings" – and/or with longer business history in their local communities.

Also in this case, even though evidence is lacking, on the basis of what observed up to now, the argument can perhaps be put forward that, with respect to commercial banks, cooperative banks should be more resilient to the crisis. Once more, this feature would be key to help household and the SMEs overcome the expected credit crunch.

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