



EUROPEAN ASSOCIATION OF CO-OPERATIVE BANKS



# RESEARCH PAPER

## EUROPEAN CO-OPERATIVE BANKS IN THE FINANCIAL AND ECONOMIC TURMOIL First Assessments



**PUBLICATIONS 2010**

The voice of 4200 local and retail Banks - 50 million Members - 160 million Customers

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## About EACB

The European Association of Co-operative Banks (EACB) has been the voice of co-operative banks at European level since 1970 and more recently at international level. It represents, promotes and defends the common interests of its 27 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. With 4,200\* locally operating banks and 65,000 outlets, co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system based on a long-term approach. In their long tradition, they have served more than 160\* million customers, mainly consumers, SMEs and communities. Europe's cooperative banks represent 50 million members and 750,000 employees and have an average market share of about 20%. In some countries, such as Austria, Germany, Finland, France, Italy and the Netherlands, the market share is well above this figure, ranging from 30% to 50%. Their resilience during the crisis make co-operative banks a key driving force in the economic recovery.

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\* 2007 figures



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## Foreword

It is evident that the interest of analysts, policy makers and researchers in the co-operative banking model has increased considerably over the last two years. The European Association of Co-operative Banks largely attributes this increased attention to the fact that co-operative banks escaped relatively unscathed from the financial and economic crisis thanks to their unique characteristics, not least in terms of their corporate governance. This development is encouraging, because the characteristics and achievements of co-operative banks in the past few years have been largely neglected in publications, the press and various reports. But the success of the co-operative business model has been clearly evident in the results they have achieved at local and regional level. The strongest proof of the vitality of the co-operative business model is the increase in market shares over the last decade and the rise in member-to-population ratios in particular.

This report prepared by the European Association of Co-operative Banks aims to contribute to an even better understanding of the strengths of the co-operative banking model. To this end, this study assesses the short-term and longer term implications of the financial crisis for co-operative banks. As it is convincingly demonstrated, member ownership has contributed to the relatively good performance of co-operative banks before and during the crisis. The key point is that members, who are also customers, own the entire co-operative organisation. Member ownership is reflected in an approach that is consensus-driven to a greater extent and avoids a strong fixation on just one stakeholder. The concomitant long-term view and risk-averse stance translate into a more conservative banking strategy directed towards retail banking. In addition, co-operative banks add a large part of their profits to reserves or own funds. Consequently, co-operative banks are some of the most highly capitalised institutions in Europe and tend to contribute to the stability of national financial systems.

The unique features and core competences of co-operative banks provide a solid starting point with clear opportunities for the forthcoming years. For instance, most of the 'new' characteristics of the global financial system – a much stronger customer focus, a greater focus on integrity and ethics, a responsible risk attitude, a longer-term perspective and improved transparency – have been part of co-operative banks' DNA from the outset. But this does not mean that these opportunities can be simply cashed in. A proactive and innovative attitude is needed to contend with a wide range of manifest challenges. The bottom line is that the success and life expectancy of co-operative banks depend on the legal environment, their competitiveness, the quality and strategy of their management, and, last but not least, their relationships with their members. The long history of co-operative banks shows that they can live up to these expectations.

### **Piet Moerland**

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## Introduction

In the recent years we have faced an unprecedented turmoil that has profoundly shaken the fundamentals of finance and economy worldwide. This has stimulated reflections and analyses from various perspectives. Economists, policy makers, analysts, international organisations, opinion makers and many others have contributed to this discussion with reports and studies on different aspects of this crisis. The European Association of Co-operative Banks (EACB) intends to contribute as well to this debate and has co-ordinated the efforts of its members and of the European think tank on co-operative banks to produce an assessment of the crisis and the performance of co-operative banks. The analysis is structured as follows: chapter 1 focuses on the causes and effects of the crisis; chapter 2 assesses the position and performance of co-operative banks before and during the turmoil; chapter 3 suggests a new model to assess banks performance concluding that the stakeholder finance embodied in co-operative banks might be a more sustainable lending model for the future.

To sum up, the co-operative banks business model has demonstrated to be both sustainable and resilient to financial shocks. Co-operative banks have been displaying stable profit growth, relatively limited write-downs, low provisions and low losses, fewer significant credit risks and a strong capitalisation vis-à-vis commercial banks over a long number of years. Moreover, comparisons with commercial banks on the basis of key financial figures and simple measures of banking stability indicate a beneficial influence of co-operative banks on the stability of national financial systems. Before the US asset price bubble burst, co-operative banks did actually have better Tier 1 ratios, more stable profit growth and a more solid balance sheet structure. Their operations, measured in terms of the cost/income ratio, became more efficient in the years before the crisis. Owing to their characteristics, structure, financial solidity and their ability to remain close to the customers, co-operative banks seem to emerge as clear winners of the recent turmoil, with less write downs, a viable business model generating solid revenues, and renewed approval from customers.

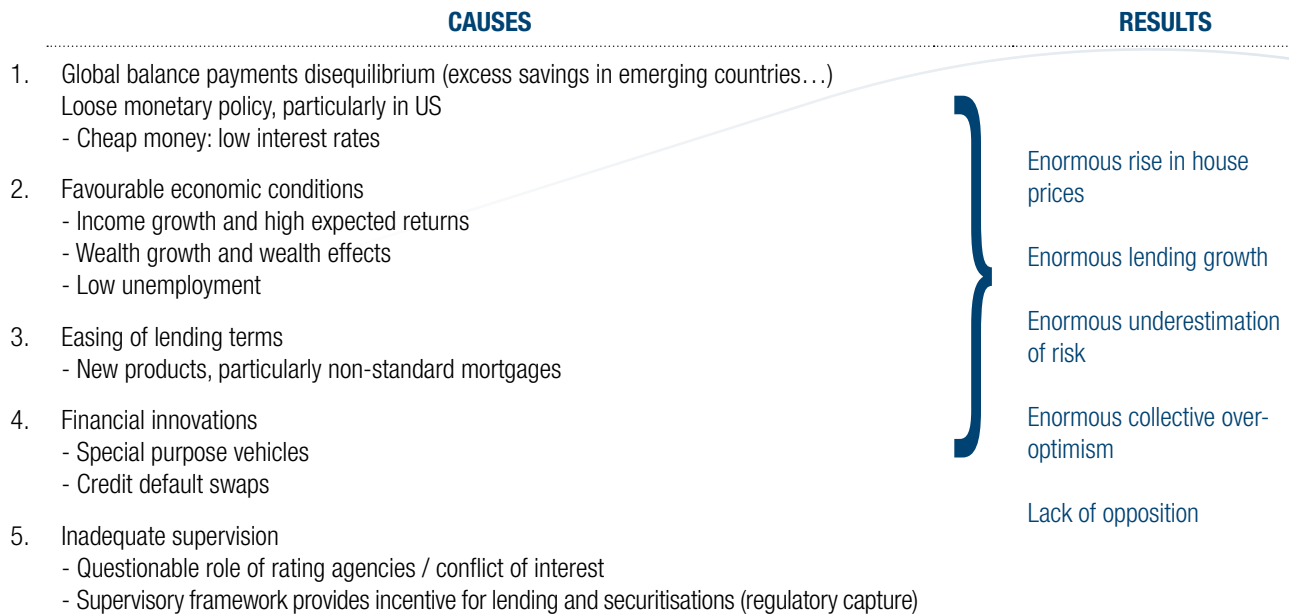
This ability of co-operative banks to come along their members and clients in the good days as well as in the bad days shows the efficiency of their sustainable development strategy. It also shows the quality of their governance, based on the principle “one person, one vote”. Marrying general interest with individual interests, this principle fosters the adoption of decisions reflecting the whole utility of a project, on a short as well as on a long term. Co-operative banks remain faithful to the ethic guiding their actions: responsibility, solidarity, proximity.

## I. Causes and direct effects of the financial crisis

The roots of the most recent credit crisis lie in the United States. Initially, five key factors activated a self-reinforcing mechanism in the financial system (see diagram 1). This took place against a macro-economic background of extensive worldwide imbalances in balances of payments, with the US developing into a major debtor. The excess of savings in emerging countries was invested in the US and led to low long term interest rates. The level of interest rates stimulated lending and raised households' borrowing capacity. US house prices increased sharply, and although this decreased the affordability of houses, banks were both able and willing to provide further credit, with no increase in capital requirements as they could book it off their balance sheets. Households' willingness to borrow and banks' willingness to lend were based on expected continued rises in house prices. In order to increase lending, banks eased mortgage loans criteria, and more risky mortgage products were introduced. This set of circumstances gave rise to speculation in the US housing market and drove prices up further. Banks were able to continue to finance the accelerating credit growth by partly securitising mortgages immediately. This was stimulated by the prevailing international framework for banking supervision (basically, Basel I). Securitisation generated liquidity for banks and mitigated the solvency pressure of lenders. Securitisation enabled banks to free up a relatively substantial amount of capital to increase the provision supply of mortgages further.

Owing to the increased risk tolerance and the search for yield among many market participants, the mortgage securities, despite their diminishing quality and increased risks, were in great demand for a long time among investors and banks worldwide. Supervisors and rating agencies insufficiently recognised the growing discrepancy between the actual and the underlying value of these financial products. This gave rise to a self-reinforcing process, nourished by over-optimism, insufficient pricing of risk and a search for yield in times of low interest rates. In the run-up to the financial crisis, the risks associated with financial transactions were collectively underpriced worldwide.

**Diagram 1 Causes of the credit crisis**



This process of continually rising asset prices was progressively ended by monetary tightening of the Federal Reserve Bank, which unexpectedly produced dramatic chain reaction in the financial and economic systems. It started with increasing payment difficulties for households that led to foreclosure sales, which put pressure on house prices. A negative spiral of falling house prices, foreclosures, declining consumer and producer confidence, increasing defaults on credits, collapsing confidence and rising questions about the real value of assets linked to the housing market, then those questions spread toward other asset classes, and entailed a freezing of many markets. These developments led to write-downs of credit portfolios for all banks owning such products, worldwide losses and capital shortages at (investment) banks, a closed interbank money market and a complete loss of confidence in the financial system ensued.

Despite major liquidity support operations and enormous interest rate cuts by central banks and capital injections by governments around and after mid-2008, several banks have failed or had to be bailed out by take-overs or nationalisations all over the world. But most troubled banks received state support and were saved, since they played a vital role in national economies (too big to fail). Among them are some of the biggest European banks, like Royal Bank of Scotland, Lloyds TSB-HBOS, Fortis, Dexia, Commerzbank, Hypo Real Estate, Northern Rock and Bradford & Bingley, as well as Irish and Icelandic banks.

### 1.1 FROM FINANCIAL TO ECONOMIC CRISIS

The financial crisis has also induced consumers and enterprises to clean up their balance sheets (deleveraging) and to adjust their consumption and investment patterns. These adjustments have had severe repercussions for the real economy. Consumption and investment have fallen worldwide, causing an unprecedented recession. In an attempt to mitigate the negative effects of the financial crisis on their real economies, many governments have taken measures to support certain industries, e.g. the automobile sector, to boost consumption and to maintain purchasing power. These budgetary and fiscal measures lead to sharply rising government deficits (not to mention the capital injections in financial institutions). Many countries have been confronted with rapidly rising unemployment rates and increasing bankruptcies since 2008.

Hence economic and financial crisis intertwined, resulting in severe consequences on the social and economic life in developed countries. In many countries, economic crisis started before the financial crisis, which in return fuelled the economic crisis.

While we are currently witnessing some signs of recovery, we are still far away from a situation of solid economic growth. The rebuilding in inventories, the next "bullish" story in the months ahead will play an accelerating role on industrial production. However the normalisation process will presumably not last long as the recovery in global demand is not expected to be robust enough to sustain the momentum.



Moreover the underlying fundamentals of the European economy remain fragile. In most EU-countries, the ongoing deterioration in the labour market, tight credit conditions, the reversal of the deflation process and finally the mounting pressure to deleverage also public debt will put some drag on consumption and investment growth. Private consumption is expected to grow but at a moderate pace. The overcapacities inherited from the crisis will be the main impediment to a revival in investment, but the contraction is expected to slow down in 2010.

## 1.2 PRIMARY AND COLLATERAL DAMAGE FOR THE BANKING SYSTEM

Banks were in the eye of the financial crisis storm very early on, and they are still making headline news, despite the spread of the crisis to other economic sectors. Until the end of 2008, the financial crisis had mainly only affected CIB (Corporate and Investment Banking) business areas and asset management in the broadest sense, including private banking, global custody and life insurance. It is only after the failure of Lehman Brothers that a more marked propagation to all areas of banking and to a very large number of countries has taken place. The dimension of the crisis has been growing over time and even emerging economies, that were initially spared, have been more or less severely hit later on. Among the hardest hit were various new EU member countries not yet belonging to the European Monetary Union, relying on large capital inflows and having their exchange rates pegged to the euro.

Hence bank support plans and ongoing efforts to bolster their financial strength, restore confidence and ensure that they continue to finance the real economy are of utmost importance. As “finance providers” banks could very negatively affect the recession cycles, should they ration the supply of credit. In other terms a credit crunch might be very dangerous and would increase the customers’ difficulties and delay the economic recovery. At the same time the economic slow down has dramatically reduced the production and the demand for credit. It should be noted however that the current situation and the impact of the crisis is very different from one country to the other and between banks.

The fact remains that all banking businesses, starting with the securitisation business, have been suffering and the situation is not likely to improve substantially in the coming quarters. Whereas the first phase of the crisis, which was more financial in nature, mostly affected securitisation activities, phase two has turned into a more classic crisis featuring a general activity slowdown and, most importantly, an increase in the cost of risk that has spread to a broader range of businesses. Following the initial blow of the direct effects, financial institutions are now confronted with the recessionary effects of the financial crisis. They have hopefully now recovered sufficiently from the initial shock to face these economic challenges and to bear the associated losses. The wave of regulatory and supervisory adjustments, that has followed the crisis also risks adding new burdens, despite the incontestable constructive aiming at bringing more stability in the financial sector and reducing the probability of the next crisis.

## 1.3 OUTLINES OF A NEW FINANCIAL SYSTEM

The crisis has revealed various shortcomings of the financial system and its supervision. This has stimulated actions from the legislative point of view but also a wave of self-assessments and reflections of the role of financial institutions. As a result, the main characteristics of the financial system are likely to change drastically. Six major changes can be identified, on which future policies are likely to insist: the most striking one is the increased level of capital requirement for financial institutions, on which most countries agreed on, notably in the G20 summit. It is closely followed by a greater focus on integrity and ethics, a more efficient risk attitude, the application of a longer term perspective, more transparency and last but not least a greater customer focus. Of course, the financial sector has also been performing a critical self assessment and is taking initiatives to improve its ethics, risk perception and risk attitudes. Accordingly, proposals have been put forward for an adequate structure of executive and employee remuneration in the financial system.

Overall, it is expected that greater emphasis will be placed on people and their ability in taking financial decisions, as well as on the social role of banks. The incorrect assessment of the underlying risks of subprime securitised mortgages has taught important lessons in terms of a dangerous short-term attitude and individual behaviours. Banks, institutional investors, businesses and private individuals will have to make much more conservative risk decisions when dealing with complex financial instruments. It is also likely that greater emphasis will be placed on customer education, protection and responsible lending. The likely outcome will be a reallocation of capital in favour of universal banking model, both well funded and well capitalised. It is also likely that a return to a more traditional intermediary role of banks on the basis of the original “originate to hold” model will gain momentum.

The perspective of a return to a more conservative and traditional model that puts the clients and the real economy at the heart of its activities will hopefully restore confidence in the financial system, which will in turn contribute to financial stability. Co-operative banks have in this respect an important role to play. They are all the more motivated to fulfil this responsibility, as the crisis underlined the high adequacy and solidity of their model. In this regard, co-operative banks somehow exactly match the new model fostered by regulators.



## II- Co-operative banks and the crisis

Co-operative banks were certainly not immune from the worldwide developments described so far. While many of the large co-operative banks have suffered substantial losses on risky investments, they do seem to have been hit relatively less severely by the direct effects of the crisis than private and investment banks. Their losses and write-downs appear to be relatively moderate and mainly concentrated in the international activities. Besides, no co-operative bank has fallen under nationalisation programmes nor has been declared bankrupt. As it will be discussed later, co-operative banks are predominantly domestically and retail orientated. As such, they have better knowledge about the risks in their business than other players. This does not mean however that they are immune: as part of the system they are also affected by the economic downturn because many of their retail and wholesale clients are hit by the recession.

This is not surprising as with very strong ties in local economies, co-operative banks are affected by any turbulence at local level. This has been quite severe in recent months. Moreover, due to the central role of members in the banking relationships, they are impacted by the reduced financial capacity of households, professionals and businesses who are typically members of co-operative banks.

However at least five characteristics set co-operative banks apart from other banks:

- they are generally well capitalised, and solid;
- they apply a distinctive business model in banking that puts the members and customers at its heart, with a long-term perspective through good and bad times;
- they have built-in anti-cyclical behaviour and internal deposit guarantee schemes.
- they have tight bottom up control mechanisms.
- they apply a democratic governance scheme, based on a wide involvement of their members in decisions taking, in a bottom-up way.
- In general those distinctive characteristics have ensured that the co-operative banks model would show its resilience and sustainability during the crisis.

### II.1 THE RESILIENCE OF EUROPEAN CO-OPERATIVE BANKS

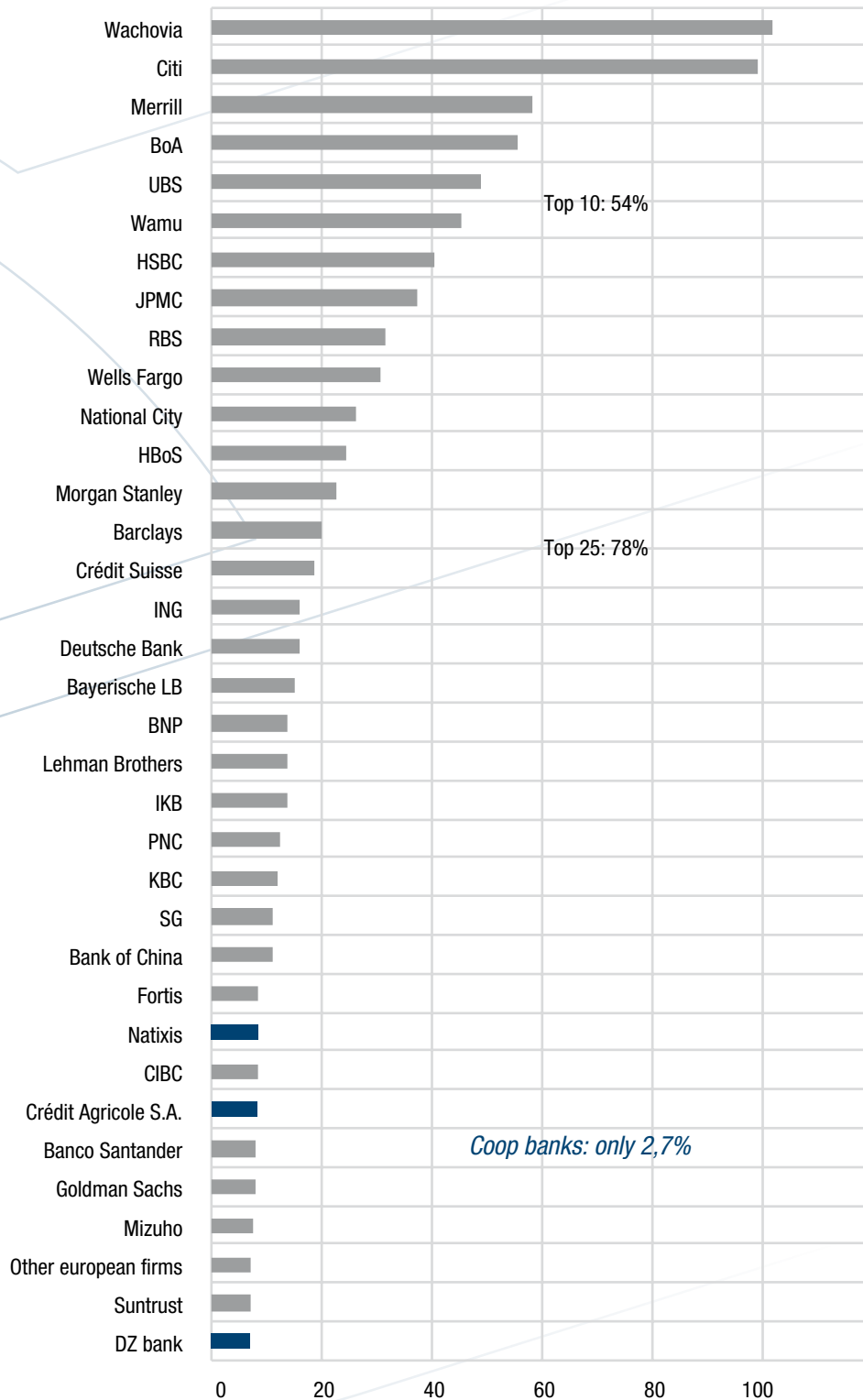
During the recent crisis, we have observed the failure of a large number of financial institutions, even the least suspect. In general however the financial institutions that have failed were commercial banks and public banks (Landesbanken in Germany) or former co-operative groups that choose to demutualise, such as Northern Rock and Bradford & Bingley in the UK. On the contrary, no European co-operative bank has ever failed.

When looking more closely at the direct cost of the crisis, similar conclusions can be drawn: more than 95% of write downs registered worldwide were due to commercial banks and some public banks; the cost in terms of loan losses provisions seems more equally distributed. Recapitalization (in particular state aids) was also massively directed towards commercial banks and some public banks. Co-operative banks have therefore been hardly responsible for the direct costs of the crisis, despite their heavy weight in the economy, with about 20% in terms of deposits market share.





**Global cost of the crisis to date (\$ Bn)**



Source: Bloomberg, October 2009



There are a number of explanations for this lower fragility. The most important ones can be identified as follows:

1. The corporate governance structure plays an important role. Member ownership entails a conservative banking approach with a longer term perspective and a focus on retail banking because the primary mission of co-operative banks is to provide services to their members/ customers who are typically, individuals, household and SMEs, i.e. retail banking. This banking area is characterised by relatively lower risks, lower volatility and more stable returns. Their focus on retail banking is mirrored in the type and number of customer they serve. Co-operative banks serve more than 159 million customers in Europe with an average market share in SME financing of around 29%. Although co-operative banks have naturally expanded the scope of their activities in recent years by moving into cross-border markets and rolling out new services, this expansion has respected their core values and their corporate governance rules, resulting in a business model with prudent management and clear responsibilities towards members.
2. Secondly, co-operative banks' business model is not based on selling commoditised credits (OTD, "originate to distribute") but, with the aim of responding to the needs of their members/customers, it is based on a more traditional "intermediation role" along the OTH ("originate to hold") model. As a consequence co-operative banks remain committed to the real economy, and they can play an important role in the recovery process after the crisis.
3. Third, the resilience and solidity of co-operative banks is also linked to the existence of internal cross guarantee or institutional protection schemes. Those schemes create solidarity between the independent local co-operative banks, by guaranteeing the client deposits in case of failure of one of the local banks adhering to the scheme. In fact this specific mechanism of co-operative banking groups exists alongside the national deposit banking schemes that are imposed by the national authorities in the European countries to guarantee clients deposits. This co-operative feature turns out to be highly valuable in these times of turbulences as it strengthens customer trust. This element contributes to reassuring clients as far as the guarantee of their savings is concerned: co-operative banks are perceived as bulwarks of safety and accessibility.
4. Finally, the resilience of co-operative banks can be explained by their strong financial performance as it emerges from data collected before, during and after the credit crisis<sup>1</sup>. The analysis below aims at demonstrating how the distinctive characteristics of co-operative banks are reflected in their financial performance and/or key figures. Three important, interdependent indicators are reviewed:
  - a - Tier 1 ratio
  - b - Profitability
  - c - Efficiency (expenses/income ratio)

#### **a. Tier 1 ratios**

Chart 2 shows the Tier 1 ratio for several co-operative banks at year-end 2008. This ratio reflects the amount of regulatory capital relative to the risk-weighted assets of a bank. It can be concluded that co-operative banks maintain a high level of capital. Those results are not surprising and in line with some of the features described in the previous paragraph. As co-operative banks add a major portion of their profits to the reserves year after year, they were able to become quite large. This is partly due to legal requirements under co-operative banking law in the different European countries, but also more basically due to the conviction (recently agreed by the G20) that high capital level is simply necessary with a view to continuity. Co-operative banks capital could be interpreted formally as an intergenerational endowment<sup>2</sup>, while the options to quickly raise capital are usually limited.

In the course of 2008, the Tier 1 ratios of many banks have deteriorated worldwide. Several banks have had to attract extra capital. Chart 2 below illustrates the fact that co-operative banks entered the crisis with a strong capital base and subsequently strengthened their capital position in 2008. It should be noted that the Tier 1 capital ratios pertain not just to the co-operative banking part, but to the entire co-operative groups (including other financial services like e.g. insurance companies).

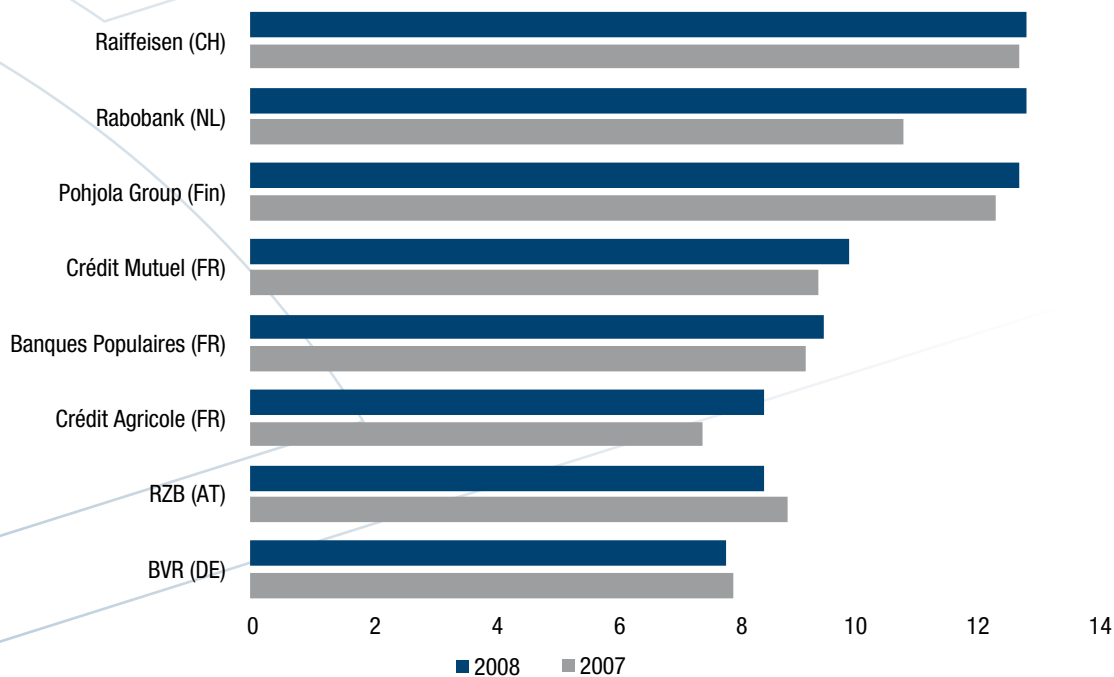
1. The performance of the co-operative is not merely restricted to its financial performance or favourable pricing for customers. Performance is also reflected in the degree of customer satisfaction, in the extent banks act in customers' interest, in the access offered to networks and knowledge of the bank, in the stability/duration of relationships, in the way banks deal with the environment/sustainability, in the degree of transparency et cetera (not necessarily in that order).

2. For more precise details, see Fonteyne (2007).



The notion that European co-operative banks, with their strong capital reserves and stable income, contribute to the stability of the banking system is increasingly supported by empirical studies. The researchers Hesse and Mihák (2007) of the IMF concluded that the strong capitalisation, the stable income of co-operative banks and their prudent risk-management more than offset the adverse influence of lower profitability on their stability<sup>3</sup>. Overall, in their view, financial co-operatives have a very positive contribution for the stability of the national financial sector.

Chart 2 Tier 1 ratio



Source: Annual reports

### b. Profitability

The primary goal of co-operative banks is to maximise members/customers value, while profit maximisation is not a target per se. Profit is however a necessary condition, without which the co-operative banks would be unable to grow or invest sufficiently. In this respect it is not surprising that data show a comparatively slightly lower profitability vis-a-vis the average of the commercial banking sector. More precisely, co-operative banks do not only chase profits maximisation, but rather stakeholders' value maximisation, their members being also customers. So besides a pure financial dividend, co-operative banks externalize a social dividend. It consists for example in providing its members/customers with top quality products and services at the best possible prices.

Profitability is usually assessed in terms of return on assets and return on equity. EACB calculations, based on a sample of forty five banks located in Western Europe, show that the return on assets and return on equity of co-operative banks are lower than for commercial banks, as expected. The lower return on equity, however, can be partly explained by the lower leverage resulting from a higher core capital ratio for the co-operative banks.

3. See also Groeneveld and de Vries (2009).

**Table 1 Average financial performance of banks, 2002-2007 (sample)**

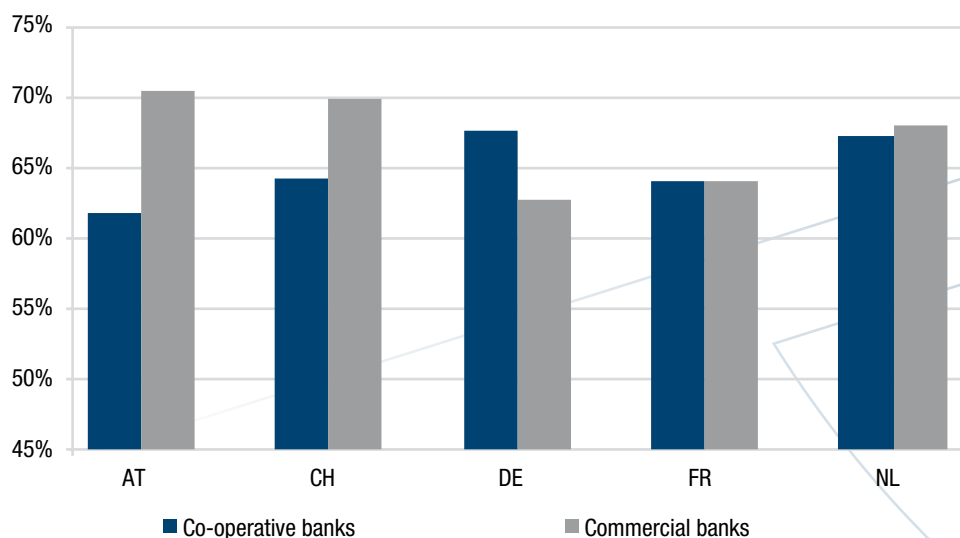
	<b>Co-operative Banks</b> (N=9 / O=53) Percentage (standard deviation)	<b>Commercial Banks</b> (N=36 / O=159) Percentage (standard deviation)
ROE	9.3 (4.5)	13.4 (8.5)
ROA	0.4 (0.2)	0.5 (0.3)
Core capital ratio	4.7 (1.4)	3.6 (1.4)
Tier 1 ratio	9.2 (1.4)	8.4 (1.4)
Cost / Income ratio	62 (6.7)	61 (13.3)

*Source: Rabobank calculations (2008) based on annual reports. Figures are based on 45 large banks established in Western Europe. N=number of banks. O=number of observations during 2002-2007.*

**c - Efficiency (cost/income ratio)**

EACB calculations show that, in the period from 2002-2007, most co-operative banks in Western European countries operated more efficiently than commercial banks (see chart 3).

**Chart 3 Cost / income ratio by country (2002 – 2007)<sup>4</sup>**



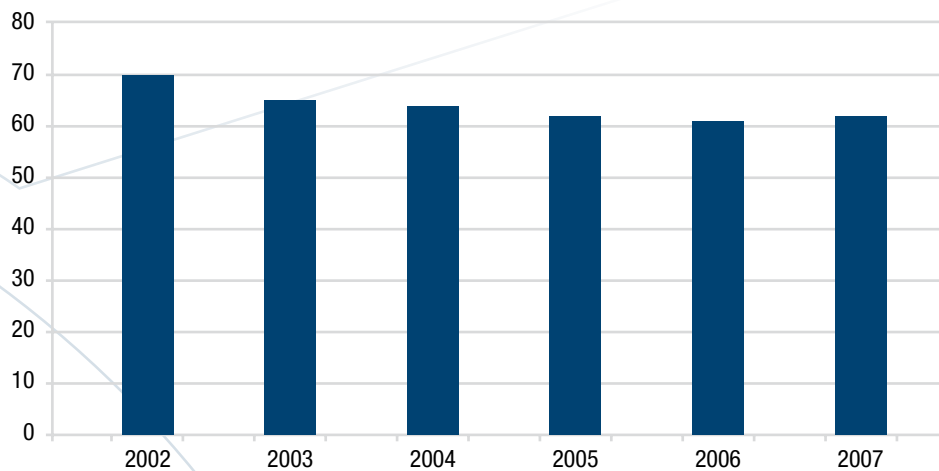
*Source: Calculations by Rabobank based on annual reports and ECB data*

The cost/income ratio of the co-operative banks improved significantly on average between 2002 and 2006 (chart 4). This can be explained by the fact that co-operative banks strive to serve the needs of their members/clients. Indeed, for co-operative banks it is further necessary to reduce their cost/income ratio to combine the value maximisation for clients and members with the necessity of being profitable.

4. Note: AT = Austria, CH = Switzerland, FR = France, DE = Germany, NL = Netherlands. The co-operative banks in these countries were compared with the total group of 45 banks.



Chart 4 Cost / income ratio of co-operative banks (2002 – 2007)<sup>5</sup>



Source: Rabobank (2008)

## II.2 THE POSITION OF EUROPEAN CO-OPERATIVE BANKS

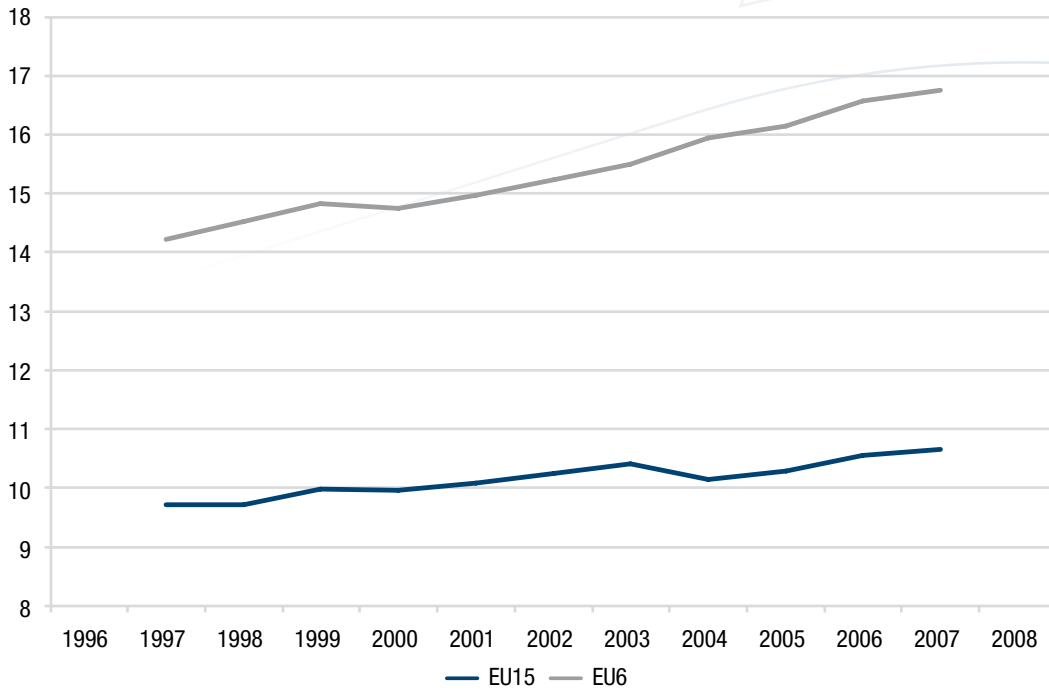
The success and popularity of co-operative banks has been increasing in recent years in Europe. A possible way to measure this is to quantify how many people have chosen to be members of co-operative banks as a percentage of the total population. This measure is the 'member-to-population' ratio. Chart 5 displays the evolution of this ratio in fifteen EU countries (EU15)<sup>6</sup>. The same ratio is plotted for six European countries with a relatively large co-operative banking sector: Austria, Finland, France, Germany, Italy and the Netherlands (henceforth EU6).

In both the EU15 and EU6, an increase in the member-population ratio is discernible. The ratio in the EU6 is substantially higher and has increased from 14 to almost 17 percent between 1996 and 2008. This clearly shows an increasing popularity of the co-operative model. The underlying reasons for this popularity are hard to isolate and are of a financial and immaterial nature. What is sure is that co-operative banks have succeeded in attracting new members with their products, services, co-operative business models or other distinguishing features. Co-operative banks appear to have found appropriate answers to the many trends and competitive challenges in the field of retail banking, by putting their members at the heart of the business. With conservative risk management and longer-time horizon views, co-operative banks have managed to restore the confidence of disoriented customers in these times of turbulences. Moreover the members-driven governance offers a good alternative to satisfy customers' appetite for having a say and exert control on how business is conducted and how their money is used.

The member-population ratios differ considerably across the EU15 countries. The highest ratios are found in Austria (28.5), followed by France (25.5), Finland (23) and Germany (19.8).

5. Note: The calculations cover Germany, France, Austria, the Netherlands and Switzerland. The data for 2008 are not yet available because not all annual reports have been published yet.  
6. The EU15 area comprises Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Greece, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

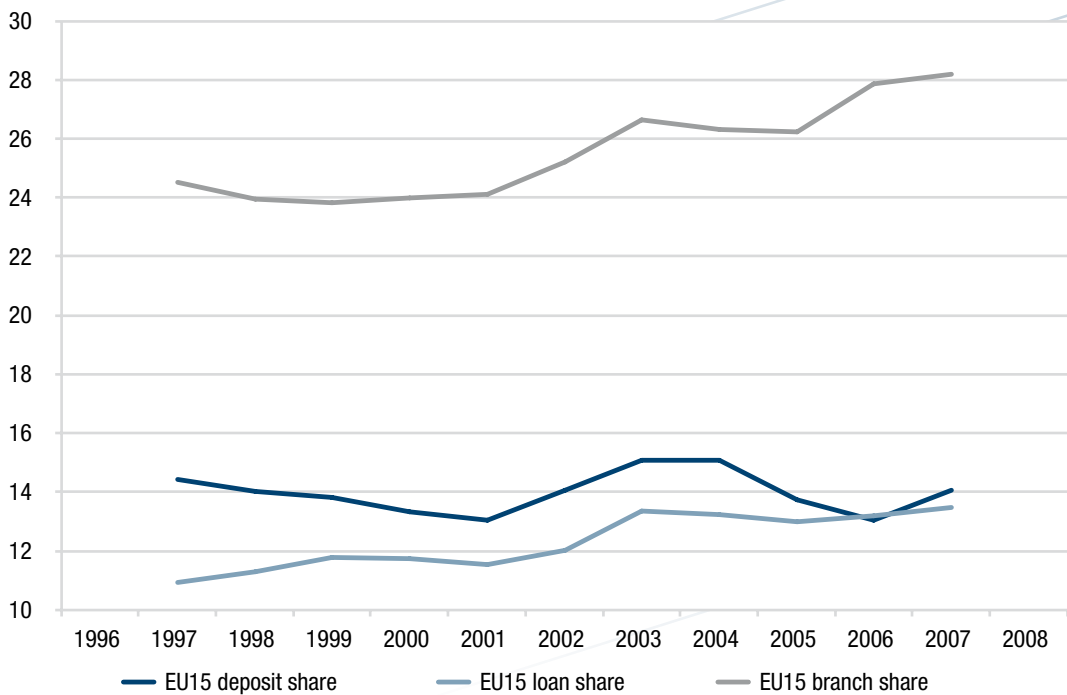
**Chart 5 Members as percentage of total population**



Source: ECB and EACB figures.

On average, co-operative banks in the EU15 were able to gradually increase their market shares in the loan and deposit markets over the last decade. The figures lead to conclude that the loan-to-deposit ratio is somewhat lower for co-operative banks than for commercial banks. This partly reflects their traditional strong position to attract local deposits.

**Chart 6 Market shares of co-operative banks in the EU15**



Source: Annual reports, EACB and ECB figures.



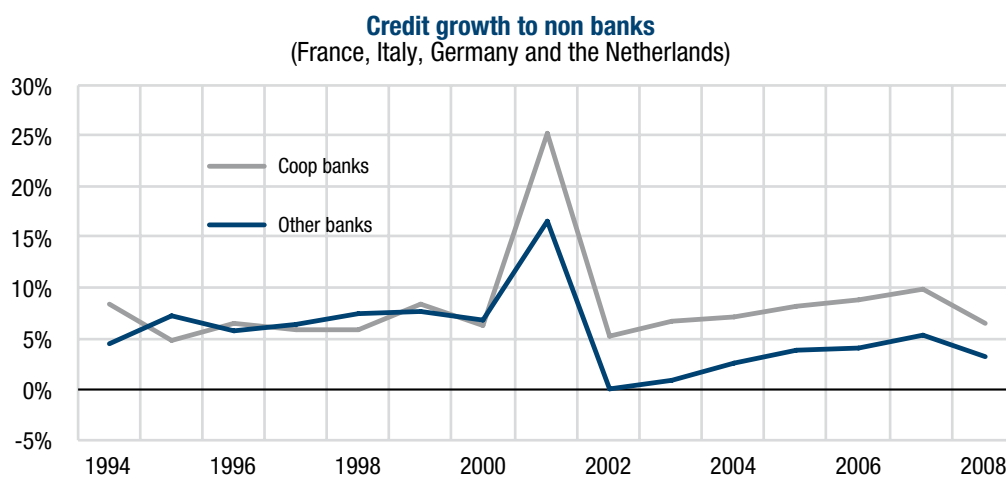
Although the market shares for deposits and loans (especially for households and SME's) are significant, the market shares on branch offices are even higher and can be more meaningful (chart 6)<sup>7</sup>. Over the last decade, co-operative banks have gained branch market share for two reasons. The first reason is that co-operative banks in France, Italy and Spain have expanded their branch office networks either organically or via acquisitions. The second explanation is that co-operative banks in eight EU countries have slimmed down the number of branch offices to a lesser extent than their competitors in the context of cost-cutting or efficiency programmes. As a result, co-operative banks have strengthened their local presence. This is an important development to underline in the context of a changing banking landscape and the expected return to a more stable banking model faithful to its original intermediation mission. In our EU6 panel of countries, co-operative banks currently own over 40 percent of all bank branches. Of course, many co-operative banks have also introduced or stimulated the use of cheaper virtual distribution channels, while remaining loyal to their core value of "proximity".

### II.3 CUSTOMER FOCUS IN TURBULENT TIMES

As part of the economic system, co-operative banks are deemed to be suffering also from the global economic recession. Nevertheless, they have a crucial role to play in supporting their customers, whether they are households, SMEs or wholesale and to restore confidence in the banking sector and in the economy. With a satisfactory solvency ratio (the overall Tier 1 ratio of European co-operative banks at 31/12/2007 stood at around 8.5%) they are not being forced to resort to the recapitalisation plans put in place by the authorities and, if they do so resort to them, it is with the intention of sustaining a rate of growth in their lending tailored to a severely degraded and risky environment.

This relatively favourable position is key to continue fostering local development and to reinforce the commitment to the real economy. The figures concerning the credit growth in 4 European countries where co-operative banks have a strong presence are very comforting in this sense, even if the interpretation of these data should be cautious. In France, Germany, Italy and the Netherlands the credit growth of co-operative banks has remained significantly higher than that of the other banks (Chart 7)

Chart 7 - Credit Growth



Sample of cooperative banks includes : all coop banks in France, Germany and Rabobank (NL). Italian cooperative banks included for the period 2000-2008.

Sources: Central banks

This is a strong indication of the commitment to remain connected to their members/clients through good and bad times, it also mirrors the strong capitalisation of co-operative banks as well as their ability to raise additional funding in the retail and wholesale markets.

7. The same holds for market shares for staff, albeit to a lesser extent.



## II.4 PROSPECTS FOR EUROPEAN CO-OPERATIVE BANKS

In the global financial system, integrity and ethics will play a growing role. Traditionally, the financial sector thrives on trust. In a sense, the 'new' characteristics of the global financial system have been part of co-operative banks' DNA from the start. In the words of the European Association of Co-operative Banks (EACB, 2005): *"The primary mission of co-operative banks is to promote the economic interest of their members, who are their customers. Co-operative banks strive to do so by offering quality products and services at attractive prices from the perspective of what is good for the customer. They have an impact presence on the conditions of products in the whole banking market and support the economic and social integration of individuals"*.

This concise formulation embodies the roots of co-operative banking. The customer has always been at the core of their operations and, at a local level, members have a say in the local member bank's policy. As a summary of the previous analysis it could be concluded that 'the unique and defining characteristics of co-operative banks.' could be divided into six main categories (Groeneveld and Sjaauw, 2009):

- Specific corporate governance: member ownership
- Customers' interests first
- High capitalisation, high rating and low funding costs
- Profit as a necessary condition
- Conservative business model: focus on retail banking
- Proximity to customers: dense branch networks

Co-operative banks are successful when they remain truthful to their original mission of maximising members and customers' value. The current crisis shows that in turbulent times, co-operative banks may have a 'co-operative or reputation premium', which can be related to their perceived status as safe havens due to their conservative approach to banking. Customers may also feel attracted to co-operative banks on the basis of 'soft' or 'emotional' factors, like appreciated differences in business principles, cultures or better scores on non-financial performance indicators than those of other banks.

Hence, European co-operative banks are well positioned for the future after the financial crisis. Their original business principles come very close to responsibility, proximity and solidarity requirements, that are more and more often expressed, as well as the characteristics of the new financial system. Co-operative banks have never pursued profit maximisation but aimed at maximising customer value instead. Thanks to their roots, they always had to take into account a broad range of stakeholders. This means that co-operative banks can be more externally oriented and could gain market shares if they are able to communicate their long standing distinguishing features in a credible way to the wider public.





### III- Co-operative banks as a more sustainable lending model<sup>8</sup>.

To go further in the analysis, this conclusive chapter focuses on why differences between models in terms of corporate governance seem to be at the root of the high co-operative banks contribution to financial stability. The evolutionist theorem – suggesting that banks should give way to financial markets – had a lemma regarding the bank's company model: the most appropriate company model to support financial development was for the bank to be established as PLC, bearing the objective of maximising shareholder value. The model of the co-op bank was then depicted as archaic since, assigning value (also) to objectives different from maximising short-term profit and putting on the same par (at least in their statutes) – especially via the principle “one head one vote”, irrespectively of the amount of shares actually held – the weight of each shareholder in the bank's choices, allows better representing all members.

The corporate governance of the co-op banks is under discussion. Some observers hold that it contributes to generate untouchable directors who will rarely be replaced and, thus, may act in a self-referential way. Though there is some truth in this claim, this reasoning neglects the possibility that the long tenure of co-op banks' directors is the inevitable price to pay to allow a wider representation of all members. Evidence shows it's the governance model of the co-op banks that seems at the basis of their lower profit volatility and that likely allows these banks to pursue longer-term objectives. It is also their governance that makes it more sustainable for the co-op banks to do business on the basis of a banking model which is not only OTH (originate to hold) but features the deep rooting of relationship banking. Thus, being more devoted to relationship banking and, so, better able to reduce the information asymmetries on borrowers, co-op banks are better able to overcome the market failure at the origin of the establishment of the bank.

However, irrespectively of this, for many years we have seen a substantial dislike of co-op banks by lawmakers/supervisors. This determined a double subordination for the co-op banks: as their shareholder value homologues they were increasingly subordinated to financial markets in terms of their business model and, on top of that, they were also subordinated to the shareholder value banks in terms of their company model.

The crisis urges abandoning that negative prejudice. It is not by chance that co-op banks were less penalised than shareholder value banks during the crisis: they are better inclined to follow a business model having longer-term objectives and, as such, better suited to strengthen relationship banking and thus to favour responsible behaviour, in lieu of that irresponsible behaviour at the origin of the crisis. The arguments against the co-op governance model may be phrased in terms of the asymmetric information theory. Complex organizations systematically suffer from a moral hazard problem between owners and managers. An organization with a clear and unambiguous, measurable, objective has some advantages. Profit lends itself nicely to the definition of targets for the managers and therefore curtails discretionary behaviour and rent extracting by the managers.

However, for banks, this approach is too simplistic. The existence of banks depends as well on another sort of asymmetric information, the one between lenders and borrowers and to scale economies in monitoring and screening activities. Also, the fact that banks mainly borrow capitals from depositors makes them agents rather than principals in another relationship, the one between owners and depositors. The owners/managers moral hazard is still relevant, but judging the governance of banks on the basis of this only is absurd. We need a more general analysis to assess the ability of different models to overcome difficulties in the various imperfections the banks face. Unsurprisingly, then different types of institutions seem better suited to overcome different information problems. At each stage the link between the upper and the lower level features at least an agency relationship with moral hazard.

The level at which lies the most studied agency relationship so far is the one between borrowers and lenders. Dealing with this is the key reason behind the existence of banks. So, Banks' Owners & Managers are there to mitigate the basic agency conflict that exists between Depositors and Borrowers. However, there is a depositors/bank-owners agency conflict too. In turn, there is an agency conflict between bank owners (focusing on profit maximisation only) and managers (driven by other objectives, e.g. size and perks, raising intermediation costs): the for-profit banks seem to have an advantage only to deal with this conflict. Note that managers may be more interested than owners in the stability of the bank and, therefore, their presence may mitigate the owners' conflict with depositors. In sum a for-profit bank, as an organization that substitutes for markets, is useful and welfare-enhancing if the costs from the additional conflicts that it causes is lower than the costs of the original unmediated agency relationship.

8. This part is a conclusive contribution by Prof. Giovanni Ferri and draws on Coco and Ferri (2009). Prof. Ferri, Chairman of the Department of Economics & Mathematics University of Bari and member of the European Think Tank on co-operative banks.



So, the organizational structure should be evaluated on the total agency costs it delivers (not on a single stage of the chain) and analysing banks as other firms in competitive markets not plagued by asymmetric information markets is highly misleading. The approach used to dismiss the co-op bank governance is not based on economic theory and simply reflects a prejudice.

The key feature of co-op banks is that distinctions become more blurred: depositors/shareholders and members/borrowers often overlap. This dampens some conflicts of interests. Opportunistic behaviour is less likely as co-op bank members usually feature a network of linkages beyond the pure lending relationship have two positive effects: a) the stigma associated with a default is possibly larger; b) facilitating both screening and cross monitoring among members/borrowers. This favours SMEs. So, the co-op bank governance is appropriate at least sometimes. Thus, the most sensible policy approach is not to choose a fixed governance as the one preferable in every context. It's reasonable encouraging governance diversity to ensure that the most appropriate ones emerge naturally as the winners. Of course, here levelling the playing field would not necessarily entail enforcing the same regulation on every type of intermediary. As seen, the perils for bank instability come mainly from bank owners' perverse incentives and, therefore, from the agency problem between them and depositors. This problem seems less important in co-op banks as the Owners-Members are, for an important part, also Depositors. Also, the fact that profit is not the (only) objective of co-op banks considerably dampens the incentive to increase risk taking. Prudential regulation could thus theoretically be less necessary for this type of intermediaries. Limits to the discretion of Managers on the contrary may be more useful than in traditional for-profit banks.

While financial markets tend to be more cyclical than banks, even within banks some types may be less pro-cyclical than others. Banks maximising value for all members (co-op banks) may be better able than shareholder value maximising banks to overcome the asymmetric information problems between depositors and borrowers, while reducing also the overall conflicts of interests affecting the entire intermediation chain. Thus, co-op banks should be more stable than the other banks, as risk tends to be pro-cyclical. Also, when the economy's price system is distorted by a financial bubble the risk-seeking incentive for shareholder value banks is amplified too as it becomes very difficult for supervisors to spot it and curb it. This finds support in various papers (published at the IMF and by independent academics) concluding that co-op banks tend to be more stable because of their lower return volatility. While co-op banks' larger focus on traditional bank intermediation – and less on financial market related activities – explains part of this, the literature also finds that some of their lower volatility is germane to their co-op corporate governance model.

## Conclusion - Co-operative banks are major economic actors

The special position of European co-operative banks clearly stands out from the analysis in this report. Co-operative banks have acted and performed differently in the run-up and aftermath of the financial crisis than commercial banks. This can be largely attributed to their distinctive governance based on member ownership. As a result co-operative banks are characterized by a longer term orientation where profit maximization is not a goal per se, more prudent business model with a strong capitalization and focus on retail banking. This strategic path has clearly proven successful in the run of the financial crisis. The strongest proof of the popularity and vibrancy of the co-operative banking model is the strengthening of their overall market positions over the past decade.

Their financial solidity and consistent business model have also been beneficial for the stability of national financial systems. In the context of the economic recession, co-operative banks were well aware of their social and economic responsibility. Based on credit growth data, they remained well equipped to grant loans to firms and private households, thus supporting the real economy. In light of all the fundamental changes ensuing from this crisis for the financial sector, co-operative banks seem well positioned for the future too. In short, two key words may describe co-operative banks attitude, in the current context: responsibility and commitment.

Responsibility, as they never contributed to the disequilibrium that led to the crisis. On the contrary, they tried to stick to their members and clients needs, offering them products adapted to their needs, and respectful to the basic long term security rules.

Commitment, as they work hard to foster the economic recovery, starting from the local level, the tissue of our economies. It is the meaning of their commitment towards the citizens of Europe.



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