



Cooperative banks: international evidence
Part of nef's Stakeholder Banks series

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Executive Summary

Cooperative banks outperform shareholder owned banks on a number of measures: they generate more stable long-term profits, they provide better customer service, and they boost local economies by lending more to small and medium-sized businesses. Plus, their more prudential approach to managing capital allowed them to weather the financial crisis better than the commercial banking sector, demonstrating their positive contribution to financial stability.

Co-operatives are owned by members (usually their customers) rather than shareholders. This ownership model appears to have profound effects on the priorities and performance of the institutions. It places an incentive on managers to maximise long-term customer value, and ensures that profit is treated as a means to an end rather than an end in itself. This focus presents a range of benefits, not just for customers but for the economy as a whole:

- **A focus on high-street banking and branch services.** Cooperatives focus on services that are directly relevant to their customers, and are much less fixated on risky wholesale and investment activities. This means they maintain branch access to communities and localities that would otherwise have none.
- **Inclusive banking.** Cooperatives punch above their weight in lending to small and medium sized business, and often make it their objective to ensure that banking services are available to all individuals.
- **Prudent management and stable profits.** By targeting lower returns, cooperatives generate more stable profits over the longer term and are much less likely to suffer losses.
- **Stability in a crisis.** Their prudent management of capital means that cooperatives make a positive contribution to financial stability. During the financial crisis, the entire European cooperative banking sector accounted for only 8% of total losses. Given cooperative banks' significant share of European lending markets – e.g. 47% in France, 33%, in Austria and 32% in Italy – this figure is relatively minor, and is in fact comparable in scale to the *individual* losses of HSBC and UBS. Thus, while commercial banks withdrew credit from their customers during and after the crisis, cooperative banks were able to expand their lending and, in doing so, aid recovery.

To achieve economies of scale while retaining their local roots and accountability, cooperatives often collaborate in networks to pool resources

and share services. This model has proved successful in many countries, although in some cases central institutions have become too dominant and entered non-traditional investment markets with poor results.

Criticisms that cooperatives are unaccountably managed and inefficient are unconvincing. It is certainly the case that the ownership model prevents raising significant new capital to fund rapid growth and mergers and acquisitions; but, far from being a weakness, this model of steady organic growth actually contributes to the stability and prudence of cooperative banks.

Cooperatives account for a significant proportion of the banking market in many countries, particularly in Europe. Although the UK has one large cooperative bank, this differs from most cooperatives because it is not directly owned by its members and has no local accountability or governance.

We conclude that cooperative banks have thrived where independent local institutions have collaborated in networks to gain economies of scale, and where the regulatory environment has recognised and protected the cooperative ownership model.

Cooperative ownership makes rapid expansion difficult, particularly through acquisitions, and so alternative financing arrangements will have to be found. However, this is a difficult balance to strike, because the benefits of cooperative banks tend to be eroded the more like commercial banks they become. The expansion of the Cooperative Bank in the UK, for instance, raises an interesting question. That is, should government policy aim to help sizeable cooperatives compete directly with existing commercial banks, or should it help them compete by offering a genuine alternative? If the answer is the former, then it is unlikely that the benefits of cooperative banking sectors outlined in this report will be realised.

1. What are Cooperative Banks?

Cooperative banks are owned by members (usually their customers) rather than shareholders. As a result they prioritise maximising customer value over profits, and they typically focus on high street banking. To achieve economies of scale while retaining their local roots and accountability they often collaborate in networks to pool resources and share services. They account for a significant proportion of the banking market in many countries, particularly in Europe.

Though cooperative banks vary enormously in structure both within countries and between countries, they share what is in essence a broader and more democratic form of ownership. They are controlled by members on the basis of one vote per person, rather than by shareholders whose vote is proportional to their financial stake.

Any customer can choose to become a member by investing a small amount of money in the cooperative to buy a share. You cannot sell shares in a cooperative bank to a third party, like you can shares in commercial banks. Instead, you can only sell them back to the bank itself in order to reclaim the money you originally put in.¹ Furthermore, unlike shareholders in joint stock companies, cooperative members do not have any legal claim on the profits generated by the businesses, or any share in the appreciation in the value of the business.² Cumulative profits are instead owned by the cooperative itself, often in the form of a trust, and are used for four primary purposes:

1. to build up an 'endowment' for future members as a reserve of capital;
2. to reinvest in the business, for example, by reducing borrowing rates, increasing savings rates, or by investing in staff training to improve customer service;
3. to invest in community projects, and;
4. to be paid out to members in the form of dividends (which are not linked to profitability).

Members can run for election to sit on the bank's supervisory board, which, in contrast to a commercial bank's board of directors, is typically made up of non-finance professionals. Members can receive other benefits, such as reductions at local events and museums that the cooperative has supported, and access to professional networks, training and expertise.

Mutuals, such as Building Societies in the UK, are similar to cooperatives, although they differ in important respects. Customers of mutuals automatically become members rather than choosing to and, unlike members of cooperatives, cannot usually run for election to the supervisory board. Another difference is that cooperatives can be owned by employees, suppliers or other stakeholders whereas mutuals are always owned by customers.

Cooperatives generally operate according to the 'Rochdale Principles'³ (see Box A), which are a set of guidelines for how cooperative businesses should behave and be organised.

--- Start Box A ---

The Rochdale Principles

1. Voluntary and open membership
2. Democratic member control ('one member, one vote')
3. Member economic participation (cooperatives raise money by selling shares to their customers, normally in quite small amounts, who then become 'members')
4. Autonomy and independence (cooperatives are controlled by their members)
5. Education, training and information (cooperatives provide education and training for their members, staff, and the local community, to promote cooperative ideals and enable stakeholders to engage more effectively in and with the business)
6. Cooperation among cooperatives
7. Concern for community

--- End Box A ---

Cooperative and mutual institutions emerged in the mid-eighteenth century. They started out as self-help movements that believed they could work together to meet local collective needs, instead of depending on or being exploited by outside people or institutions. The Fenwick Weavers' Society, founded in Scotland in 1761 is credited with being the first recorded cooperative.⁴ The modern cooperative structure was developed in 1844 by the 'Rochdale Pioneers', a group of English cotton weavers that pooled their resources together to provide cheaper food and household goods⁵.

Financial cooperatives did not emerge until sometime later, however, when Friedrich Wilhelm Raiffeisen⁶ started the world's first credit union in 1862⁷ in Heddesdorf, Germany. European commercial banks during the Industrial Revolution primarily catered for larger urban businesses and wealthy individuals. In response, small businesses, lower income individuals, and rural communities started their own cooperative banks, and the movement spread across Europe.

Nowadays, cooperative banks are still typically small, locally owned and run institutions that focus on retail banking activities, such as personal savings and loans, mortgages, and lending to small and medium sized businesses. However, as the trend for commercial banks merging and taking over one another took off over the past century, small cooperatives have started to struggle to compete with their larger commercial counterparts. This is because small institutions cannot individually achieve the 'economies of scale' enjoyed by larger institutions.

The difficulties suffered by small institutions as a result of this inability to achieve economies of scale are well documented in economic literature. Nevertheless, cooperative banks have gradually developed an innovative way to circumvent these problems: by collaborating with one another, and

pooling together certain activities (such as developing and maintaining IT systems), they have found themselves able to operate at a financially viable scale.

This tactic has proven so successful that almost all European cooperative banks now exist as part of very large formalised networks. These networks are generally coordinated by a central institution⁸ which enables them to achieve economies of scale in wide variety of activities, including systems and product development, public relations, marketing, risk and liquidity management, training programmes, and lobbying efforts. Some central institutions also help coordinate intra-network deposit guarantee schemes, which help increase stability and confidence within the group, and should mean that cooperatives are less likely to have to turn to nationally run deposit guarantee schemes. Because other cooperatives within the network will provide support if any single institution gets into trouble, the credit-worthiness of each individual institution is improved. Not only does this enable the member institutions to access funding at reduced costs, but it also encourages dialogue, collaboration and mutual monitoring to ensure adherence to cooperative principles like prudent risk-taking.

There is a long history of such pooling and collaboration, as some of these central organisations have been around for over one hundred years. In 1898, for example, two such institutions were formed in the Netherlands.⁹

Cooperatives consequently differ enormously from commercial banks, not just with regards to their ownership structure, but also in terms of how they approach other banks within their respective sectors. Whilst competition may be the backbone of stock market capitalism, cooperatives instead believe that they work most effectively when cooperating with one another, in accordance with the Rochdale principles.

2. The case for Cooperative Banks

The ownership structure of cooperative banks appears to have a profound effect on the priorities and performance of these institutions. Customer ownership places incentives on managers to maximise long-term customer value. The resulting focus on high-street banking, inclusive approach to customers, and prudent approach to risks and managing capital have positive benefits for the economy as a whole as well as for individual customers.

2.1 The impact of cooperative ownership

Cooperatives are owned by their members, who in most cases are also the customers of the bank. The Rochdale principle of ‘one member, one vote’ means that individuals can have a direct and meaningful say in how the important institutions in their life are run, even without significant funds to invest. In this way, cooperatives are less likely than commercial banks to be controlled by only affluent individuals, corporations or institutional fund managers, instead attracting lots of small investors.¹⁰ In addition to making the ownership structure more equal, the ‘one member, one vote’ principle should, at least theoretically, encourage all members to take an equal interest in the governance of the institution, instead of effectively surrendering corporate governance to the largest shareholders.

The ownership structure of cooperatives encourages investors to take a long-term interest in the bank. Although some investors in stock market listed banks will be seeking to hold the shares over extended periods to generate long-term returns, many will be trading shares based on short-term targets for returns on their investment funds. Indeed, the rise of ‘high frequency trading’ using computer algorithms means that a significant percentage of owners may hold their stakes in a commercial bank for only a fraction of a second. In contrast there is often only one opportunity per year when members of cooperatives can request to redeem their shares. This, and the fact that members do not have a claim on profits, means that managers do not face pressure from owners to maximise short-term profits and share price performance.

Cooperatives frequently aim to maximise ‘customer value’ rather than simply profits, which are considered a means to financial sustainability rather than the end in itself. As explained by the Hans Groeneveld, Senior Vice President of Rabobank, a large network of Dutch Cooperative Banks:

“as with all banks (irrespective of their capital structure), healthy profitability is an important necessary condition for

Cooperative banks to safeguard their continuity, to finance growth and credit, and to provide a buffer for inclement times. But, unlike with [shareholder owned] banks, profit is not a goal in itself but are necessary for continued growth: they are a 'means to an end' rather than the 'end' itself.¹¹

In theory, profit-maximising banks within competitive markets should ensure good customer service to the extent that this increases shareholder value. In practice there are several reasons why the interests of shareholders and customers might be in conflict. These include the pressure for short-term returns, the logic of ignoring less profitable customers and geographical locations, and pressure on managers to increase sales resulting in mis-selling of financial products.

Many benefits potentially flow from customer ownership, not just for customers but for the economy as a whole:

- Focus on high-street banking and branch services
- Inclusive banking, serving local SMEs and individuals
- Prudent management and stable profits
- Stability in a crisis: consistent lending and prudent management of capital.

We examine these in turn below.

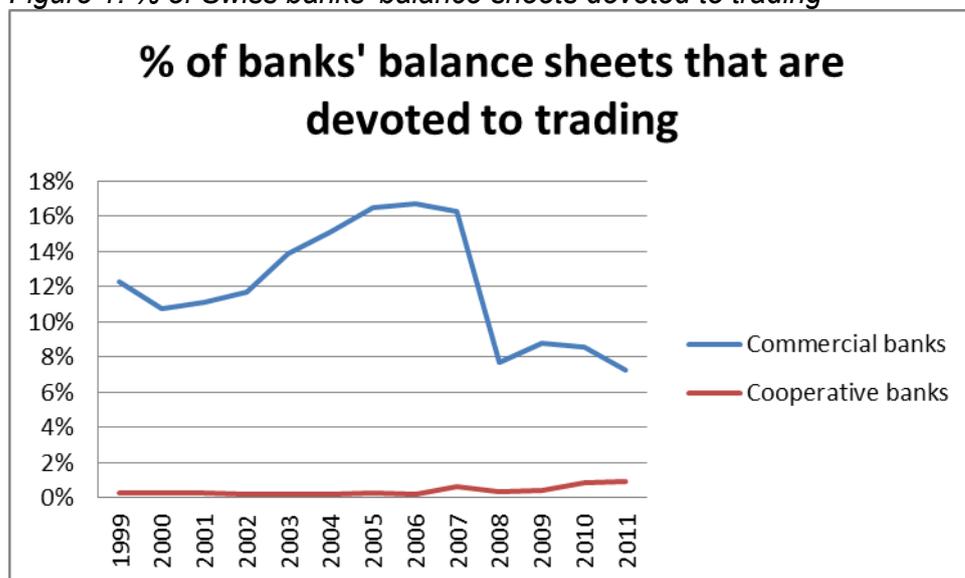
2.2 A greater focus on high-street banking and branch services

Customer ownership means that cooperative banks are generally more interested in traditional high-street banking than in investment banking activities, and have very little interest in speculative trading with the bank's own capital. The evidence behind this claim is as follows.

First, cooperative banks tend to devote a greater percentage of their balance sheets towards retail banking than commercial banks.¹² In Germany, for example, commercial banks devote approximately 28% of their balance sheets to holding derivatives, in comparison to central cooperative institutions which devote only 14%, and local cooperatives which devote 0%.¹³ In the UK, RBS, Barclays, HSBC and Lloyds devote 35%, 34%, 14% and 6% of their respective balance sheets towards holding derivatives, while The Cooperative Bank devotes only 2%.¹⁴ In Switzerland also, cooperative banks consistently dedicate less of their balance sheets to trading portfolios than commercial banks (see Figure 1).

There is also evidence to suggest that cooperatives are more focussed on domestic markets than commercial banks. German cooperatives, for example, have only 13% of their balance sheets tied up in foreign securities versus 21% for commercial banks.¹⁵ Similarly, only 16% of Austrian cooperatives' liabilities are foreign, compared with 31% of Austrian commercial banks' liabilities¹⁶.

Figure 1: % of Swiss banks' balance sheets devoted to trading¹⁷



Source: Swiss National Bank statistics

Provision of branch services

Using bank branch access as a simple measure, cooperatives are making faster progress than commercial banks when it comes to customer service.

Over the past fifteen years, European cooperatives have increased their share of European bank branches from just under 25% to over 28%. This is because, while commercial banks have been closing down branches to increase cost efficiency, cooperatives (with their focus on customer value) have generally been opening up shop.

The UK is a case in point. In the ten years between 2002 and 2012, it lost 16% of its commercial bank branches, leaving many communities without branch access.¹⁸ Yet between 2007 and 2010, it gained 252 cooperative branches. Likewise, 1226 and 975 new cooperative branches opened in France and Italy respectively¹⁹. Not *all* European cooperatives expanded their branch networks during this period – in the Netherlands and Germany the number of cooperative branches fell by 248 and 151 respectively – but overall the trend was positive.

Given the rise in digital banking and reduced demand for branch services, are the commercial banks simply being quicker to react to market forces? Perhaps, but branch services are still essential for small businesses and individuals who are unable to access digital services or need more personal assistance. Branches are also crucial when it comes to maintaining close face-to-face relationships with customers. The fact that cooperatives target a lower return on equity enables them to keep more extensive branch services available. This is perhaps best illustrated by where cooperatives operate their branches in relation to commercial banks.

Cooperatives frequently concentrate their branches in areas that are neglected by commercial banks. For example, 33% of Austrian commercial bank branches are in Vienna compared with only 3% and 8% of the branches of the country's two main cooperative networks. These networks

base a third of their branches in rural locations, compared to 11% of the commercial banks' branches.²⁰ Similarly, commercial banks in France concentrate in urban areas, whereas French cooperatives typically locate between 25% and 33% of their branches in sparsely populated areas.²¹

2.3 Inclusive banking for SMEs and individuals

Maximising customer value rather than profits and being owned by and accountable to local customers allows cooperatives to cater for less profitable customers who are under served by commercial banks. This problem is typically believed to arise because banks find it extremely expensive and time consuming to properly assess the viability of lending to small businesses and lower income households. This has been exacerbated by the demise of 'relationship banking' and the rise of centralised credit decisions. Commercial banks are no longer local institutions that intimately know local people and the local economy, and are instead simply branches of enormous, centrally-controlled, national giants, where investment decisions are typically set by head office. In search of cost efficiencies they have relied less on local managers and more heavily on 'credit scoring', which involves noting down a few of the business's or person's characteristics and using algorithms and historical data to determine the probability that that business or person is a good risk. Plus, they often demand high levels of collateral from their borrowers. Because having this collateral as back-up significantly reduces the risk they are taking, banks can avoid taking putting proper thought and consideration into a customer's future prospects. It is also argued that large banks don't take the time to work with their small business customers, to help them understand what information they need and why their loan applications may have failed.

The resulting under-provision to the SME sector (although rational for individual profit-maximising commercial banks) is damaging overall to the economy because it means wealth-creating enterprises often fail to obtain bank financing.

Cooperatives serve SME customers better. Take the UK, where business lending is dominated by four commercial banks. Failure to meet credit scoring thresholds is the most common reason why SME loans are rejected, with approximately 40% of applications failing because of this.²² In addition, the majority of rejected loan applications overturned in favour of the customer during formal appeal processes are done so on a basis of unreasonable credit scoring.²³ Empirical evidence suggests that small banks are better at seeking and assimilating the 'soft' information needed to holistically assess the prospects of small firms.²⁴ Finally, large banks appear to lend proportionally less to SMEs than to smaller banks.²⁵

The data available on European cooperatives corroborates this picture.²⁶ For example, Figure 2 shows that cooperatives in five out of seven of the profiled countries punch well above their weight with regards to SME lending. The best performing cooperatives are in Austria and the Netherlands. The two Austrian cooperative networks are together responsible for 46% of all SME lending (versus 33% of the all loans) and Rabobank in the Netherlands is responsible for 43% of SME lending (versus 29% of the all loans). Only in one country, the UK, do cooperatives (slightly) underperform in SME lending; however, this may well be a result of the unique structure of The Cooperative Bank, which is examined below.

Figure 2 – Cooperatives' market shares of loans and SME loans in seven countries in 2010

	Market share of loans (%)	Market share of loans to SMEs (%)
Austria	33	46
Denmark	1	1
Germany	17	28
Hungary	3	8
Netherlands	29	43
Portugal	3	5
UK	2	1

Source: European Association of Cooperative Banks²⁷

The same is true of the provision of transactional banking services to individuals. Profit-maximising banks will turn away customers to whom they have little prospect of cross-selling lucrative financial products, despite the positive social and economic benefits of all adults having full access to transactional banking. As more transactions take place online, preventing a significant number of potential customers from participating is harmful to the interests of business and consumers alike.

Finally, there is also evidence to indicate that cooperatives are more responsive than commercial banks to the needs of civil society organisations. For example, cooperative banks in Germany are responsible for 29% of all lending to German NGOs – nearly three times the 11% provided by commercial banks. This is despite the fact that cooperative banks hold only approximately 17% of the total German loans market versus commercial banks' 32%.²⁸

Local accountability

Cooperatives are typically tied to a specific geographical region, in contrast to commercial banks which often operate at national scale with centralised decision-making (the Cooperative Bank in the UK is a notable exception to this, being a national bank – see Box B).

This greater proximity to customers and owners enables local communities to have greater control over cooperative banks and the local economy. Being bound to a particular place, local banks can and must maintain an intimate understanding of local people and the local economy in order to thrive. Unlike commercial banks, they cannot simply up and move to a more affluent area to chase easy money. As discussed above, this can give them an informational advantage over centralised national banks in the market for SME lending. Interestingly, despite the fact that Italian cooperatives lend more to SMEs than commercial banks, they appear to suffer fewer losses.²⁹ This indicates that they actually lend more wisely to SMEs than commercial banks, despite lending more frequently. Empirical studies in Italy³⁰ and Germany³¹ found that cooperative banks help reduce 'capital drain' to urban centres and thus regional inequality, probably as a result of their strong SME lending.

Another advantage of having locally controlled banks is that they provide senior managerial career opportunities outside the capital and large cities.

--- Start Box B ---

The Cooperative bank

The UK's Cooperative Bank PLC is actually a commercial bank that is 100% owned by the Cooperative Group, a British consumer cooperative that provides a wide range of products and services including supermarkets, funeral services, farming and pharmacies. Because it is owned by customers of the whole Cooperative Group rather than by just its own customers, the bank is not strictly a cooperative (although the overall Cooperative Group does, to some extent, follow the direct customer-ownership model that typifies cooperative banking).

Unlike other cooperative banks in Europe, the Cooperative Bank did not arise in response to the need of local communities; it was started to provide banking services for other cooperative companies in the UK. It is therefore effectively a single, national, centrally coordinated bank, rather than a network of small, local banks.

These differences are counter-balanced to some extent by the structure of the bank's parent Cooperative Group, which attempts to maintain localised control by having 'area committees' comprising elected local representatives. Members sitting on these area committees can then run for election on 'regional boards', whose members can, in turn, be elected onto the 'Group Board'. Members from the Group Board sit on the board of the Cooperative Banking Group; however, the latter is also composed of a certain number of 'independent non-executive directors', in order to satisfy regulatory requirements. The extent to which this structure successfully fosters local accountability is debatable and certainly cannot be viewed as a perfect substitute for locally owned institutions.

--- End Box B ---

As we will explore in Section 3, the central institutions in cooperative networks appear in some cases to exert very significant control over their networks of local cooperatives, instead of the other way around. The Rabobank network in the Netherlands, for example, exists as a single brand, and its central organisation sets rules and monitors the local cooperatives to ensure they conduct themselves in a manner in keeping with this label. Might such cooperatives be only superficially local? In the case of Rabobank, the network may appear centrally controlled but ownership of the local cooperatives by their local customers maintains a key difference from being simply branches of a commercial bank. Data from the Netherlands on SME lending in Figure 2 earlier in this section appears to confirm a substantive difference between centrally co-ordinated local cooperatives and branches of centrally controlled commercial banks.

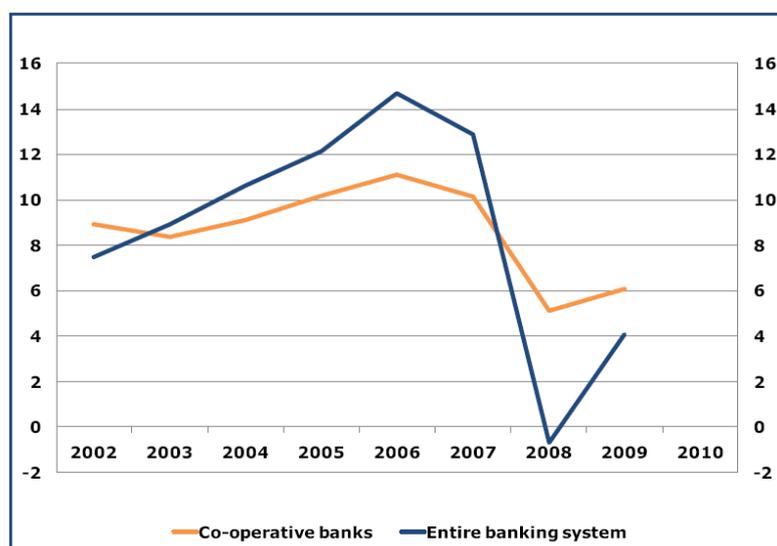
2.4 Long-term thinking and stable profits

Cooperatives argue that members having no legal claim on profits, and as a result no claim on any increase in the value of the business. This promotes a long-term view and prudent attitude to risk compared with commercial banks, who place a strong emphasis maximising short-term profits and share price and, in doing so, encourage excessive risk taking and unsustainable growth. Data on return on equity (ROE) and return on assets (ROA) appear to support this argument, and suggest that targeting lower returns produces more stable profits. Prior to the financial crisis, cooperative banks, on average, posted lower returns than commercial banks, but the commercial banks' returns fluctuated nearly twice as much.³² (see Figures 3 and 4).

Figure 3 – Comparison of rates and fluctuations in average returns³³

	Cooperative Banks	Commercial Banks
Return on Equity (2002-7)		
Average ROE	9.3%	13.4%
Standard deviation (+ or -)	4.5%	8.5%
Return on Assets (2002-7)		
Average ROA	0.4%	0.5%
Standard deviation (+ or -)	0.2%	0.3%

Figure 4 – Cooperative Banks vs Commercial Bank Return on Equity



Average Return on Equity for cooperative banks in Austria, Finland, France, Germany, Italy, The Netherlands, Spain, and Switzerland, vs. the return on equity for the entire banking systems in these countries. Source: Groeneveld, H. (2011)³⁴

2.5 Stability in a crisis: consistent lending and prudent management

European cooperative banks as a whole were far less engaged in the speculative activities that unravelled during the financial crisis – and as a result weathered the crunch much better. In total, they suffered only 8% of the total losses incurred by the entire European banking system during the financial crisis³⁵. To put this in perspective, UBS alone accounted for 12% of total losses, and HSBC for 10%. HBOS, Barclays and Deutsche Bank accounted for 7%, 5% and 4% respectively³⁶.

Considering the sizeable shares of European lending markets occupied by cooperative banks (in France 47%, Austria 33%, Italy 32%, the Netherlands 29% and Germany 17%)³⁷ their 8% combined losses were remarkably minor.

Some of the cooperative networks' central institutions, particularly those who had been engaged in wholesale and investment banking activities like OVAG in Austria, did require some state support during the crisis. But, unlike commercial banks such as RBS and Lloyds in the UK, no cooperative network needed to be nationalised³⁸. In fact their network structure meant that central cooperatives were frequently bailed out by their networks rather than by taxpayers. For example, the Austrian centrals received cash-injections from their networks of local cooperatives. The central Rabobank institution also received support from its locals (although this didn't show up as a formal bailout, as the Rabobank network operates under one consolidated balance sheet.)

Cooperatives were also, on average, much better capitalised than commercial banks. Figure 5 shows that in the run up to the financial crisis, European cooperative banks, on average, had higher 'core' and 'Tier 1 capital ratios', which are two of the main indicators used to determine the financial strength of a bank. Cooperatives and commercial banks, on average, showed similar degrees of variation in these levels over the five years considered.

Figure 5 – The average financial strength of European cooperative and commercial banks between 2002 and 2007.

	Cooperative banks	Commercial banks
Average core capital ratio (%)	4.7	3.6
Standard deviation of core capital ratio (percentage points)	1.4	1.4
Average Tier 1 capital ratio (%)	9.2	8.4
Standard deviation of Tier 1 capital ratio (percentage points)	1.4	1.4

Source: 'European cooperative banks in the financial and economic turmoil: First assessments.' *European Association of Cooperative Banks (2010)*³⁹

This higher level of capitalisation reflects the fact that cooperative banks' owners (their customers) prioritise high quality service and long-term financial strength and thus hold a larger proportion of profits aside as a capital buffer against future losses. In contrast, commercial banks are incentivised to reduce the amount of capital they hold back in order to boost their returns on equity for their shareholders – despite the fact that doing so may threaten the bank's resilience in a crisis.

This perverse incentive is echoed in the problem of too-big-to-fail (TBTF) bank – banks that are so large, and so interlaced in the economy that their failure would spell disaster. Senior executives of such banks are able to seek high risk, high return activities safe in the knowledge that, if their activities backfire, the government will step in to prevent the bank from going out of business⁴⁰. Whilst some cooperative banks networks may deserve the TBTF label just as much as a commercial bank, they are less likely to engage in the risky practises that often lead to failure. Since the financial crisis, various regulatory reforms are attempting to increase the level of loss-absorbing capital held back by banks, address the TBTF

problem⁴¹ and to align executive remuneration with long-term value and prudent management. Nevertheless, current initiatives are still a long way off solving the problem – as demonstrated in nef’s recent “*Quid Pro Quo*” report.⁴²

As well as increasing the stability of individual banks, the high level of capital held by cooperative banks generally helps to increase the resilience of the financial system in many countries. Many cooperatives actually expanded their lending activities during the crisis, whilst commercial banks struggled to meet the demand for credit. For example, at the peak of the ‘credit crunch’ in 2009, European cooperatives increased their lending to non-financial firms by 3.5% compared with a decrease of 1% in lending from all other banks combined.⁴³ Similarly, cooperatives in seven out of nine profiled countries maintained or increased their market shares of deposits and loans between 2007 and 2010 (see Figure 6).

Figure 6 – Change in cooperatives’ market shares of deposits and loans in nine countries between 2007 and 2010

Market share of deposits			Market share of loans		
	2007	2010		2007	2010
Austria	36	37	Austria	31	33
Finland	32	33	Finland	31	33
Germany	18	19	Germany	16	17
Italy	34	34	Italy	30	32
Japan	11	11	Japan	13	7
Netherlands	41	40	Netherlands	28	29
Portugal	6	5	Portugal	3	3
Spain	5	7	Spain	5	5
UK	1	5	UK	3	2

Source: European Association of Cooperative Banks⁴⁴

The cooperative sector was not free of problems during the crisis, however, with some central cooperatives suffering losses as a result of having previously ventured into investment banking activities. For the same reason, a number of building societies (which, as ‘mutual’ institutions, work in a similar way to cooperatives – see Box C) also ran into trouble. In the UK, for example, the Dunfermline Building Society collapsed because it had strayed out of traditional building society territory and become heavily involved in commercial property lending.⁴⁵

Nevertheless, building societies performed better on average than commercial banks during the crisis.⁴⁶ This was partly a result of regulatory restrictions that ensure building societies, like cooperatives, are primarily funded by customer deposits and savings rather than by more volatile inter-bank lending.⁴⁷ It was also partly a result of their ownership structure, long-termism and prudential approach to management outlined above.⁴⁸

--- Start Box C ---

Mutuals

Mutuals are not quite the same as cooperatives, but they are extremely similar. While there isn't a formal, internationally-consistent definition of either a cooperative or a mutual, a couple of key differences emerge. First, cooperatives can be owned by a variety of stakeholders (i.e. you can have customer-owned cooperatives or employee-owned cooperatives). Mutuals, on the other hand, are always owned by their customers. Second, membership of a cooperative is voluntary, meaning you can be a customer of a cooperative without being a member. Customers of mutuals, however, automatically become members. Finally, any member of a cooperative can run for election to be on the supervisory board; whereas, in mutuals, it is the current supervisory board that nominates candidates for future elections. In these last two regards, mutuals may be considered slightly less democratic than cooperatives.

--- End Box C ---

3. What criticisms are typically made of the sector?

Cooperatives have been criticised both for being too much like commercial banks, and too little like them. Local branches of cooperatives networks, it seems, can struggle to keep their central institutions on the straight and narrow. Arguments that the cooperative model leads to inefficiency and lack of management accountability are unconvincing, however. Similarly, while they are constrained in their ability to raise capital quickly, this is not necessarily a disadvantage.

3.1 Cooperatives cannot quickly raise large amounts of capital

A potential downside of the cooperative ownership model is that it fosters a smaller investor base. Cooperative banks' cannot raise large amounts of capital quickly by issuing shares on a stock market. Over the past few decades this was considered to be holding back growth in the sector and preventing cooperatives from competing with large commercial banks. In the UK, this was one of the main arguments for the demutualisation of many of the largest UK building societies in the 1990's. In many other countries, it prompted a move towards central institutions becoming so-called 'semi-cooperatives' – i.e. banks that are owned by a mixture of members and shareholders.

The inability to raise external capital need not be a constraint, however, if the strategy of the bank is to grow its activities in line with its retained capital. Cooperatives do not pursue growth for its own sake, and do not need to grow in order to attain the economies of scale provided by the central cooperative service model. The primary reasons that commercial banks raise additional equity capital are to finance mergers and acquisitions or to rebuild core capital after suffering losses. The former is somewhat redundant to the cooperative model, and the latter has proved less of an imperative for cooperatives who generally made steadier profits throughout the financial crisis.

Furthermore, cooperatives' difficulties raising capital theoretically should mean they are more careful about how capital is invested. If they make poor investment decisions, any resulting lost capital will be harder for a cooperative than a commercial bank to replace. This is reflected in the higher levels of capital held by cooperatives and helped them to avoid needing state support after the financial crisis to the same extent as the commercial banking sector.

3.2 They are not as democratic as they claim to be

This second criticism relates to semi-cooperatives, which were developed to help overcome the lack of access to capital markets. They are partly owned by customers and partly owned by stock market investors, who typically gain rights to profits, but not to voting. The idea underpinning semi-cooperatives is that they enable the bank to have easier access to capital while retaining a significant element of cooperative ownership. This helps mitigate excessive risk-taking, and keep activities aligned with customers' interests.

The prevalence of semi-cooperatives varies from country to country. Crédit Agricole, the largest French cooperative, is a semi-cooperative, but remains majority owned by a network of local cooperative banks. Similarly, ownership of the international operations of the Raiffeisen group in Austria is split 3:1 between the local cooperatives and stock market investors. Rabobank, the Dutch bank, is 100% owned by local cooperatives.

The emergence of semi-cooperatives undoubtedly starts to erode many of the values that cooperatives supposedly hold close, such as structuring incentives so that owners are not motivated by profits alone. However, to date, most semi-cooperatives remain majority owned by their network of local banks⁴⁹ which should maintain the focus on customer value rather than profit maximisation.

3.3 They act like commercial banks, but less successfully

The central institutions in cooperative networks are owned and thus, technically, controlled by the local cooperatives that use them. However, as these central institutions have developed, broadened their scope of activities, taken on an increasingly important role within the network, and hired staff with high levels of financial expertise, they have also begun to exert an element of centralised coordination and control over the network. Many, such as Rabobank, even have an explicit and formalised supervisory role over their network of locals.

Thus, there are generally two opposing forces battling for control in cooperative groups. One is the 'bottom-up' control of the central institutions by the local cooperatives that own it. The second is a 'top-down' central force stemming from the central institution and imposed on the network.

Which of these opposing forces has the upper hand depends on the specific cooperative network. There is enormous variation in the extent to which cooperative bank networks in Europe behave like one centrally controlled unit or operate like a network of autonomous local cooperatives that simply collaborate with one another and pool resources for certain activities. For example, the local cooperatives in Germany remain highly autonomous, despite having a central institution that they use to achieve economies of scale; whereas, Rabobank in the Netherlands operates under a single, well-defined brand, and the entire group consolidates its balance sheets into one large combined balance sheet.

In general, these large central institutions in cooperative networks *did* engage in many of the same activities as large commercial banks, including investment banking activities, and thus also got into trouble during the financial crisis. For example, Rabobank was significantly involved with both mortgage-based derivatives and short-term, inter-bank trading, and suffered heavy losses accordingly.

The central institutions of the two Austrian cooperative networks also stepped off typical cooperative banking turf, by becoming very big players in the domestic banking markets in Central and Eastern Europe.⁵⁰ These economies of such countries were hit particularly hard by the financial crisis, and, thus, so too were the Austrian cooperatives.

In contrast, local cooperatives emerged relatively unscathed from the financial crisis, having engaged only in traditional, low-risk high-street banking. This divergence in behaviour and fortunes between local and central cooperatives is not surprising given the ownership structure of these two types of institutions.

Local cooperatives are owned by their customers, which help minimise so-called 'principle-agent problems', whereby one party (e.g. the owners of the banks) act in their own interests rather than in the interests of the other party (e.g. the customers of the banks). Cooperatives also typically exist on a relatively small scale and operate in only a small geographical region, which makes oversight and accountability relatively simple and transparent. In contrast, the central institutions are owned by the local cooperatives and sometimes, in the case of semi-cooperatives, also by external, remote investors.

To take the latter case first, semi-cooperatives obviously dilute the cooperative ownership and governance model somewhat. Nevertheless, even if the central institution in the network is entirely owned by the local cooperatives, one is still adding middle men to the chain between owners and customers, and thus monitoring becomes more challenging. In addition, the central institution is engaged in activities such as wholesale banking and corporate banking that the owners of cooperatives (i.e. ordinary people) may be unfamiliar with and therefore unable to govern.

Cooperatives argue that enough checks and balances are in place to ensure that central institutions and semi-cooperatives do not neglect their cooperative roots and succumb to the short-termism and high appetite for risk that characterise commercial banks. However, the fact that central institutions *did* stray into areas outside the traditional realm and scope of cooperative banking suggests that local cooperatives do often struggle to keep their central cooperatives on the straight and narrow.

3.4 They struggle to remove ineffective or opportunistic managers

A frequent criticism levied at cooperatives is that their ownership structure makes it essentially impossible to transform inefficient institutions. Because cooperative shares cannot be bought and sold to third parties, it is impossible for external players who believe they can improve the bank's performance to mount a bid to take over management of the company.

It is also argued that the cooperative principle of 'one member, one vote' makes it more difficult to hold directors to account. This is because it is extremely difficult to coordinate a large number of members with equal votes to monitor and sanction directors who are either ineffective or who are pursuing their own interests at the expense of the bank's. In contrast, in shareholder banks, a few investors holding significant power individually may have a much greater incentive to monitor management and can easily act to bring about change in management if this appears desirable⁵¹.

Customer value (the central objective of cooperative banking) is also much harder to measure than profit (the driving factor of commercial banking). Unlike profit, which can be objectively quantified, measuring customer value requires qualitative as well as quantitative assessment. Because

progress towards their key aim is trickier to monitor, bad cooperative managers arguably have more scope for hiding laziness, ineptitude or exploitation of customers or the business.

One might, however, point to the superior performance of cooperatives since the financial crisis as evidence of their overall good quality of management. It is possible that, because local democratic control generally aligns managers' interests with those of the bank's owners, the need for certain external pressures (such as the threat of third party take-over) is not as vital to the cooperative banking sectors' efficiency.

After all, the regulation that cooperatives are subject to in many countries already helps keep management in check. The German regions, for example, demand that all cooperatives are assessed by regional Audit Associations. As well as scrutinising the financial state of the company, these associations investigate the performance of management.⁵²

3.5 Cooperatives are inefficient

Economic theory states that – in 'textbook' market conditions of perfect competition, perfect information and rational behaviour – profit-maximisation is the best way to ensure maximum efficiency. Clearly, this is at odds with the cooperative model's focus on customer value.

It has also been argued that the cooperative ownership structure holds back innovation and the optimum use of capital. This is because cooperative shareholders do not have a direct claim to capital, as the cumulative profit of all members, past and present, is held in trust rather than distributed to owners – leading some to consider it "capital in dead hands".⁵³

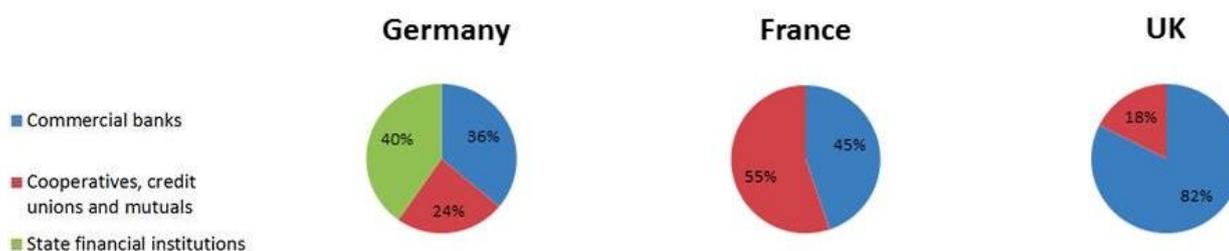
Yet textbook conditions of perfect competition never have, and never will, exist in the real world. It has become apparent since the financial crisis that a significant proportion of the capital invested by commercial banks went into unsustainable activities and unproductive sectors of economies fuelling asset price bubbles. The 'dead' capital held by cooperatives was instead, on average, invested in more sustainable, albeit less lucrative, products and services. This, together with the scale of government support that was required to bail out commercial banks, has called into question the assumption that profit-seeking banks will by definition be the most efficient and economically productive.

4. Why are cooperatives more common in some countries than others?

The cooperative banking sector has developed differently in different countries. This is for a variety of historical, regulatory and ideological reasons: In countries like the UK, for example, neoliberal economic policies viewing shareholder companies as inherently superior to all other models have been pursued much more rigorously than in others.

According to the European Association of Cooperative Banks there are 4,200 cooperative banks in Europe that operate 60,000 branches and serve 159 million customers.⁵⁴ In addition, 45 million people are members of a European cooperative bank. As Figure 7 shows, however, cooperatives have much more significant presence in some countries than others.

Figure 7 – Market shares of deposits in Germany, France and the UK



Source: World Bank (2011)⁵⁵

There are many factors behind these differences. One is the degree of decentralisation of political and economic power within countries. The German banking system, for example, reflects its federal structure and historical origins as many autonomous states. Many of its institutions developed on a regional rather than a national basis and as a result it has a significant local banking sector.

In general, cooperative banks are a significant presence in many European countries, especially in Europe. The UK is a notable exception, however, despite being the birthplace of cooperatives and having a thriving mutual

sector until the 1990s. Building societies are a type of mutual that traditionally focus on providing mortgages, although they also provide other retail banking products and services. These institutions have been around in the UK since 1775.⁵⁶ They were formed because members wanted their savings to be put towards helping other members buy their own homes (hence the name 'building society').

The number of authorised building societies in the UK fell from 1,723 to 49 in the hundred years between 1910 and 2010. Much of this was the result of mergers within the sector, as – in a bid to achieve economies of scale and become more competitive – building societies moved from being very local institutions to working on a larger, sometimes even national scale.

In the 1970s-1990s, building societies came under heavy criticism for being inefficient institutions because they didn't post anywhere near the high financial returns generated by commercial banks. The reason for this was put down to the criticisms discussed in the previous section: lack of focus on profit maximisation; difficulty removing ineffective managers; immunity from 'disciplining' market forces; and, inability to raise capital from external investors. Also, the restrictions placed on their activities (building societies were not allowed to offer current accounts, credit cards, unsecured loans, cheque books, and many other products and services) were also strongly criticised.

In 1986, the Building Societies Act gave building socialites much more freedom in their activities. The legislation also permitted current members to cash-in on the value of the building society, which had been created over-time by past members and was meant to be an endowment for the future. To make matters worse, many opportunistic investors observed the privatisation trend and subsequently became members of building societies in order to (a) put pressure on the society to privatise, and (b) enjoy the unearned 'windfall gains' of cashing-in during privatisation. These 'carpet-baggers' led to a wave of privatisation during the 1990s, which resulted in approximately 70% of building societies' assets being privatised⁵⁷ - including all the larger companies bar Nationwide.

The UK effectively dismantled its mutual sector thereby removing the advantages that such institutions bring to the overall banking industry. By 2009 the building societies that were privatised during the 1990s had all either been absorbed into other banks, such as Santander taking over Abbey National, or had got into such enormous difficulties during the financial crisis that they had to be taken over by the Government (Northern Rock), or other banks (HBOS).⁵⁸ According to an All-Party Parliamentary Group inquiry there was little economic benefit derived from the de-mutualisations⁵⁹.

Whilst similar pressures to privatise banks were present in countries such as Germany, they were successfully resisted in many – but certainly not all – instances. In short, neoliberal economic policies never achieved the same degree of supremacy in other countries as they enjoyed in the UK and US.

5. How can governments foster a prosperous cooperative banking sector?

Governments should help the cooperative banking sector thrive in a number of ways. First, they should ensure that banking regulation takes into account the particular capital structure of cooperatives instead of discriminating against it. Second, they should enable and encourage the creation of central service structures, allowing the sector to achieve economies of scale without losing local accountability. Last, they should regulate to protect mutuals against opportunistic demutualisation by current members pursuing short-term gain at the expense of their institutions' long-term success.

The difficulty that cooperatives face in accessing capital can be considered both a strength and a weakness. Its disadvantage is that it forces the sector to grow very slowly and organically. This is illustrated by the current acquisition by the Cooperative Bank of 630 branches of Lloyds (a commercial bank): not only is Lloyds planning to effectively lend the Cooperative Bank the money to take over its branches, it is also going to inject additional capital into the branches before transferring them to Cooperative Bank, and provide extensive IT systems support along the way.

Governments looking to expand cooperative sectors, or to encourage new entrants into the banking market to challenge powerful incumbent firms, must take these capital raising difficulties into careful consideration.⁶⁰ If governments acknowledge that having a diversified banking system is a public good, and that cooperatives have something to offer, then efforts to grow the sectors, particular through acquisitions, may have to be subsidised in some way.

This subsidy could come in a variety of forms. For instance, commercial banks could be forced to subsidise branches being sold-off to cooperatives (as it appears Lloyds will be to the Cooperative Bank). Alternatively, the government could subsidise the process itself by injecting capital into these institutions. A final option would be for the commercial banks that were nationalised during the financial crisis, such as Royal Bank of Scotland (RBS), to be transformed into cooperatives. Whilst the government would forego the potential proceeds from selling nationalised banks back to stock

market investors, restructuring them into cooperatives instead could relatively quickly and dramatically diversify the landscape of UK retail banking, generating greater medium- and long-term value for taxpayers.

Governments looking to bolster mutual or cooperative sectors should also take steps to protect the sectors from privatisation by opportunistic owners that want to cash-in. Some UK building societies now have membership clauses specifying that someone has to have been a member for a given time, for example, five years, before they are entitled to any personal share of the proceeds of privatisation.⁶¹ Certain legal structures could also help protect a mutual or cooperative's assets against such forces, for example by ensuring assets were held in a trust.

By encouraging the establishment of networks and central institutions, governments could also help mutuals and cooperatives achieve economies of scale without having to merge. Building societies in the UK, for example, have never really collaborated in networks⁶² and as a result there has been a lot of consolidation in the sector. Whilst this consolidation helps building societies compete with banks, it also means that the perks of local banking are gradually lost.

Finally, it is crucial that regulators appreciate that there are different types of banks in an economy, and stop developing one-size-fits-all regulation. For example, new European regulations for bail-in bonds (debt that converts into equity if a financial institution gets into financial trouble) at first did not take into account the fact that shares in cooperatives come with a very different set of rights to shares in commercial banks. Similarly, cooperative banks are currently concerned that they will be disproportionately hit by capital adequacy requirements. These requirements will demand that banks hold proportionately more capital against SME lending, in which the cooperative sector outperforms commercial banks.

6. What does the future hold for cooperative banks?

Cooperative banks play a valuable complementary role to profit-seeking shareholder owned commercial banks. The trend in recent decades towards demutualisation and pressing cooperatives to behave more like shareholder banks should therefore be reversed. Nations without cooperative banks would be wise to encourage their growth, and those with cooperative banks would be wise to protect them and help them to flourish.

Cooperatives have come out of the financial crisis relatively well. Not only did they weather the storm better than commercial banks (and, in many cases, were even able to expand their share of key markets), they also suffered nowhere near the same level of reputational damage.

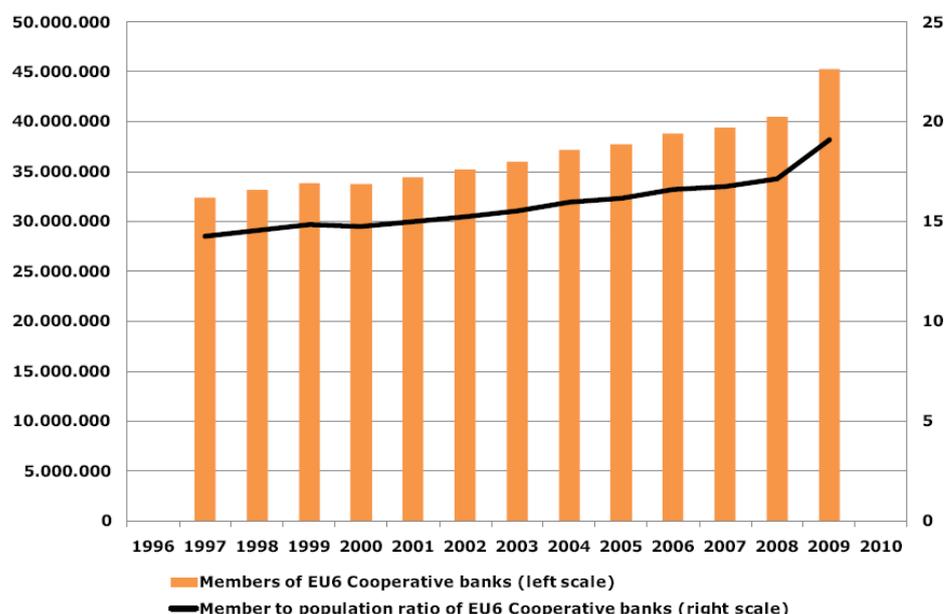
The number of customers using cooperatives was maintained or increased in eight out of nine profiled countries between 2007 and 2010⁶³. This could reflect an increased enthusiasm for the cooperative model, disillusionment with commercial banks, or both.⁶⁴

Cooperative membership has also increased over the past decade. Figure 8 below shows that across six European countries the average membership increased by 12.5 million, a rise of 38%, and the average member to population ratio rose by 6.5 percentage points to 22.5% between 1997 and 2009.

Cooperatives are rightly keen to point out that changes in emphasis by commercial banks in the aftermath of the crisis (such as renewed focus on high-street customers, ending of branch sales incentives, a shift to a longer-term perspective, and lower, more sustainable returns and risk appetite) are values that have always been at the heart of the cooperative banking model.

Political pressure, bolstered by neoliberal theories of efficient markets, has gradually helped push European cooperative banks into adopting increasingly less cooperative structures.⁶⁵ But the superior performance of cooperative banks during and since the financial crisis warrants a sharp reversal in this policy direction. In the UK, where the mutual sector has been steadily dismantled, many politicians are now mourning the lack of alternatives to mainstream commercial banks.

Figure 8 – Average membership and member to population ratio of cooperative banks in Austria, Finland, France, Germany, Italy and The Netherlands.



Source: Groeneveld, H. (2011).⁶⁶

International experience and evidence on the benefits of having a cooperative banking sector as part of the overall banking mix provides compelling reasons for the UK to try to rebuild a mutual sector. The promotion of mutuals in the financial sector is a stated aim of government policy⁶⁷, and we will examine policy options for the UK in forthcoming research.

This evidence also provides important considerations for developing nations in determining banking policy and the optimum mix of banking structures. While cooperative banks have their advantages and disadvantages, it is clear that they have a valuable complementary role to play alongside profit-seeking, shareholder-owned commercial banks. Developing nations that lack cooperative banks would be wise to help kick start their growth, while those that have cooperative banks already would be wise to protect them and help them to flourish.

Endnotes

¹ There is no rule without an exception. Some Italian cooperatives *do* allow people to sell their stake in the enterprise to third parties.

² Except some Italian cooperatives, which do allow members a claim over the institution's assets via dividends and capital gains. These are the same cooperatives that allow secondary trading of their shares.

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⁸ Some cooperative networks have a 'three tier' structure, with lots of small local banks, a few regional institutions, which provide a basic level of economies of scale, and then a national central institution, which provides higher level economies of scale, etc.

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