Special Report 2011/12

Cooperative banks in the spotlights

The United Nations has declared 2012 the International Year of Cooperatives. This is why we are focussing on the European cooperative banks in this Theme Report. What are these banks' key characteristics? And how are they performing during this period of financial instability and economic downturn?

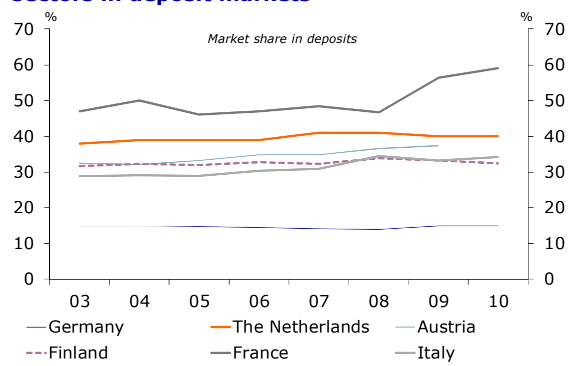
What distinguishes cooperative banks?

Cooperative banks are widely represented in the European banking industry. Approximately 4,000 local cooperative banks serve more than 176 million customers, 50 million of whom are members (source: EACB). Cooperative banks have traditionally focused on retail services: providing savings products and credit lending to consumers and small- and medium-sized enterprises (SME). This is related to the fact that cooperative banks arose in Europe in the nineteenth and twentieth century because the existing banks were not meeting local rural populations' financial needs at that time (refer also to Groeneveld, 2010). Over the years cooperative banks have developed further and most have expanded their activities to include international services and/or investment banking activities. [1] They do, however, still have a strong presence in national savings and loan markets (figure 1).

Retained earnings important source of capital

Cooperative banks allocate virtually all of their earnings to equity. Retained earnings consequently represent an important source of capital and a prerequisite for the continuity and further growth of services for cooperative banks. The cooperative banks also have member capital and different forms of hybrid capital. Unlike listed banks, cooperative banks cannot issue shares, although cooperative banks in a few countries, including France, Austria, Italy and Finland, do have listed subsidiaries or business units.

Figure 1: Market shares of cooperative banking sectors in deposit markets[2]



Source: Cooperative banks annual reports

Member ownership and focus on customer value

Another key characteristic of European cooperative banks is that many of their customers are also members of their bank. At most cooperative banks, the members own the bank (joint-stock cooperative) and are consequently able to influence the bank's decision-making.[3] This is elaborated differently at the national, regional and local levels. At the local level, members are active in feedback groups and serve on member advisory committees for example.

At the national level, the local member banks determine the strategic course as members of the central institution. The primary objective of cooperative banks is to provide excellent products and services at sharper prices and to

[1] Examples of cooperative banks with sizeable international networks are DZ BANK in Germany, Crédit Agricole, BPCE and Crédit Mutuel in France and Rabobank Group in the Netherlands.

[2] The rise in the market share of the French cooperative banks is partially attributable to the merger of Banque Populaire and Caisse d'Epargne in 2009. The latter was designated as a savings bank in 2009.

[3] The ownership structure is somewhat more complex at the cooperative Rabobank Group. There are customers who are members of the local Rabobanks which in turn are owners and members of Rabobank Nederland. None of the members, however, own the Rabobank Group, meaning that the Rabobank essentially owns itself (Boonstra, 2010).

operate in the interests of customers and members. This focus on customer value and the necessity of a minimum return on equity is also referred to as the dual bottom line function of cooperative banks (Ayadi *et al*., 2010).

Organised in networks
Most cooperative banks are organised in networks, with the degree and method of integration (regional, national) varying by country. Key services and processes, including IT, product development, marketing, accountting and research, that provide scope for achieving economies of scale are centralised within these networks. At some cooperative banks, the central institution also acts as a sort of internal central bank by allocating liquidity among the affiliated institutions and raising funding on the financial markets.

Internal support mechanisms and guarantees
Nearly all cooperative bank networks have internal support mechanisms. These mechanisms operate as follows: if a bank runs into financial difficulties, these problems are absorbed with the aid of other banks. The applicable mechanism within the Rabobank Group is, for example, the mutual guarantee scheme. This scheme means that, if an institution participating in the scheme has insufficient funds to meet its obligations to its creditors, the other participants are required to supplement the institution's funds so that it is able to meet its obligations (Rabobank Group Annual Report, 2010). As a result the assets of the individual institutions are, as it were, tied up with each other. This in turn means that, despite the legal independence of the local member banks, the group of banks is viewed as one banking institution by both the regulator and the financial markets.

Stability of cooperative banks during crises

Theoretical assumptions
Various assumptions have been made about the stability of cooperative banks and their contribution to financial stability. It is, for instance, presupposed that characteristics such as relatively high capital buffers, internal support mechanisms and guarantee schemes and long-term strategies contribute to the banks' stability. Relatively high market shares in savings markets can furthermore make cooperative banks less dependent on sometimes volatile financial markets for their funding (Ayadi *et al.*, 2009). According to Lewellyn (2009), cooperative banks also take a more conservative approach to their capital because it is less easy for them to supplement it. Cooperative banks may also have more stable, but lower profitability. Boonstra (2010) says this is because banks that aim to maximise earnings for their shareholders will make greater use of core capital leverage than cooperative banks.

Fonteyne (2007) conversely argues that cooperative banks may possibly be less stable than other banks due to their limited options for raising capital during crises. The opposing point can, however, be made in this respect that it is also difficult for listed banks to realise a share issue during periods of crisis. Fonteyne (2007) furthermore conjectures that democratic decision-making within cooperative banks can impede a rapid response to changing circumstances. Hesse and Čihák (2007) claim that cooperative banks' high market share in retail markets could weaken comercial banks because it makes them more dependent on less stable sources of income. Llewellyn (2009) and Ayadi *et al*. (2010) conversely argue that cooperative banks actually promote financial stability by contributing to the diversity of business models and ownership structures in the banking system. They suggest that this makes the system as a whole more stable.

What does research reveal?
While Hesse and Čihák (2007) based their empirical research on a different assumption, they concluded that cooperative banks are in reality more stable than commercial banks and

savings banks. They furthermore deduce that a greater presence of cooperative banks *increases* the stability of an average bank within a banking system, but *decreases* the stability of commercial banks, especially of the weaker ones. Boonstra (2010) says history has shown that cooperative banks can withstand crises well. He refers in this context to studies including the historic research conducted by Mooij (2009) that demonstrates that Dutch cooperative banks also weathered the financial crisis in the 1930s well. Based on data from 2007 and 2008, Groeneveld and De Vries (2009) reach the same conclusion concerning the performance of European cooperative banks during the credit crisis. The effects of the economic crisis that ensued after the credit crisis have not, however, been included in the research. This is why a number of standards for the stability of cooperative banks at an aggregated European level are analysed in the following paragraph for the period 2003-2010. A detailed study will be published in 2012.

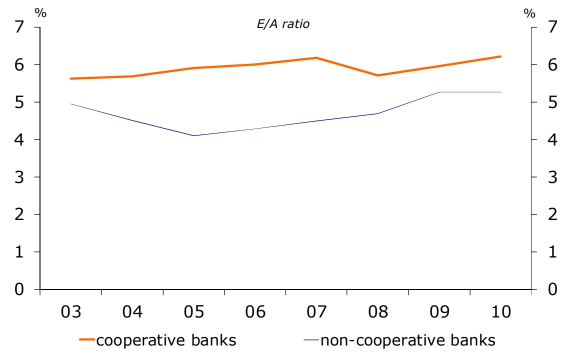
New research results

Bloomberg data (WDCI) reveals that European cooperative banks accounted for 7% of all the European banking industry's writedowns and losses in the period Q3 2007 - Q1 2011. The cooperative banks' weight in the European banking sector and economy is, however, much greater with an average market share of 20%. This result can be partially explained by the fact that most cooperative banks had limited exposure to US subprime mortgages and fewer investment banking activities (Groeneveld and De Vries, 2009).

Average equity/unweighted assets ratio

Excessive debt build-up (leverage) by banks is considered one of the causes of the credit crisis. Figure 2 shows the average leverage of European cooperative and non-cooperative banks in terms of the average equity to unweighted assets ratio.[4]

Figure 2: Equity/Unweighted Assets Ratio European Banks[5]



Source: Economic Research Department calculations (annual reports, OECD data)

Cooperative banks' average equity to unweighted assets ratio was higher during the period 2003-2010. This illustrates that cooperative banks actually do hold relatively large amounts of equity and make less use of capital leverage.

Average profitability

The European cooperative banks had a more stable average return on equity (ROE) than the non-cooperative banks (figure 3) in the period 2003-2010. This is because in 2008 the average ROE of cooperative banks fell less sharply, and, unlike non-cooperative banks, remained positive. After 2008, the average profitability of both cooperative and non-cooperative banks recovered to approximately the same level. This figure consequently does not provide proof for the assumption that cooperative banks may have been hit harder by the economic recession than by the credit crisis.

The average return during period 2003-2010 was 7.5% for the cooperative banks and 5.7% for the non-cooperative banks.

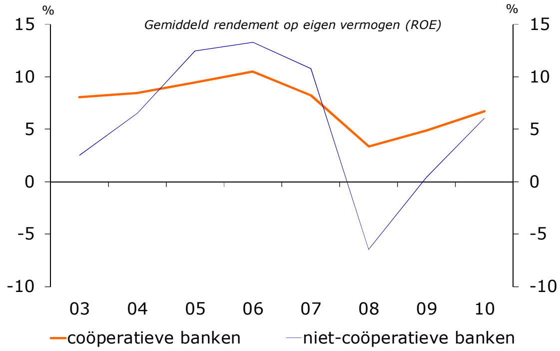
Z-score sums up stability in one figure

The Z-score is a frequently used method for measuring a bank's stability. This is determined

[4] This ratio is *not* comparable to the minimum leverage ratio of 3% contained in Basel III. This is because this ratio is defined as the ratio between the Tier 1 capital and the non-risk weighted assets on and off the balance sheet (Smolders, 2011).

[5] Figures 2 and 3 pertain to banks from Germany, Finland, France, Italy, the Netherlands and Austria.

Figure 3: Profitability of European banks



Source: Economic Research Department calculations (annual reports, OECD data)

by the following three ratios: equity/total assets (E/A), return on assets (ROA) and related volatility (standard deviation ROA). The Z-score measures the number of standard deviations the ROA must decrease before the bank's equity is completely depleted. This is why it is sometimes also referred to as the 'distance to bankruptcy'.

Figure 4: Z-scores European banks 2003-2010

	Cooperative banks	*Non-cooperative banks*
Germany	36	15
The Netherlands	141	8
Austria	34	41
Finland	29	19
France	29	16
Italy	55	29

Source: Economic Research Department calculations (annual reports, OECD data)

In the period 2003-2010, most cooperative banking sectors had higher Z-scores than non-cooperative banks and were consequently more stable according to this measuring method (figure 4). This result can be largely explained by the lower volatility of cooperative banks' profitability (standard deviation ROA). In addition, during this period all the cooperative banking sectors had higher E/A ratios than non-cooperative banks and most had higher profitability (ROA) as well. Cooperative banking sectors' higher Z-scores are in line with the results of Hesse and Čihák (2007), Groeneveld and De Vries (2009) and Ayadi *et al.* (2010).

In conclusion

While European cooperative banks were also hit by the credit crisis and the subsequent economic recession, data shows that they performed relatively stably compared to non-cooperative banks. But we are now facing a new crisis in the form of the periphery debt crisis. Only time and further research will tell how the European cooperative banks will perform during this period. The differences in banks' performance may be the greatest between national banking sectors because the exposure to the countries facing debt problems varies by country for the most part. The differences in the risk profile and risk management also play a pivotal role. Even though cooperative banks have their own characteristics and market position that can promote stability, there are also major differences among them. In addition, cooperative banks are, just like other banks, dependent on the stability of the entire economic and financial system.

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