



Rabobank



Co-operative banks in the new financial system

Rabobank Group

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Preface

Last year's financial crisis shook the global financial system down to its very foundations, as the fallout from the collapse of the sub-prime lending bubble spread across the globe. The full extent of the integration of the world's financial markets was revealed. Large-scale government intervention and extraordinary monetary measures were necessary to safeguard financial stability. After the shuddering blow of the immediate effects, financial institutions now face the recessionary effects of the financial crisis.

The business principles underlying the financial system have to change fundamentally if confidence in the financial system and financial stability are to be restored. Trust, the traditional cornerstone of the financial sector, has been replaced by a general distrust of the banking sector. Both financial markets and consumers must regain confidence in banks. And banks must likewise regain confidence in each other. Governments and society are calling for fundamental changes from financial institutions: a greater focus on integrity and ethics, a responsible risk attitude, a longer-term perspective, improved transparency and, last but not least, a much stronger customer focus.

Co-operative banks were and are certainly not immune to these developments, and made some mistakes themselves. All large co-operative banks suffered substantial losses on more risky investments. But by comparison with private banks they appear to have been dealt only a glancing blow by the immediate effects of the crisis. I think that co-operative banks escaped relatively unscathed from the crisis thanks to their unique characteristics, not least in terms of their corporate governance. The members, who are also customers, own the entire organisation. And member ownership is reflected in an approach that is consensus-driven to a greater extent and avoids any strong fixation on 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 distribute little of their profit, adding it to reserves or own funds instead. 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 platform with clear opportunities for the coming five years. For instance, most of the 'new' characteristics of the global financial system, and customer centricity in particular, 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 mature co-operative banks depend on their competitiveness, the quality and strategy of their management, and, last but not least, their relationships with their members. Past experience shows that co-operative financial institutions are able to adapt to changing circumstances and re-invent themselves. This is abundantly clear in the case study of the Rabobank Group that concludes this report.

I hope that this report will contribute to a better understanding of the strengths of the co-operative banking model. I am convinced that the principles of this model are viable, future-proof and offer clear added value. This holds true as much for the developed world as it does for emerging and developing countries, where access to finance is more often the exception than the rule.

Piet Moerland
Chairman of the Executive Board of Rabobank Group

1 Executive summary

Financial institutions must recognise that the future will not be like the past. The organisations that come out from the financial crisis as winners, will be those that do what is required for survival, but also adapt to the realities of a new world. Financial institutions must resist the urge to focus excessively on their first-line response to the crisis at the expense of longer-term considerations. At the same time, financial parties are compelled to adjust to the realities of doing business in a global world where the interests of multiple stakeholders are becoming increasingly important and the balance of economic power is shifting to the East. This report focuses on the direct and indirect effects of the crisis for European co-operative banks. The crisis entails both clear opportunities and challenges for co-operative banks in the coming five years. This study has been prepared for the 'Duisenberg Lecture' at the annual meeting of the IMF/World Bank in Istanbul, Turkey in October 2009.

After the house price bubble burst in 2007, governments and monetary authorities took a broad range of drastic measures to avoid the collapse of the global financial system. The restoration of public confidence in the banking industry had top priority in the short term, while the need for remodelling the global financial architecture to make the financial system more resilient against future shocks became apparent. In 2008 and 2009, many banks were engaged in reorganisations of their businesses. Some returned to the basics of traditional banking and others needed to strengthen their capital position substantially. Today's banking industry is facing the effects of a deep economic recession and is set to suffer additional losses in credit portfolios. Meanwhile, governments and financial authorities have announced stricter banking rules and more stringent supervision at an international level. Capital and solvency requirements for banks will be tightened, and improved risk management will be required. Moreover, stringent policy measures to safeguard the stability of the financial system are underway.

The global turbulence shook up the banking sector and led to new rules of the game. Banks had to rethink their strategy and adjust their business principles and structures. The new financial system will maintain a tighter focus on customer centricity, while integrity and ethics will play a more important role in retail banking than in the past. International controls will be improved, and the corporate governance and compensation schemes of banks must be adjusted to provide adequate incentives for a responsible balance between risks and their capital position. Banks have to apply a long-term perspective instead of a dominant focus on short-term profit.

A distinction is drawn in this study between private and co-operative banks. The fundamental difference between them is their corporate governance: shareholder versus member ownership. This difference entails numerous consequences in terms of their business orientation and principles. The characteristics and achievements of co-operative

banks in the past few years have remained notably underexposed in recent publications, the press and various reports. But the success of the co-operative business model is abundantly evident in the figures they have posted. Average market shares of European co-operative banks as well as member-to-population ratios have increased over the last decade. This is one of the strongest proofs of the vitality of the co-operative business model. But one has to bear in mind that co-operative banking is not by definition better than other banking models and after all, past performance is no guarantee of future success. For instance, co-operative banks were - and are - not sheltered from extraordinary events resulting from the crisis. They too suffered losses and incurred write-downs directly related to the financial crisis. But they appear to have been hit less hard than private banks and they did not need large-scale government support. They too feel the effects of the general loss of confidence in the banking sector and face competitors on a sharply tilted playing field. Owing to their strong position in the retail markets, they will feel the negative impact of the deep economic recession. To sum up, co-operative banking is not a panacea for post-crisis banking in general, but should be viewed as an interesting alternative to the other banking models that have been in the spotlight for most of the time in recent decades.

Looking further ahead, the unique features and natural core competences of co-operative banks provide clear-cut opportunities in this new banking environment. The 'new' characteristics of the financial system have been part of co-operative banks' DNA from the start and are considered to be their main competitive advantage. As member-owned institutions, co-operative banks now have the opportunity to leverage the new banking rules and ethics to their advantage in a well-designed public relations campaign. In addition, their strong capital base, balanced corporate governance structure and large yet finely-meshed branch networks enable them to maintain a more pronounced external focus than many of their competitors, which may translate into market share gains.

Building on the work by Unico and the European Association of Co-operative Banks, closer international co-operation between European co-operative banks likewise offers promising advantages. The reason is that operational scale will become increasingly important to remain

competitive, operate efficiently and attract customers in the future. By joining forces in specific banking areas, co-operative banks may achieve sufficient scale compared to their counterparts and diversify the risks of cross-border activities. To that end, ways of closer co-operation on international markets could be developed, building on the awareness that non-committal attitudes and non-committal partnerships belong to the past. The ultimate aim of these alliances could be to create European co-operative institutions in certain banking areas. The feasibility of this strategic direction requires further evaluation, but could be an enticing prospect for co-operative-minded bankers.

Another opportunity stems from the origins of most co-operative banks. They were often established more than a century ago in rural areas where people were deprived of financial services. The original 'raison d'être' may have disappeared for mature co-operative banks in mature financial markets, but this is definitely not the case in many countries all over the world. Co-operative banks are eminently well-equipped to help these countries in setting up sustainable financial infrastructures, visibly contributing to economic and social development. With a presence in these emerging or developing countries, co-operative banks can clearly demonstrate their 'presence value', which is virtually impossible to show in Western countries. They know very well that copying and pasting their own co-operative template to other countries is not the right way forward. Adjustments are necessary to allow for historical and cultural differences. Microfinance is a natural fit for co-operative banks in emerging and developing countries and they should make it their business to claim this promising area of banking. When the financial sectors in these countries mature, co-operative banks will possess a strong foothold based on a long-term commitment. The governments, regulators and financial sectors of developing countries should also embrace co-operative banks, since they would provide the necessary access to finance for enterprising poor people.

This does not mean that opportunities can simply be cashed in. Five main challenges can be identified.

A. Proactive and innovative attitude

Many competitors are redefining, often with government support, their strategy and business models and reorganising their businesses.

Within about two years, competitors will be leaner and meaner and some of them will re-enter the market aggressively to regain market share.

B. Improving efficiency levels

The pressure for offering competitive and innovative products/services in the market is rising, while margins tend to shrink. This requires a critical evaluation of the costs and benefits of the extensive distribution network. Integrating physical and virtual distribution channels and pursuing ways of personalising contacts with customers via virtual channels is necessary. In addition, continuous training and education are required to ensure employees' knowledge is state-of-the-art. The attitude, knowledge and competences of staff are the main differentiators in banking competition.

C. Strategic choices: differences compared to other financial services providers

Competitors tend to copy business models and products/services quickly. Co-operative banks have to communicate clearly the unique features they offer. Products and prices do not differ much between players. Strategic choices for servicing customers efficiently and maintaining a strict focus on core activities are necessary.

D. To balance benefits and risks of international versus national (home market) activities.

It will be a balancing act to reconcile the interests of domestic members, i.e. the co-operative part of the organisation, with the size and risks of international activities. Operations abroad that become substantially larger than the co-operative part might threaten to dilute the co-operative nature of the bank concerned. Also, doing more international business may increase the overall risk of the organisation and destabilise the co-operative banking business.

E. To balance local delivery and central management

It has become more difficult for members to monitor the organisation due to the increased organisational complexity of mature co-operative banks, where management is carried out by dedicated professionals. A transparent and durable balance between local delivery and central management is needed to safeguard engagement and involvement of - members of - local banks.

The winners emerging from the financial crisis will be those banks that are able to offer good products and services at fair prices with highly efficient operations in the long run, that put the customer first, and that are well-capitalised with moderate risk profiles. Strategic choices for serving customers efficiently and a strict focus on core activities and competences are indispensable. Modern co-operative banks must be entrepreneurial, cost-effective, efficient and businesslike organisations. The long history of co-operative banks shows that they can live up to these expectations.

2 The fallout from the financial crisis

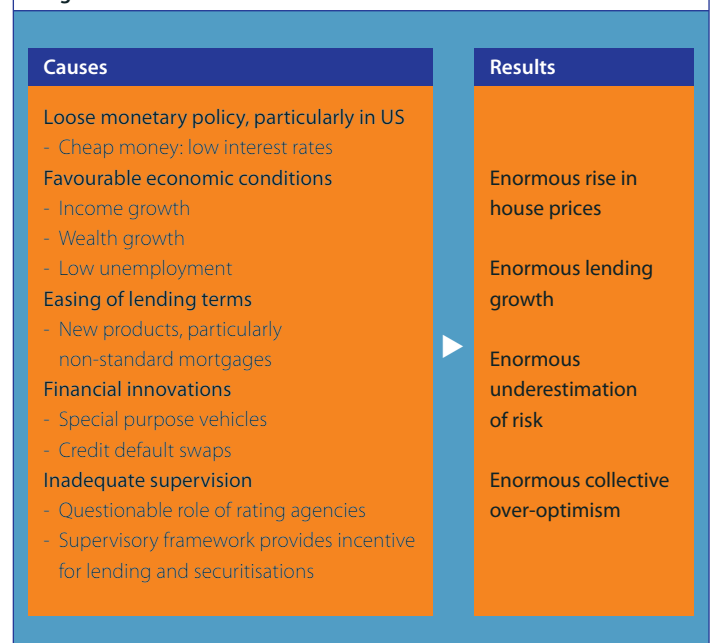
Numerous studies and reports have already been devoted to the causes and direct and indirect effects of the recent financial crisis.¹ This chapter will focus primarily on the aspects that are relevant for answering the following two questions: (i) How has the financial crisis affected the customs and business models in the financial system; and (ii) How will the financial crisis impact national banking structures in the longer term? In this report, the initial lessons learned from the first global financial crisis of the twenty-first century are summarised in order to address these questions. The short and longer term effects of the crisis on the financial services industry are then outlined. The subsequent chapters examine how the effects of the financial crisis will specifically affect co-operative banks in the short and long term.

2.1 Causes and direct effects

The roots of the most recent credit crisis lie in the United States. Five key factors initially activated reinforcing dynamics within the system as a whole (diagram 2.1). Not only banks, but also rating agencies, banking regulators, supervisors and private households played a part in the creation of the bubble in house prices in the United States. It is consequently impossible to point out a single culprit. In essence, the incentives within the financial system and private households were not right and led to greedy and reckless behaviour. Generally speaking, too many financial institutions aimed to make more and more profits for their shareholders, investors and managers in a low interest rate environment. This was caused in part by perverse compensation schemes, an overriding short-term orientation and little attention to stakeholders other than shareholders. Households also speculated on continuing rising house prices and incurred more and more debts, initially at low interest rates. In the run-up to the financial crisis, the risks associated with financial transactions were collectively underpriced worldwide. The end result was a tremendous growth in credit,

exceptional increases in house prices and a global spread of assets, particularly through securitisation of US mortgages of increasingly poorer quality.

Diagram 2.1 Causes of the credit crisis

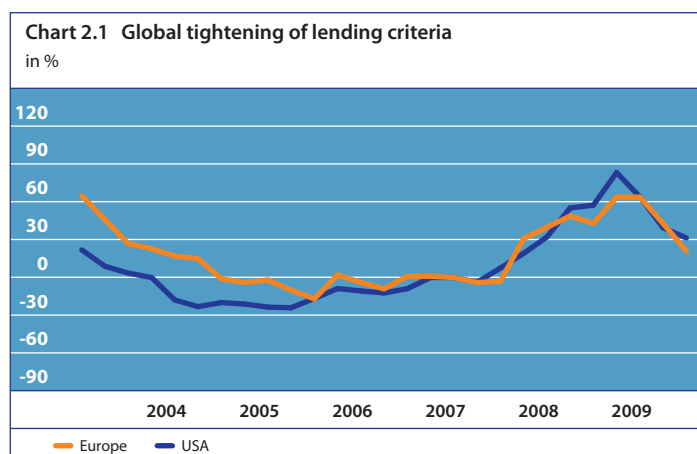


Source: Rabobank

¹ Detailed information on this topic can be found in, for example CEPR/VoxEU.org publications edited by Felton and Reinhart (2008) and reports from the industry (Financial Stability Forum, 2008).

This process of continually rising house prices was brought to an end by the Federal Reserve Bank's monetary tightening that resulted in the now well-known chain reactions within the financial and economic systems mid 2007. It started with increasing payment difficulties for households that led to foreclosure sales, which in turn placed pressure on house prices. A negative spiral of falling house prices, foreclosures, declining consumer and producer confidence, increasing defaults on credits, write-downs of credit portfolios in the US, worldwide losses and capital shortages at (investment) banks, a stagnating interbank money market and a complete loss of confidence in the financial system ensued. Despite major liquidity support operations and significant interest rate cuts by central banks and capital injections by governments around and after mid-2007, several banks around the world either failed or had to be bailed out by take-overs or nationalisations.

The fallout from the collapse of the sub-prime lending bubble has spread across the globe. This has revealed the full extent of the integration of the world's financial markets. Banks incurred huge losses and had to write-down substantial amounts worldwide. Many banks have therefore become appreciably more reticent in providing credits and loans to the private sector due to weakened capitalisations. Chart 2.1 illustrates that the credit criteria for businesses and households have been tightened worldwide in 2008. This exerts a downward pressure on investment and economic activity.



The financial crisis has also revealed the necessity for consumers and firms to clean up their balance sheets (deleveraging) and to adjust their consumption and investment patterns. These adjustments have 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 on top of the capital injections in financial institutions. Many countries have been confronted with rapidly rising unemployment rates and increasing bankruptcies in 2009.

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. It is evident that strong capital buffers and prudent risk management are needed. The truth is that painful worldwide economic and financial adjustment processes are taking place in order to correct previous bubbles in not only some housing markets, but also in commodity, raw material and energy markets.

Co-operative banks are certainly not immune to these worldwide developments and have also made mistakes themselves. While all the large co-operative banks have suffered substantial losses on risky investments, they do seem to have been hit relatively less hard 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 their international activities. As will be discussed later in this report, co-operative banks are predominantly domestically orientated and operate primarily in less risky retail banking markets. Co-operative banks are, however, nonetheless clearly feeling the impact of the economic downturn because many of their retail and wholesale clients are being affected by the economic recession.

2.2 Effects on business principles and banking models

New business principles

The business principles of the financial system must change drastically in order to restore confidence and financial stability. While the financial sector has traditionally thrived on trust, a general distrust of the banking sector has now emerged. Financial markets and consumers must regain confidence in banks. And banks must win back confidence in each other. There have been accusations of corporate greed due to the sustained and often record profits that bank shareholders and management earned until the financial crisis broke out. This led to a public condemnation of the focus on short-term gains and materialism by banks. In this light, governments and society are demanding the following fundamental changes from financial institutions: A greater focus on integrity and ethics, a healthy risk attitude, a longer-term perspective, improved (product) transparency and, last but not least, a much stronger customer focus.

The financial sector is also performing critical self-assessments and is taking initiatives to improve its ethics, risk perception and risk attitudes. Proposals have accordingly been put forward for healthier and more modest executive and employee compensation structures in the financial services industry (Institute of International Finance, 2008). These schemes induced risky behaviour and led to a fixation on short-term profit

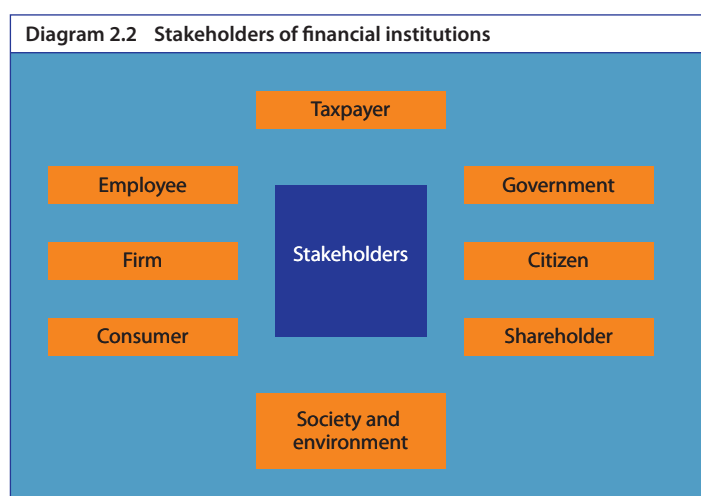
maximisation and consequently acted as a catalyst for the emergence of the crisis. A relatively large number of banks have already expressed their intention to give the interest of customers again a more prominent place in their daily business.

After the massive bailouts, society understandably expects financial institutions to adjust their behaviour to reflect the wider public interest and not, necessarily, shareholder interests. More emphasis will be placed on people and their motives in taking financial decisions, as well as on the social role of banks. Integrity and ethics are once again central and the short-term perspective with an exclusive focus on material gains and shareholder value will be much less accepted. The attention paid to financial institutions' external effects will become more pronounced. Priority will be given to collective and sustainable interests.

Regulation and supervision

Both in the US and in Europe, the financial crisis has given rise to intense discussions about reforming the regulatory and supervisory regimes². The Financial Stability Forum (FSF) recommendations, for example, focus on valuation and disclosure as means of rebuilding confidence in the creditworthiness and robustness of financial institutions. They also address issues pertaining to reinforcing banks' capital and liquidity buffers and enhancing risk management practices. The basic principles as formulated by the G-20 fit in with those of the FSF: strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets and reinforcing international co-operation among regulators and supervisors (G-20, 2009a/b).

Based on current international policy discussions, a two-tier financial services system is likely to develop (PWC, 2009). On the one hand, retail and investment banks will be operating under a tighter regulatory regime. The general consensus is that banks should hold more capital. How much and in what form are less straightforward questions. More capital will make the industry safer, but will also lower returns and, as a result, most likely raise prices for customers. On the other hand, the



Source: Rabobank

² For example, Financial Stability Forum (2008), G-20 (2009a/b), The de Larosière Group (2009).

'shadow banking system' comprising hedge funds, private equity, off-balance-sheet vehicles and rating agencies will be subject to less heavy regulation, even though it will still face greater scrutiny than in the past.

The renaissance of classic banking

Due to the envisaged new business principles and tighter regulation and supervision, certain national and international banking models have become less viable or unattractive. With respect to products, a number of dubious complex and non-transparent financial products that have been developed in the past few years, partly due to demand from the non-financial sector, will be eliminated. While this does not include derivatives, their volumes may shrink and become more aligned to the size of real economies. In addition, some activities will change, diminish or disappear (see ECB, 2008a). The number and size of special purpose vehicles will certainly diminish in line with the related decrease in securitisation activities. Investment banking will continue to be an important activity, even though it will be carried out on a reduced scale. A decline in cross-border banking is expected as banks refocus their activities on their original home markets. As a result of both massive write-downs and losses and government interventions, banks have less scope for international aspirations. In this respect, the ECB sees signs that the financial turmoil has led to a retrenchment of financial markets within national borders and consequently to a reversal of the European financial integration process in banking (ECB, 2009).

Due to the narrowing range of products and activities, fee and commission revenues will decrease and the dependency on interest income will increase. Large parts of the shadow banking system and some large international financial conglomerates will be dismantled and there will be a move back towards retail banking.³ It appears that the public and politicians have developed an aversion to financial institutions that are considered 'too big to fail', 'too big to manage' or 'too big to save'. In many countries, the crisis has prompted banks to reconsider the nature, size, geographical distribution and goals of their activities. A number of banks have already stated that they intend to

concentrate more on providing services to retail customers and SMEs rather than on wholesale banking and to focus more clearly on their core activities and traditional home markets.

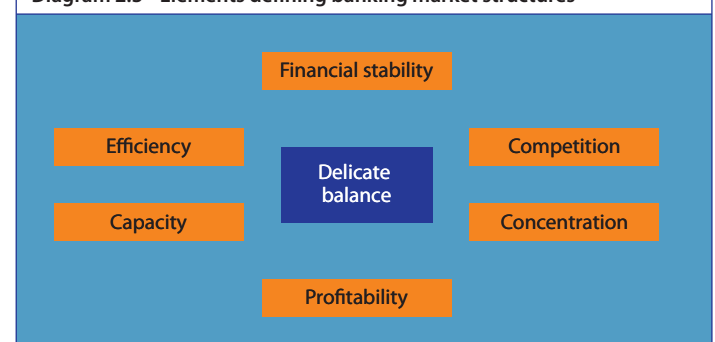
2.3 Impact on banking market structures

The financial crisis has both short-term and longer-term effects on banking market structures. These structures are generally defined in terms of financial stability, competition, concentration, capacity, efficiency and profitability (diagram 2.3). While these conceptual notions are interconnected, the signs of the correlations between these aspects are difficult to establish and may also vary over time.

Financial stability and competition

The current relationship between financial stability and competition is obviously influenced by the abnormal market conditions ('new rules') prevailing in the financial services industry. The recapitalisations and government aid programmes are contributing to the restoration of financial stability and are helping to restore the confidence needed to bring about a recovery of inter-bank lending. These moves may also support the objective of ensuring lending to the real economy. In the longer term, recapitalisation could support efforts to prepare a troubled bank to either return to long-term viability or to wind up its operations in an orderly fashion. In this current recessionary period, additional capital also provides a cushion to absorb losses and limit the risk of banks becoming insolvent.

Diagram 2.3 Elements defining banking market structures



Source: Rabobank

³ Retail business is defined as financial products and services distributed through physical and non-physical networks to retail customers and SMEs.

Be that as it may, the assessment of any government intervention must take into account possible distortions of competition (European Commission, 2008b). Recapitalisation schemes may, for example, give an undue advantage to distressed or less-performing banks compared to banks that are fundamentally sound and better-performing. This will distort competition in the market, distort incentives, increase moral hazard and weaken the overall competitiveness of banking systems. A public scheme that crowds out market-based operations will frustrate the return to normal market operation. It is obvious that a balance must be struck between these competition concerns and the objectives of restoring financial stability, ensuring lending to the real economy and addressing the risk of insolvency. A situation in which the various forms of government aid exert a long-lasting influence on future competition in the banking industry must be avoided.

Competition could endanger financial stability in the longer term if banks were to begin imitating each other's strategic approach. Competition may become extremely fierce as a result of the overriding strategic reorientation of many banks towards - the top end of - the

retail banking market and their original home markets as stated earlier (diagram 2.4). In addition, government-supported or nationalised banks will sooner or later re-enter the market as trimmed-down financial institutions that are expected to focus predominantly on retail banking.

Concentration issues

In combination with the expected increase in competition, government interventions, bailouts and/or forced or emergency mergers and acquisitions will undoubtedly lead to further consolidation in banking. A trend towards higher market concentration ratios has already been discernible in the fifteen original countries of the European Union⁴ over the past ten years, for instance as measured by the Herfindahl Index and CR5 ratio (chart 2.2).⁵ This reflects the decrease in the number of credit institutions and the dynamic growth of certain banking groups, due in part to their M&A activity. The concentration ratios vary considerably from country to country. Smaller countries tend to have more concentrated banking sectors. Banking sectors in larger countries, such as Germany, Spain, Italy and the United Kingdom are more fragmented.

Diagram 2.4 Competition risk: focus on and imitation of retail strategies



⁴ The data comprises countries that originally formed the European Union prior to the expansion on 1 May 2004.

⁵ A country's Herfindahl index is calculated as the sum of the squares of all the credit institutions' market shares in terms of total assets. The CR5 is the percentage share of the five largest credit institutions, ranked according to assets, in the sum of the assets of all the credit institutions in the EU15.

Cross-border consolidation is a different story. From a financial integration perspective, both the retail banking segment and the underlying market infrastructure (ECB, 2009) remain quite fragmented. Retail banking is characterised by a higher degree of inertia and is influenced more by structural elements such as the regulatory framework. This is clearly visible in the evolution of cross-border assets and liabilities in the euro area. The share of cross-border non-bank loans and deposits in the euro area has remained stable over the past decade at around 5 to 6 percent.

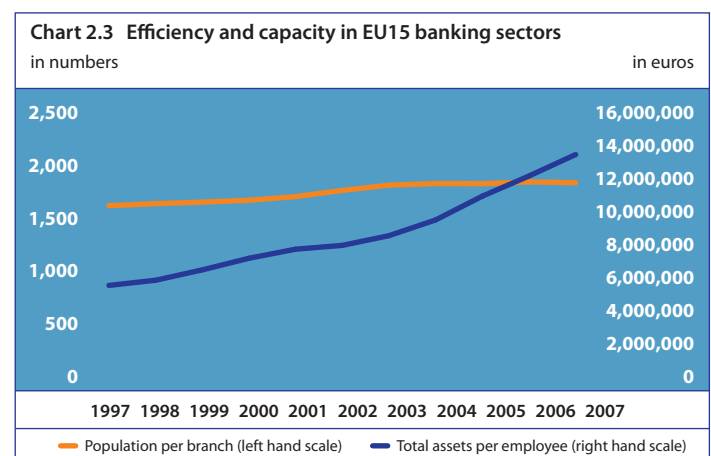
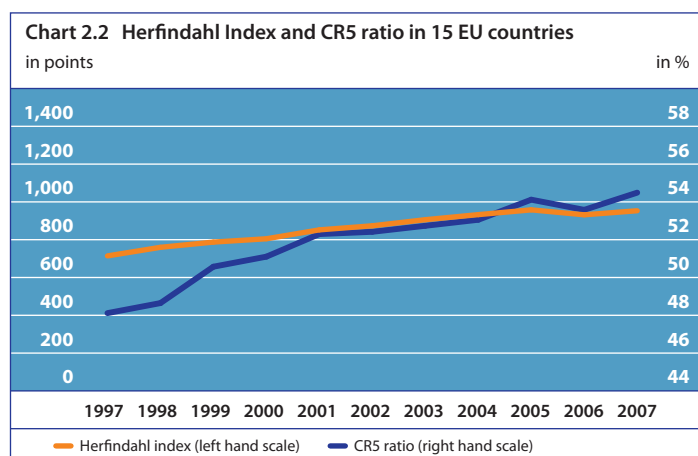
Efficiency and capacity

By creating 'new' rules and a different business environment, the financial crisis has boosted the importance of efficiency improvements and cost reductions. The economic recession, increasing competition, elimination or decreased scale of certain activities and products and the reorientation towards retail banking all clearly necessitate efficient operations in order to offset the fall in revenues. Sufficient scale, particularly in back-office operations, is a key precondition for realising low unit cost prices. Banks are currently cutting jobs, closing branches and divesting activities and business lines. They are also promoting virtual service and distribution concepts. These factors will be reflected in the efficiency and capacity indicators of EU15 banking systems.

Based on the ratio of assets per employee, efficiency in the EU15 banking sector has already improved continuously over the past ten years. As a corollary, capacity in banking is expected to decrease; there will be fewer branches per inhabitant.

Profitability

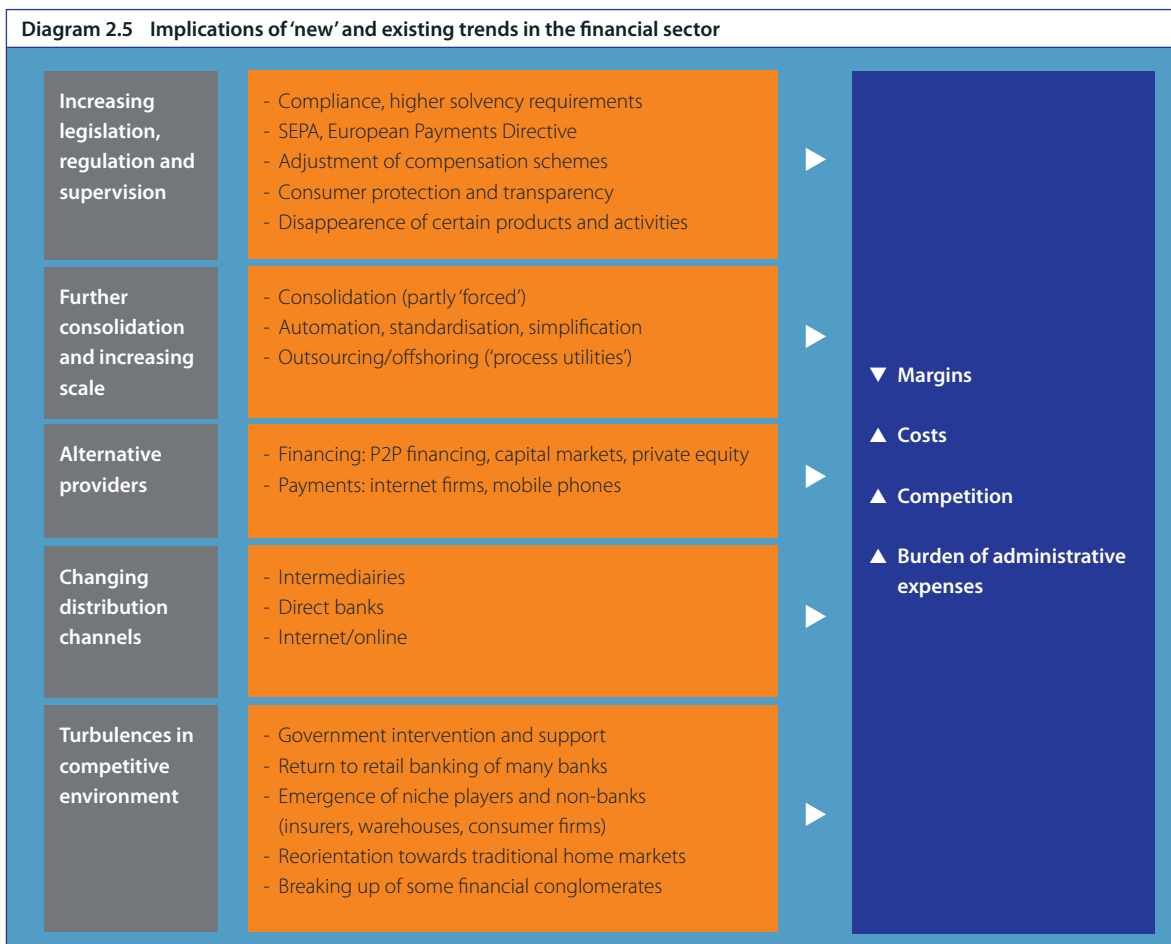
The outbreak of the financial crisis in June 2007 caused a plunge in banking profitability in 2007 and 2008. The ensuing economic recession will place pressure on banking profits in 2009 and 2010. However, the impact of the financial crisis extends further than these remarkable short-term consequences. The new rules, principles and business models will be visible in all the other determinants of the banking structure in the years ahead and will eventually result in structurally lower profitability for the entire sector. For example, the return to retail banking, higher capital requirements and funding costs and the elimination or reduction of some products and activities will all exert downward pressure on the longer-term margins and profitability for the rest of the banking industry as a whole. Apart from these 'new' trends, there are also other important trends that will have similar consequences for profits. Diagram 2.5 shows the major 'new' and existing trends and their overall implications.



2.4 Summary

The financial crisis will lead to new rules, new business principles and new business models in banking. The resulting banking model will eventually be simpler, more risk averse and more transparent. Given the dramatic experience of the crisis, special attention should be paid to the impact of investment banking activities on the stability of the new global financial system. Another salient feature is the expected 'return to retail banking' of many players. These new elements, whether enforced or not, will

undoubtedly contribute to the restoration of financial stability, which is an important factor of the banking structure. All the other structural characteristics of banking will, however, undergo fundamental changes as a result of the financial crisis. The financial crisis will consequently have effects on banking structures both in short and long term.



3 History, evolution and special features of co-operative banks

As discussed in chapter 2, practices and business models in banking will change fundamentally. Before exploring how the newly emerging banking environment affects co-operative banks, this chapter will first provide a brief overview of the history and evolution of the co-operative banking sector. Subsequently, the comparative advantages of mature co-operative banks will be discussed.

3.1 Origins of co-operative banks

The history of many co-operative banks can be traced back to the financial exclusion faced by many communities in nineteenth-century Europe. With the industrial revolution in full swing, the emerging financial services sector was primarily focused on wealthy individuals and large enterprises in urban areas. The rural population, in particular farmers, small businesses and the communities they supported, were effectively excluded from financial services (Oliver Wyman, 2008). Most co-operative banks were established following the ideas of Hermann Schulze (1808-83) and Wilhelm Raiffeisen (1818-88). Independently from each other, they started to promote the idea of credit co-operatives, with Schulze focusing on helping small business owners and artisans in urban areas and Raiffeisen seeking to assist the rural poor.

Thus, co-operative banks were originally set up to correct this market failure and to overcome the associated problems of asymmetric information in favour of borrowers. They could do so because member/consumers financed the institutions and were involved in the decision-making process. Within small communities, relatively intimate knowledge of each other's credit and trustworthiness guaranteed that loans were only provided to borrowers who could be expected to repay them. Financial incentives for members to monitor each other and the social relationships among members hence contributed significantly to the flourishing of co-operative banks. Beginning in Germany, the co-operative banking concept gradually spread to the rest of the continent and to the Nordic countries.

Despite the fact that they addressed similar issues, different co-operative banking models emerged in Europe. These variations resulted from country-specific historical and cultural factors, which shaped national market structures and market environments. In some countries, the development of co-operative banking was initiated, nurtured and supported by outside forces, e.g. governments. Consequently, the form, appearance, organisation and operation of co-operative banking groups differ across countries and over time. They vary in terms of their attitudes to membership and their interpretation of co-operative values (Oliver Wyman, 2008). Hence, the co-operative banking model does not exist (Van Diepenbeek, 2007).

3.2 Disappearance of original 'raison d'être'

The original 'raison d'être' of co-operative banks have largely disappeared in most European countries in the last 50 years. Unlike for developing countries, access to banking services and products is no longer a major issue in the developed world. Dependence on members for funding has eroded, since most co-operative banks now access debt capital markets and therefore must satisfy rating agency requirements to secure funding on favourable terms. At the same time, members' potential losses are now limited due to deposit insurance schemes, thus weakening their incentives to monitor the organisation. Furthermore, autonomy and discretion of local member banks in managing their affairs have diminished due to the increased requirement for centralised business functions to deliver efficiency gains through economies of scale and scope. This has created a distance between the centralised management of co-operative banks and their members. The increasing

complexity of financial services provision and the establishment of subsidiaries for international activities corporate and investment banking required professionalisation of management and the associated establishment of central institutions where decisions are increasingly taken. Finally, the comparative disadvantages that non-co-operative banks faced in the past for servicing small farmers and small businesses have also largely disappeared. Legal and juristic frameworks now offer much stronger contract enforceability and verifiable information about potential borrowers is generally available.

3.3 Evolution of co-operative banks: local-national-international

Local-national evolution

The market environment has altered dramatically for co-operative banks over the years. Quite a few co-operatively organised banks did not or could not succeed, or now just live a marginal existence. Many countries never had a co-operative sector of any significance, because the co-operative ideas did not find very fertile soil. In other countries, co-operative banks chose to be acquired by other banks or to transform themselves into private banks. This was the case in Denmark, Sweden, the U.K. and Belgium. In Sweden, the Föreningsbank network was taken over by the savings bank network, while in Belgium the legal structure of co-operative banks CERA (now part of the KBC group) and BACOB (now part of the Dexia group) was changed in such a way that they are no longer classified as co-operative banks. In the UK, a number of building societies have converted into public, quoted companies in order to expand their activities.

The currently existing co-operative banks have succeeded in following up and adjusting to changes in the market environment, but have chosen different directions and strategies. The bottom line is that they are convinced that they can still provide added value to their customers and members resulting from their specific governance structure and their disapproval of maximising profits. Although it is impossible to put co-operative banks in one box, some general patterns in their domestic evolutions can be observed (box 3.1). While they began as local banks, most of the present co-operative banks have evolved into national (network) organisations, partly as a result of regulatory requirements or

the desire to reach economies of scale and higher efficiency levels. However, the extent of decentralisation and integration within the networks varies (Desrochers and Fischer, 2005). Co-operative banks were also engaged in consolidation, diversification, domestic acquisitions of publicly quoted banks, and launching new distribution concepts. In short, mature co-operative banks re-invented themselves in the course of time to counter factors constituting a threat to their existence.

National-international evolution

In line with internationalisation and globalisation trends, co-operative banks have embarked upon international strategies. Some 30 years ago, European co-operative banks established platforms for mutual international co-operation: the European Association of Co-operative Banks (EACB) and the Unico Banking Group. The EACB constitutes a valuable partnership in the current dynamic environment. It focuses on promoting the interest of co-operative banks in Europe, but also stimulates discussions about the social role of co-operatives and flags important changes in the regulatory environment and level playing field on EU level. The original aim of Unico was to support the expansion of its partners' international operations. The most important components of the Unico alliance these days are the sharing of know-how and expertise on a wide range of banking subjects and commercial initiatives, and the joint training of staff. A notable product that has been developed in the Unico context is UniCash - an international cash management facility.

Co-operative banks also took individual international steps. The reasons and strategies of cross-border expansion differ a great deal across co-operative banks and over time, but are generally in line with those of their private competitors (ECB, 2008a). Regarding their motives, some co-operative banks state that the main driver of international expansion was the limited (organic) growth potential in their domestic markets and the higher growth potential in their host countries. Other co-operative financial organisations have argued that the internationalisation

⁶ French Crédit Agricole has a three-tier network, comprising local, regional and central organisations. The Dutch Rabobank has a two-tier network, consisting of local member banks and the central organisation. The Italian Banchi Popolari has no national structure at all, with all member banks acting completely independently of each other.

Box 3.1 Main domestic evolutions of co-operative banks

A. Organisational structures

Important changes took place in the organisational structures of co-operative banks (Di Salvo, 2003). Nowadays, the vast majority of European co-operative banks are organised in networks. Industrial reorganisation, governance reform and pressures of competition have in general led to more and more tightly integrated networks of individual co-operative banks and have fostered an accentuated centralisation of strategic and operating functions and processes. Achieving economies of scale or scope and generating synergies were the primary motives to set up so-called higher-tier levels. However, the evolution towards a more centralised structure is more pronounced in some countries than in others. The networks still vary from loose associations to cohesive groups (Fitch, 2001). The Dutch co-operative group is one of the most centralised systems, whereas the Italian co-operative system remains the most decentralised of the major European co-operative movements. The Austrian and German co-operative sector take up a middle position. Most co-operative groups have created second- or third-tier structures⁶ in order to obviate the limits intrinsic to their small scale and specific purposes. In many cases, legislation has endowed the central bodies with guidance and supervisory powers over local co-operative banks. The first-tier bank is unequivocally assigned the primary task of managing contacts with its members and local community and doing business with members and customers. The higher-tier organisations have governance models that tend to conform to co-operative principles, since they intrinsically perform a service function for their co-operative members (EACB, 2006).

B. Consolidation

In response to the increase in competition and institutional developments within domestic retail banking markets, co-operative banks have pursued consolidation in various ways. At the local level, branches have been closed or merged with others in order to achieve efficiency gains. Where third-tier structures exist, consolidation at the regional level can be observed. Co-operative banks also played a role in the domestic consolidation process. In particular French co-operative banks have acquired a number of private banks.

C. Domestic diversification

Co-operative banks have diversified away from purely retail and small business banking and have also become active in corporate banking. They have set up businesses in the fields of leasing, factoring, insurance and investment funds. Some co-operative banks formed or acquired specialised subsidiaries, whereas others offered non-banking products to customers/members from third parties. This way, the product range offered by local member banks has been expanded. In some co-operative systems, the subsidiaries are owned and governed by a well-capitalised central institution. In co-operative systems where the central organisation is insufficiently capitalised for these acquisitions, local member banks or their regional organisations are also shareholders of the subsidiaries, which complicates their governance to some extent.

D. Funding

Funding sources have been extended beyond traditional membership capital to various forms of capital market funding. To increase capital flexibility, most co-operative banks have created various options to strengthen their capital base. Some co-operative banks have chosen partial demutualisation to access the equity markets. This has happened in Finland, France and Italy. A significant development in co-operative banking has been the partial flotation of the central institution of the French *Crédit Agricole* group and its subsequent acquisition of *Crédit Lyonnais* in 2003. Rabobank and DZ Bank, the central institution of the German co-operative banks, have issued hybrid debt (e.g. trust preferred securities for professional investors).

E. Distribution and service concepts

Traditionally, co-operative banks service customers/members via branches. In recent times, co-operative banks have been increasingly distributing their products and services via virtual channels, like the internet, ATMs or call centres. Since the diversity of customers has increased considerably, co-operative banks also differentiate more and more in the way they serve particular customer groups or economic sectors.

strategies of their customers prompted their cross-border expansion. The diversification of risks and business lines as well as the somewhat circular argument that their private peers follow international expansion are less frequently put forward as (explicit) motives. Economies of scale and scope are rarely mentioned as important drivers for cross-border expansion. Rabobank estimates that European co-operative banks currently generate on average around 25 percent of their total net revenues outside their home country.

Like their private competitors, co-operative banks have explored different international strategies over the past decades with varying success. Some steps led to disappointing experiences and necessitated adjustments in the international strategy. However, a general pattern is that co-operative banks mostly entered foreign retail banking markets either via acquisitions of other banks or via strategic alliances with other European counterparts. For instance, Raiffeisen International (a subsidiary of the Raiffeisen central institution in Austria) set up a large network of retail operations in Central and Eastern Europe, largely via acquisitions of formerly public banks. French Crédit Agricole and Crédit Mutuel recently undertook international acquisition offensives in Italy, Greece, Poland and Germany. Rabobank has pursued a set of strategic acquisitions and new business start-ups, but has also concluded alliances with other co-operative banks to be able to service domestic retail customers abroad. In almost all instances, co-operative banks neither converted the acquired foreign banks to a co-operative model nor applied 'purely' co-operative principles in managing new business lines abroad.

Some co-operative banks have or had the ambition to become active in international non-retail banking areas, like investment banking. However, practices in this banking area differ substantially from those in retail banking. Investment banking has a much more transaction- and money-orientated culture, which is more distant from the co-operative banks' basic philosophy that is based on customer value (generally accompanied by a limited risk appetite stemming from the conservative domestic banking model). Finally, some co-operative banks opted for an international niche strategy. They have expanded their international activities in certain geographical or product areas where they possess comparative advantages. For instance, Rabobank has the ambition to become the leading international bank for the food and agribusiness.

Finally, the motive to 'export' the domestic co-operative model to other countries has until recently only played a minor role in the international strategies of co-operative banks. This changed, however, with the growing attention for microfinance in emerging markets and developing countries. Nowadays, some co-operative banks are seeding new banking business in new territories under the co-operative model. The French Crédit Agricole founded the Grameen Crédit Agricole Foundation to develop partnerships with microfinance institutions to operate in developing and emerging economies. For instance, Rabobank assist governments and communities in setting up agricultural co-operatives and/or supporting co-operatively organised banks. This way, they contribute to the creation of the required infrastructure to grant small loans (microfinance) to people in rural areas. In this respect, some co-operative banks returned to their original roots. The rationale of the foundation of co-operative banks in the nineteenth century was similar to the one behind current microfinance initiatives in developing countries, namely to provide people with the tools and means to collectively and individually help themselves. These initiatives are often performed under the flag of 'corporate social responsibility'.

3.4 Six distinguishing features of mature co-operative banks

At this point, two fundamental questions arise, which cannot be answered easily and unambiguously: (i) What is the 'presence' value of co-operative banks in mature domestic markets; and (ii) How do co-operatives differentiate themselves from their current competitors? Regarding the first question the European Association of Co-operative Banks has formulated the following answer (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. Thus, the 'promised' greater focus on the customer by many financial institutions following the crisis sounds quite awkward to co-operative banks. An interesting element in the passage above is the comment that co-operative banks have an 'impact presence'. To define and quantify this presence value, however, is a difficult undertaking. Even more so, because they actually hint at a noticeable causal relationship between mature co-operative banks and society and banking markets. Such a causality is hard to demonstrate empirically, as it really only manifests itself on the entry or exit of a large co-operative bank. But it also works the other way round: society and the market environment influence co-operative banks.

More founded theoretical and empirical evidence is available regarding the question of 'the unique and defining characteristics of co-operative banks.' Based on the existing literature and policy reports as well as Rabobank's experience, the key differentiators of co-operative banks in their home country can be divided into six main categories:

I. Specific corporate governance: member ownership

Members, who are also customers, own the entire organisation and are able to influence its decision-making. Members have a more direct say in the local member bank's policy, for instance on the branch location, opening hours, services and sponsoring activities. Member ownership entails a more consensus-driven approach and prevents a strong fixation on just one stakeholder. This is accompanied by a longer term and risk-averse view, which translates into a more conservative banking approach focused on retail banking. With their strong local ties and large networks, co-operative banks are in theory better equipped to assess the creditworthiness and risks of customers at a local level.

II. Customers' interests first

Co-operative banks have an edge in portraying trustworthiness as they publicly state that they do not aim to maximise profits but rather to maximise customer value. They have a competitive advantage in establishing trust. An important factor is that co-operative banks are literally closer to their customers; their branch network density is higher than that of their competitors.

III. High capitalisation, high rating and low funding costs

Co-operative banks barely distribute profit but add it to their reserves or the banks' own funds. Consequently, co-operative banks are some of the more highly capitalised institutions in Europe as a result of their unique model and ownership structure. Co-operative banks accumulate capital by design, as their original purpose was to overcome a shortage of capital for their chosen activities. Co-operatives have a lower cost of capital, because they only need to remunerate the part of their equity that is represented by member shares, not the often much larger intergenerational endowment. In addition, mutual support mechanisms that exist in various countries contribute to high ratings. These collective guarantee schemes reduce or even exclude the risk of individual co-operative bank failure. Finally, high capital reserves and high ratings provide co-operative banks with opportunities to obtain relatively cheap capital market funding, because this entails less risks for other creditors and thus lower risk premiums.

IV. Profit as a necessary condition

Based on the long-term focus on customer value and member influence, co-operative banks claim that they do not aim to maximise short-term profit⁷ while healthy profitability is an important necessary condition for co-operative banks to safeguard their continuity, to finance growth and credit, and to provide a buffer for inclement times, profit is not a goal in itself.

V. Conservative business model: focus on retail banking

Member ownership leads to a conservative business model, focused on sustainable retail banking. This leads to good liquidity and sound asset quality. The structure, knowledge of local customers and risk diversification all work in favour of co-operative banks. The knowledge that capital cannot be easily replaced by external sources after considerable losses stimulates co-operative bank managers to apply a relatively low risk appetite.

⁷ The line of reasoning of PA Consulting Group (2003) that co-operative banks spoil market conditions for profit or shareholder-orientated banks and may eventually undermine financial stability, is fairly far-fetched and cannot be supported by data. Co-operative banks simply have a profit target that is based on the objective to serve customers on a continuity basis.

VI. Proximity to customers: dense branch networks

Co-operative banks have large branch networks, providing co-operatives with an important, albeit declining, comparative advantage in retail markets. Co-operative banks are literally and figuratively closer to their customers and know those customers well through participation in numerous social networks. This is because the co-operative banking model centres above all on 'relationship banking' via local presence. Proximity to their customers is reinforced by actively supporting local communities. Finally, large branch networks facilitate mobilising and retaining a relatively cheap and important funding source, provided that their deposit rates are not much lower than those offered by competitors.

These features are generally considered benefits for co-operative banks, but it is fair to make some important qualifications. Firstly, it has become more difficult for members to monitor the organisation due to the increased organisational complexity of co-operatives in which management is carried out by dedicated professionals. It is also argued that member ownership makes decision-making slower or hinders innovation and adjustment to new developments. In addition, members

have a reduced incentive to stimulate an optimum use of the high capital base (or excess capital), because they do not have a direct claim to the capital (it is 'capital in dead hands'). This could give rise to a risk of opportunistic investments by bank executives. Secondly, the introduction of external shareholders into a co-operative system creates tensions regarding control. If capital is only provided by members, the voting power as member of a co-operative bank and the voting power as capital provider coincide within the same group. When ownership is shared with external capital providers, voting power will also have to be shared. Thirdly, the evolution of the financial sector may call for financial services, activities or concepts that are not necessarily needed by current members at the local level. These adaptations may be crucial for attracting new customers or members for co-operative banks in the future. In the longer-term, co-operative banks could find themselves at a disadvantage because they do not operate with state-of-the-art technology or are unable to offer innovative products. Finally, physical distribution networks imply large fixed costs and the distribution of some financial products has in the last decades shifted from expensive physical channels towards virtual channels.

Table 3.1 Tangible and intangible advantages for members

	Individual		Collective
	Banking	Non-banking	
Tangible	<ul style="list-style-type: none"> - Membership certificates - Co-operative shares - Discounts - Incentive loans for start-ups - Simple procedures for obtaining loans 	<ul style="list-style-type: none"> - Discounts - Special offers, e.g. mobile telephone, subscriptions - Participation in decisions - Priority in business relations 	<ul style="list-style-type: none"> - Financial support for local projects or sponsoring
Intangible	<ul style="list-style-type: none"> - Personal advice - Extra information - Seminars 	<ul style="list-style-type: none"> - Publications - Seminars - Special events - Influence based on one man one vote 	<ul style="list-style-type: none"> - Influence and say - Member councils - Social involvement - Determining the use of social funds and sponsoring

Despite these caveats, the identified differentiators must be treasured. Furthermore, it should be remembered that the quality and range of products and services offered, their pricing and the applied distribution concepts are of utmost importance. In addition to this, special advantages to members are offered (table 3.1). In fact, customers and members have to notice the comparative advantages and differences in attitude or business culture in practice in line with the co-operative objective of delivering customer value.

Apart from extreme situations like the current crisis, the co-operative business model demands cost and revenue levels for retail banking activities that do not deviate substantially from the standards of the banking industry. However, the deviation range or price/quantity sensitivity of customers may vary over time and across countries. For instance, 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. From marketing and brand research, it is a well-known fact that customers also attach importance to immaterial aspects such as access to the bank's network and knowledge, the stability and duration of relationships, sustainability characteristics, etc.

3.5 Summary

It is clear from recent history and the discussion in this chapter that all organisation forms have both problems and comparative advantages. The co-operative organisational form is just another business model and not by definition the key to success. Hence, the co-operative model should not be idolised. The success of all banks, including mature co-operative banks, is ultimately determined by the level of customer/member satisfaction, which is in turn influenced by many variables, including the quality and prices of products and services, innovative capacity, the perceived corporate social responsibility and employee attitude, knowledge and competences. For co-operative financial organisations, tangible and intangible advantages of membership are

an additional factor. The success of current mature co-operative banks can be explained by their evolving comparative advantages as well as their capability to react to and/or anticipate changes in the external environment. One of their proclaimed unique features is member ownership, which is assumed to translate into customer centricity, high capital ratios, a conservative business model and dense branch networks. However, the reduction of members' incentives to exert effective oversight over central management constitutes a major challenge. Such oversight is actually needed as co-operative banks have transformed from small institutions operating in local communities to large and complex financial conglomerates with international activities.

4 Size and performance of co-operative banks in Europe

As mature co-operative banks are by definition part of national financial systems, they are both confronted with structural developments and responsible for shaping them. Through their mere existence, they also play an important economic and social role in society (EACB, 2007). An important question is: How has their market position and performance developed in recent years? The answer may provide useful indications for their 'presence and added value', vibrancy and viability. Consolidated banking data for the period 1997-2007 are used to examine these issues. Since the aggregated data obscure situations that differ considerably from country to country, two country subgroups will be distinguished in the analysis. Data will be presented for the entire co-operative banking sector in fifteen EU countries, as well as in six EU countries where co-operative banks enjoy very high market shares.⁸

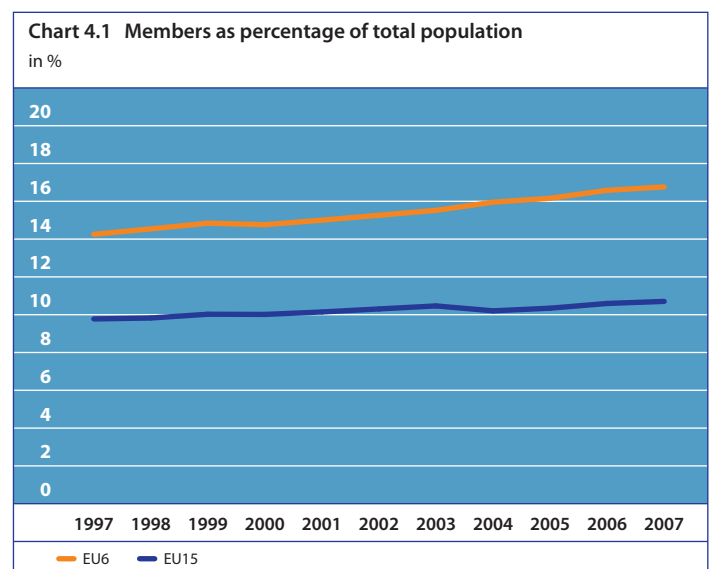
4.1 Size of co-operative banking sector in Europe

Members and customers

The co-operative sector is a major player in the European banking landscape. In 2007, the total number of customers and members approached respectively 150 and 43 million. These numbers are impressive, but do not mean much if they are not put into perspective. The success and popularity of the co-operative banking model are ultimately visible in the development of the 'member-to-population' ratio. Chart 4.1 displays this ratio in fifteen EU countries (EU15). 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).

⁸ The EU15 area comprises Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Greece, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom. EU6 countries comprise Austria, Finland, France, Germany, Italy and the Netherlands; these are countries where the co-operative sector is extremely important.

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 by 2.5 percentage points to almost 17 percent. This points to



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.⁹ They merely indicate 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. These member-population ratios differ considerably across the EU15 countries. The highest ratios are found in Austria (28.5), followed by France (25.5) and Finland (23). The Swedish co-operative sector has the lowest ratio (not counting countries without a co-operative banking sector).

The membership ratio, defined as the percentage of customers that are members, declined between 1997 and 2007 in both the EU6 and EU15. This decrease can be entirely attributed to the acquisition of customers via mergers or takeovers of other financial institutions by co-operative banks. Chart 4.2 shows the variation in the membership ratios across EU6 countries in 2007. The differences can be partly explained on historical grounds, e.g. the fact that obligatory membership was not abolished in all countries at the same time. The variation also reflects the diverging numbers of customers of subsidiaries as well as different attitudes towards membership across European co-operative banking groups. Some banks strive to make every customer a member, while others are not actively recruiting members. Whatever their position may be, without continuing good and innovative products and services

offered at fair prices, appreciated distribution concepts, and an active and dynamic membership policy, the legitimacy of co-operative banks will gradually erode.

Market shares

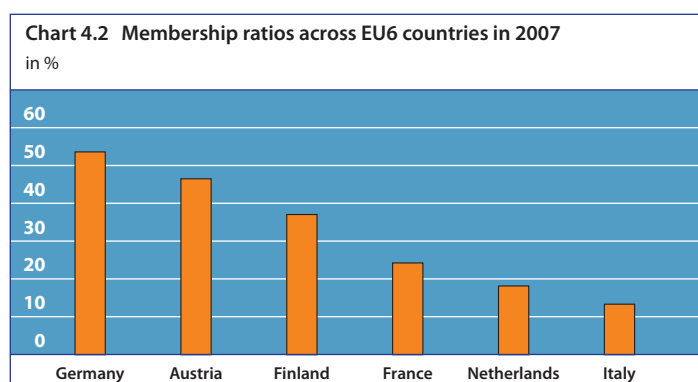
On average, only co-operative banks in the EU6 were able to gradually increase their market shares in the loan and deposit markets over the last decade. In the EU15 area, the market shares of co-operative banks remained virtually constant. The rise in market shares in the EU6 showed some acceleration in 2006 due to the acquisition of financial institutions by the co-operative banking sector. The EU6 market share of domestic deposits now amounts to almost 32 percent, whereas the market share of domestic loans lies at roughly 28 percent. It may also be noted that the figures lead us to conclude that the loan-to-deposit ratio is somewhat higher for co-operative banks than for private banks. This partly reflects their traditional strong position to attract local deposits. The available evidence also supports the argument that co-operative banks have relatively easy access to a fairly cheap, risk-free and stable funding source, i.e. a relatively large deposit base. This is likely to contribute to a healthy balance sheet composition and high credit ratings. The market shares of individual co-operative banking systems do not show a clear trend; they are declining in some countries but on the rise in others.¹⁰

The market shares for deposits and loans are significant, but below the market shares on other indicators such as branches (chart 4.3).¹¹ The market shares for branches are in both EU15 and EU6 approximately 10 percentage points higher than those for deposits. Over the last decade, co-operative banks have gained branch market share for two reasons. The first is that co-operative banks in France, Italy and Spain have expanded their branch networks either organically or via acquisitions. The second explanation is that co-operative banks in eight EU countries have slimmed down the number of branches to a lesser

⁹ Some of these reasons could be financial conditions, but also the degree of customer satisfaction, the extent to which banks act in the interest of customers, access to the bank's networks and knowledge, the stability/duration of relationships, the way banks deal with environmental and sustainability issues, the degree of product and price transparency, etc.

¹⁰ An exception is France, where co-operative banks acquired several private banks.

¹¹ The same holds for market shares for staff, albeit to a lesser extent.



Source: Calculations by Rabobank based on EACB and ECB data

Note: The displayed countries have a relatively large cooperative banking sector.

extent than their competitors in the context of cost-cutting or efficiency programmes. As a result, co-operative banks have strengthened their local presence. Against the background of the expected 'return to retail banking' of many financial players in the coming years, co-operative banks could take advantage of this fact. In the EU6, co-operative banks currently own over 40 percent of all bank branches. Of course, many co-operative banks have introduced or stimulated the use of cheaper virtual distribution channels, while remaining loyal to their brand value 'nearby'.

Co-operative banks spend more money on branches, staff and other resources to manage a given level of assets or to acquire a given level of deposits. This is mirrored in the ratio of deposits to bank branches and staff, which is universally below the ratio for the banking system as a whole (chart 4.4). The amount of deposits per employee at co-operative banks in the EU6 is about 3.6 million euros, compared to almost 4 million euro in the banking sector as a whole. This finding is consistent with the six comparative features of co-operative banks. However, the line is clearly upward sloping, implying that co-operative banks have managed to increase the efficiency of their operations. Deposits per employee have risen by sixty percent since 1997. Nevertheless, co-operative banks

still operate with somewhat higher capacity levels, for which branch market shares and 'deposit-to-employee' ratios act as proxies. In the next section, we will investigate whether this results in lower returns on capital and/or lower efficiency levels compared to private banks.

4.2 Financial performance of co-operative banks

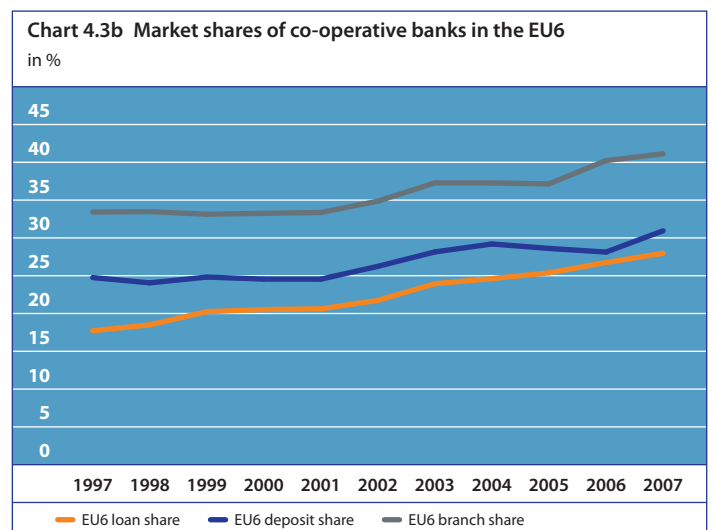
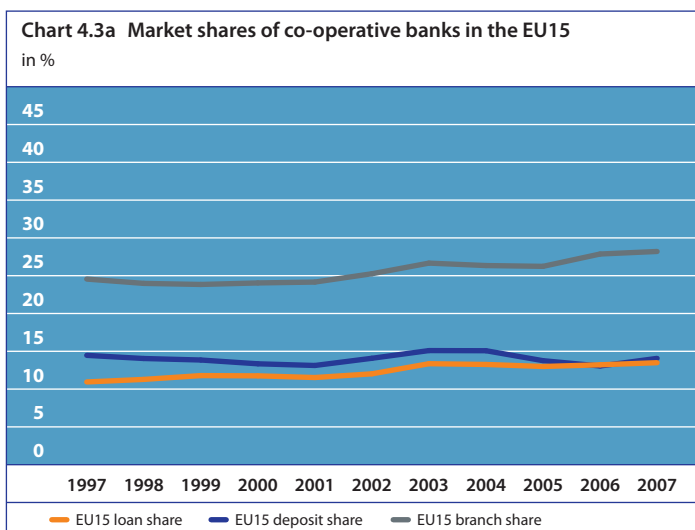
Four important, interdependent indicators will be reviewed:

- a. Tier-1 ratio
- b. Profitability
- c. Efficiency (expenses/income ratio)
- d. Rating

It must be emphasised that it is difficult to compare co-operative bank performance with that of other banks. As elaborated in chapter 3, co-operative banks pursue different objectives and employ different business models.

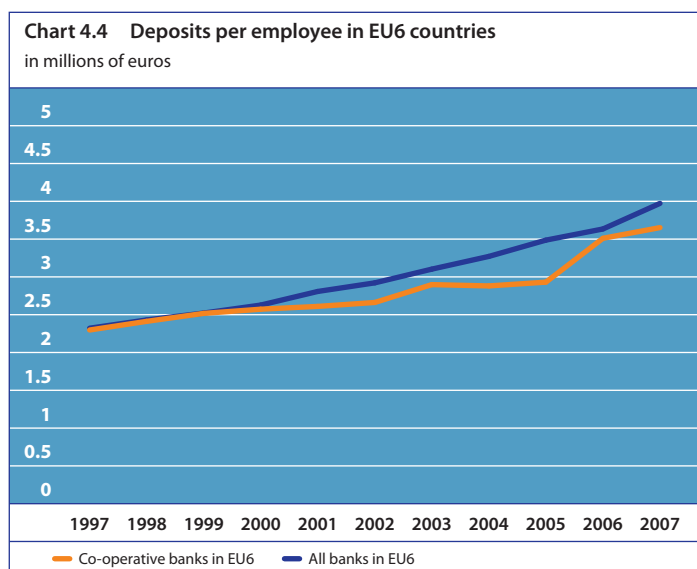
Tier-1 ratio

Chart 4.5 shows the tier-1 ratio for several co-operative banks at year-end 2007, compared to the minimum capital requirement of 8 percent



set by the market.¹² This ratio reflects the amount of equity relative to the risk-weighted assets of a bank. It can be concluded that co-operative banks maintain a comparatively high level of capital. There are a number of explanations for this (Oliver Wyman, 2008). Firstly, high capitalisation is connected with the strong focus of co-operative banks on retail operations, for which relatively high capital requirements prevail. Secondly, co-operative banks add a major portion of their profit to the capital reserves each year. Thirdly, solid capitalisation is simply necessary for co-operative banks with a view to continuity. Co-operative banks have to rely less on other options to raise capital, as most of them cannot issue shares.¹³

Chart 4.5 shows that the tier-1 ratios of most co-operative banks in 2007 and 2008 were comfortably higher than the market's minimum requirement of 8 percent. In the course of 2008, tier-1 ratios of many banks have deteriorated worldwide. Several banks needed to attract additional capital. This chart simply 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 to the entire co-operative groups, not just the co-operative banking part.



Profitability

The qualitative insights of chapter 3 fuel the expectation that co-operative banks have below average profitability, as they target customer value maximisation instead of profit maximisation. Profit is a necessary condition, without which the co-operative would be unable to grow or invest sufficiently. This would cause members to cancel their membership because its added value would be substantially reduced.

Profitability is usually assessed in terms of return on assets and return on equity. Our 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 is lower than for private banks, as expected. The lower return on equity is caused by the lower leverage resulting from a higher core capital ratio for co-operative banks. This supports the observation that co-operative banks maintain on average larger capital buffers. The findings partly reflect the primary focus on maximisation of customer value.

¹² Tier-1 ratios under Basel II. The statutory requirement is 4 percent but in practice the market demands 8 percent. This last percentage is included here.

¹³ Exceptions are Crédit Agricole and the holding company Raiffeisen Zentral Bank of the Austrian Raiffeisenbanken.

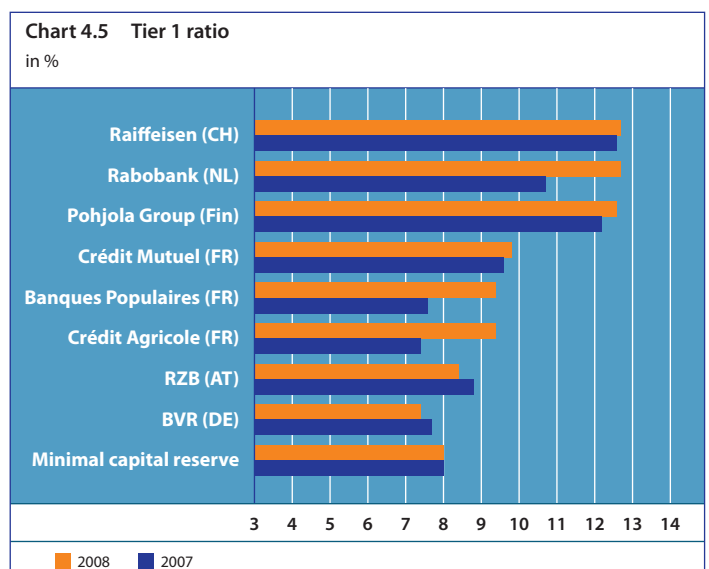


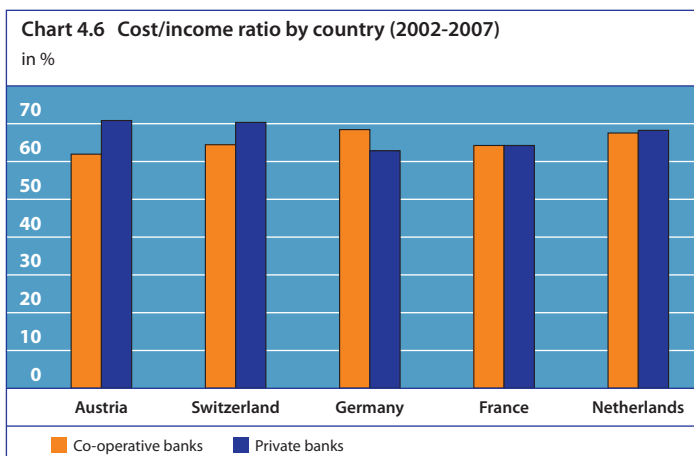
Table 4.1 Average financial performance of banks (2002-2007)

	Co-operative banks (N=9/O=53)	Private banks (N=36/O=159)
	Percentage (standard deviation)	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: Calculations by Rabobank 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.

Efficiency (cost/income ratio)

Some experts claim that the absence of a profit objective, or a lower profit requirement, deprives co-operative banks of incentives to operate efficiently. With regards to income, this would mean that they set a suboptimal price and that efficiently operating competitors realise a



Source: ECB (2008) and calculations by Rabobank based on Bankscope
Note: The co-operative banks in these countries were compared with the total group of 45 banks.

concealed 'excess return', i.e. profit on top of the co-operative price. Regarding costs, the focus on customer value is sometimes assumed to provide an excuse for more relaxed cost control and inefficient operations.

Benchmarking of expenses and revenues of co-operative banks against banking sector standards is only a rough way to verify the validity of these hypotheses. As discussed, financial facts cannot just be compared with those of other banks due to different business models. In this respect, it is interesting to observe that various studies from different parts of Europe conclude that there is little difference between the efficiency of co-operative banks and private banks in Europe (Moody's, 2003; Hesse and Čihák 2007; Oliver Wyman, 2008). In some countries, co-operative banks in fact operate more efficiently, particularly in the EU6.

Our own calculations presented in table 4.1 corroborate these views. In the period 2002-2007, co-operative banks in all Western European countries, except France, operated more efficiently than private banks (chart 4.6). Hence, the relatively expensive distribution concepts of co-operative banks do not show up in lower overall efficiency levels. Moreover, the expenses/income ratio of the co-operative banks even improved significantly on average between 2002 and 2006. The higher costs of their disproportionate branch networks were more than offset by higher revenues, which is quite an achievement in the current competitive environment. For co-operative banks, it still pays to adhere to their traditional business model. This outcome suggests that they use their assets and capital base in a highly efficient way.

Ratings

The rating of a bank is an overall report mark for its risk profile, capital buffer, stability of income flows, market shares, strategy and diversification of activities. In short, all variables described in the previous subsections are important building blocks for ratings. For co-operative banks, the organisation and the degree of decentralisation are an additional rating factor (Standard & Poor's, 2002). In practice, it also appears that all co-operative banks in the EU6 have some form of support mechanism in place (Fitch, 2003).

All things considered, major rating agencies award co-operative banks with high credit ratings and consider them to be stable, financially healthy and solid. At the end of 2008, rating agencies expected operating results and balance sheet structures of the co-operative banks to remain at a satisfactory level. Apart from a higher degree of capitalisation and a lower risk profile, this is also caused by the existence of collective guarantee schemes in co-operative banking systems to prevent the failure of individual co-operative banks.

Table 4.2 Credit ratings of a number of co-operative and private banks

Bank	Type	Standard & Poor's	Moody's	Fitch
France				
Banques Populaires	Co-operative	A+	Aa3	A+
BNP Paribas	Private	AA	Aa1	AA
Crédit Agricole	Co-operative	AA-	Aa1	AA-
Crédit Mutuel	Co-operative	A+	Aa3	AA-
Société Générale	Private	AA-	Aa2	AA-
Germany				
DZ Bank	Co-operative	A+	Aa3	A+
Commerzbank	Private	A	Aa3	A
Deutsche Bank	Private	A+	Aa1	AA-
Finland				
Pohjola Group	Co-operative	AA-	Aa1	AA-
Nordea Bank Finland	Private	AA-	Aa1	AA-
Netherlands				
Rabobank	Co-operative	AAA	Aaa	AA+
Fortis Bank SA/NV	Private	A	A1	A+
ING Groep	Private	A+	A1	A+
SNS REAAL	Private	A-	Baa1	BBB+
Austria				
RZB	Co-operative	A	Aa2	n.b.
Erste Group Bank	Private	A	Aa3	A

Source: Rating agencies Fitch, Moody's and Standard & Poor's

Note: Ratings pertain to April 2009. The rating shown for Crédit Agricole, Crédit Mutuel, DZ BANK and RZB is that of the central organisation. Consolidated rating for all individual local member banks do not exist.

4.3 Impact of co-operative banks on national financial systems

The notion that co-operative banks in Western Europe contribute to the stability of the banking system thanks to their strong capital reserves, stable income, risk diversification and focus on retail banking is increasingly supported by empirical studies. IMF researchers Hesse and Čihák (2007) conclude that the strong capitalisation and stable income of co-operative banks more than compensate for the adverse influence of lower profitability on their stability. In their view, financial co-operatives contribute to the stability of the financial sector. The relatively high credit ratings of co-operative banks also point to their beneficial impact on financial stability. All these research results offer a rather convincing counterbalance to the criticism voiced by some analysts (e.g. PA Consulting Group, 2003) that the lower profitability requirement of co-operative banks would distort the competitive environment in retail banking and would ultimately lead to instability.

An elegant yet simple measure for assessing the stability of co-operative banks and their impact on the stability of financial systems is the so-called Z-score. The Z-score measures bank stability and indicates the distance to insolvency, combining accounting measures of profitability, leverage and volatility. It can be used to compare the financial stability of a bank with that of other banks. The higher the Z-score, the more stable the bank. Rabobank calculations reveal that European co-operative banks had substantially higher Z-scores than private banks in the period 2002-2007 (Groeneveld and De Vries, 2009).¹⁴ In addition, private bank Z-scores seem to have declined since 2002, while those of co-operative banks have remained relatively stable. Consequently, co-operative banks lift the average Z-score in individual countries, and thus contribute to national financial stability.

¹⁴ Beck et al. (2009) find similar results for Germany.

4.4 Summary

Over the last decade, European co-operative banks have convinced an increasing share of the population in their home countries to become members. This is strong evidence for the high level of customer satisfaction with co-operative banks. Co-operative banks have strengthened their domestic retail market position between 1997 and 2007. Their financial performance is also satisfactory. They enjoy a strong capital base, stable profit growth, satisfactory efficiency levels and relatively high ratings. Consequently, they exert a positive impact on the stability of national financial systems. These are great and promising achievements, which create confidence for the future and lead to the conclusion that the overall business proposition of mature co-operatives¹⁵ and the immaterial membership advantages have maintained their appeal. Hence, co-operative banks find themselves under a lucky star and have a good starting position for the upcoming years. There is, however, no room for complacency. Co-operative banks must find adequate and timely answers to existing and emerging challenges in banking, which is the topic of chapter 5.

¹⁵ The overall business proposition encompasses a wide range of aspects, including prices, products, services, distribution concepts and business philosophy.

5 Co-operative banks in the new financial system

After the house price bubble burst in 2007, governments and monetary authorities took a broad range of drastic measures to avoid the collapse of the global financial system. The need to remodel the global financial architecture became apparent. In 2008 and 2009, many banks were engaged in a profound reorganisation of their businesses. Some returned to the basics of traditional banking and others needed to strengthen their capital position. Banks also took steps to restore confidence among the public. To date, the banking industry finds itself confronted with a deep economic recession and will suffer additional losses in their credit portfolios. Meanwhile, government and financial authorities have announced more stringent banking rules and supervision. It cannot be excluded that governments will have to interfere once again in the banking sector to safeguard financial stability. It goes without saying that the features of the financial system will have to change (chapter 2). This means that banks will be required to adjust their business principles, strategies and structures to meet a set of new banking conditions in the near future.

Co-operative banks were and are not sheltered from these extraordinary events. They have also suffered losses and incurred write downs which are directly related to the financial crisis. They appear, however, to be less impacted than private banks and did not need large scale government support. They have also been hurt by the general loss of confidence in the banking sector and are faced with large distortions in the competitive environment. With their strong position in the retail markets, they will now feel the negative impact of the deep economic recession. Rising unemployment and increasing failures of SME's will exert a negative pressure on co-operative banks.

If we consider the characteristics of the new financial system, we can conclude that the unique features and natural core competences of co-operative banks (section 3.4) provide good starting points and opportunities in this turbulent banking environment. This does not mean that these opportunities can just be cashed in. Co-operative banks face

a wide range of challenges which require a proactive and innovative attitude. The long history of co-operative banks shows, however, that they are able to adapt to changing circumstances and re-invent themselves. Key opportunities and challenges of co-operative banks for the next five years have been outlined below.

5.1 Opportunities

A. Customer centricity

Customer centricity, integrity and ethics will play a more important role in retail banking than in the past. These 'new' characteristics of the global financial system have been part of the co-operative banks' DNA from the start and are considered to be their main comparative advantages to date. As consumer-owned institutions, co-operative banks now have the opportunity to turn the new rules and ethics in banking to their advantage through well-designed public relations campaign. If they

Table 5.1 Main effects of the financial crisis for the entire banking industry

Main effects	Characteristics of the new financial system
New rules of the game	<ul style="list-style-type: none"> - Corporate governance, clear attention to risk management - Compensation schemes to introduce the right incentives - Tighter supervision and regulation for banks and other financial institutions on an international level - Higher capital and solvency requirements for banks - Policy measures: government intervention, exit strategies, extraordinary monetary actions, early warning systems for risk events
New business principles	<ul style="list-style-type: none"> - Customer centricity - Morality and integrity - Healthy risk attitude - Long-term perspectives instead of short-term profits - Attention to all stakeholders, not just shareholders - Attention to externalities of behaviour - Transparency in products and organisation
New business models	<ul style="list-style-type: none"> - Less, but simpler and transparent products and activities - Focus on retail banking - Reorientation towards home markets due to national support - Less scope for large-scale international aspirations, partly due to support from national governments - Dismantling of some large financial conglomerates

Source: Rabobank analysis

are able to successfully demonstrate these issues, rising numbers of members and increasing market shares can be expected. In addition, their customer-centred business model may discipline the financial sector as a whole.

B. Strong capital base and high ratings

High capitalisation and relatively high credit ratings are powerful assets of co-operative banks. This is especially true in these current turbulent

times where the financial markets and authorities are urging banks to hold more capital. How much and in what form are less straightforward questions. More capital will make the industry safer, but will also lower returns and, as a result, most likely raise prices for customers. Their starting position offers good growth opportunities. The need to attract extra capital is less pronounced, giving co-operatives a comparative advantage over many other banks which have to obtain fresh and more expensive funding on the capital markets.

C. Corporate governance structure

The financial crisis has demonstrated the necessity of improving banks' internal control mechanisms, corporate governance and compensation schemes. However, the required changes apply to a lesser extent to co-operative banks, because they have always had a solid and balanced corporate governance structure, due to member ownership. Member ownership entails a more consensus-driven approach which is accompanied by a longer term, risk-averse view and, last but not least, the absence of option packages intended excessively award managers. Many private banks are currently adjusting their corporate governance, internal (risk) organisation or business model, providing co-operative banks a good opportunity to be more externally focused: they do not have to adjust their business model and culture that extensively.

D. Gaining market shares

The 'trust or reputation premium' over shareholder-owned banks due to their proclaimed conservative approach to banking and high capitalisation could be very useful in the face of the expected surge in retail banking competition. Indeed, co-operative banks are likely to be 'attacked' in the higher segments of the retail markets and their business model will be - partly - copied by private banks. Co-operative banks may try to turn their disproportionate branch networks into an important comparative advantage, which would provide access to a huge deposit base, at least in the short to medium term.

E. Closer international co-operation

Co-operative banks are still primarily national based financial institutions. In the past decades, mature co-operative banks have gradually expanded their business abroad. But in the future, the scale of operations will

become increasingly important to remain competitive, operate efficiently and attract customers. When joining forces in certain banking areas, co-operative banks may realise sufficient scale among their counterparts to diversify the risks of cross border activities. To this end, ways of closer co-operation must be developed. This demands acceptance of the fact that noncommittal attitudes and partnerships belong to the past. These collaborations could in certain banking areas lead to the creation of European co-operative institutions. The feasibility of this road should be investigated further, but should be an attractive prospect for co-operative-minded bankers. The existing platforms for mutual international co-operation, the European Association of Co-operative Banks and Unico Banking Group could play an initiating role in the creation of such institution.

F. Introducing the co-operative model abroad

Many co-operative banks were established over a century ago in rural areas where people were deprived of financial services. Although the original 'raison d'être' of mature co-operative banks have disappeared, this is definitely not the case in many other countries throughout the world. Here lies a noble task for co-operative banks. They are well positioned to help these countries in setting up financial infrastructures. This is one field where they can visibly contribute to economic and social development. By being present in these emerging or developing countries, co-operative banks can clearly demonstrate the 'presence value' of co-operative principles, which is virtually impossible to show in Western countries. Of course, the co-operative model cannot just be copied and pasted to other countries. Adjustments are necessary to account for historical and cultural differences. Microfinance is the place to be for co-operative banks in emerging and developing countries and they should take a claim on this promising banking area. When the financial sectors in these countries mature, co-operative banks will possess a strong foothold based on a long-term commitment. Given the viability, solidity and added value of co-operative banks, the governments, regulators and financial sectors of developing countries should also embrace co-operative principles, since they would contribute to the necessary access to finance for enterprising poor people.

5.2 Challenges

In the upcoming years, the entire banking industry will have to adjust its strategy and organisation fundamentally to meet the requirements of the new financial system and restore public confidence in the integrity of banks. Co-operative banks will also be faced with great challenges to meet new banking conditions after the crisis. Given the current perspectives on the market and society as a whole, the most important challenges in the years to come are:

A. Proactive and innovative attitude

Many competitors are redefining (with government support) their strategy and business models, reorganising their businesses and focusing on the retail market. Within approximately two years, competitors will be leaner and meaner and some of them will want to re-enter the market aggressively to (re)gain market share.

B. Improving efficiency levels

Pressure to offer competitive and innovative products/services in the market is surging, while margins tend to shrink. This requires a critical evaluation of the costs and benefits of the extensive distribution network. Integrating physical and virtual distribution channels and finding ways to personalise customers contact via virtual channels is a key component of this process. In addition, continuous training and education are necessary to provide employees with state of the art knowledge. In fact, the attitude, knowledge and competences of staff are the main distinguishing factors in banking competition.

C. Strategic choices: differences compare to other financial services providers

Competitors tend to copy business models and products/services quickly. Co-operative banks have to communicate their unique features clearly. Products and prices are no longer discriminating factors, but other elements that come into considerations. It is necessary to make strategic choices for servicing customers efficiently and maintaining a strict focus on core activities and businesses. Modern co-operative banks have to be entrepreneurial, cost-efficient and businesslike organisations.

D. To balance benefits and risks of international versus national (home market) activities.

It will be a balancing act to reconcile the interests of domestic members, i.e. the co-operative part of the organisation, with the size and risks of international activities. If the operations abroad become substantially larger than the co-operative part, the dilution of the co-operative nature will be looming. Furthermore, adding international businesses may increase the overall risk of the organisation and destabilise the co-operative banking business.

E. To balance local delivery and central management

It has become more difficult for members to monitor the organisation due to the increased organisational complexity of mature co-operative banks, where management is carried out by dedicated professionals. A transparent and an endurable balance between local delivery and central management is needed to safeguard engagement and involvement of local banks members.

6 The Rabobank Group case study

This case study deals with the history and evolution of the largest retail bank in the Netherlands, the co-operative Rabobank.¹⁶ Like all other banks, Rabobank has faced social, economic, technological and regulatory challenges throughout its existence. These include, for example, the Great Depression of the 1930s, the World Wars, the reconstruction of the Dutch economy, the IT revolution and the liberalisation and globalisation of the economy. Despite the fact that Rabobank has not always made the optimal decisions, it has mostly chosen the right answers to changing circumstances, thereby preserving its co-operative identity. This is clearly reflected in a large Dutch customer base (7.5 million), comprised of 1.7 million members, and a Triple-A rating. This chapter will first discuss the history and strategic positioning of Rabobank. It will conclude with an overview of the opportunities and challenges for Rabobank for the upcoming five years as a result of the recent financial crisis.

6.1 History and evolution of Rabobank

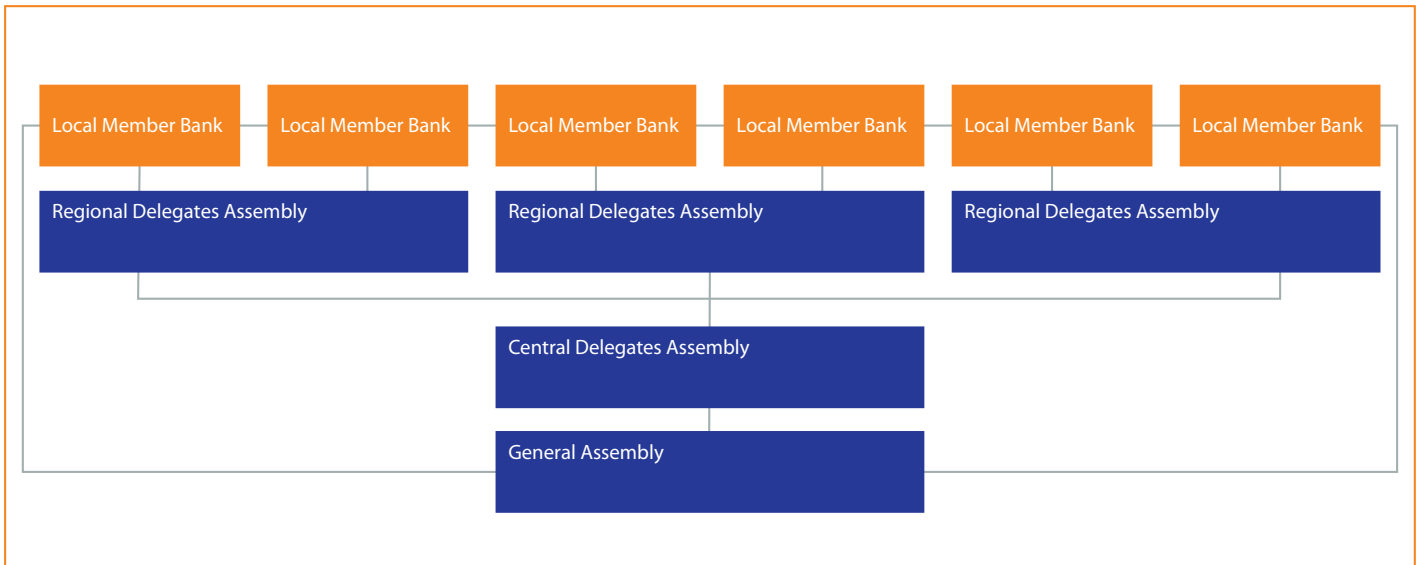
Origin of co-operative banks in the Netherlands

As in many other Western European countries, the first co-operative banks in the Netherlands had their roots in the local agricultural sector. Situated in the Rhine delta, a geographically strategic position as the gateway to Western Europe, agriculture and international trade have historically played a major role in the Dutch economy. The rapid improvement in transportation possibilities by sea and over land in the second half of the nineteenth century made Europe accessible to commodities, especially massive cheap grain imports from the United States. Farming prices in Western Europe dropped by more than 50 percent in the 1870s, leading to an agricultural depression. This caused great scarcity of capital among farmers, which led to social abuse such as buying by instalments and the provision of loans at exorbitant rates.

In 1888, an advice committee appointed by the Dutch government emphasised the need for an agricultural credit system based on sound and fair principles. Moreover, this was to be set up by the concerned farmers themselves. The committee recommended the establishment of credit co-operatives based on the principles of the German Raiffeisenbanks. Around 1896, the first co-operative agricultural credit banks were set up in the Netherlands. Soon after, many other banks were launched throughout the country. Although every local co-operative bank had its own unique historical background, there were also large similarities. For instance, farmers and dignities of the local community were often the bank's founding fathers. As early as 1898, the local co-operative banks started to work together by setting up two central

¹⁶ See Rabobank (2009) for an extensive exposition of the development of Rabobank Group.

Scheme 6.1 Governance structure of Rabobank



Source: Rabobank

organisations, one in the northern and the other in the southern part of the country. These central banks were necessary to overcome the disadvantages of the local banks' limited scale and to foster their development by performing the co-ordinating role of a 'banker's bank'.

In the following years, local co-operative banks flourished due to their strong roots in local communities, their appealing democratic structure and their attractive loans and savings rates as compared to private banks. Since the first credit co-operative in the Netherlands was founded, the number of local co-operative banks and members increased sharply to more than 1,300 local member banks and 500,000 members around 1960.

Evolution of Rabobank: local-national

The financial services industry has changed fundamentally over the years. As in other Western countries, the original 'raison d'être' of the co-operative banking model largely disappeared after World War II. The Dutch co-operative banking group developed from a local agricultural credit co-operative to a retail bank with nationwide coverage. All these developments led to adjustments in organisational structures, consolidation, domestic diversification, other sources of funding and new business models.

Especially after World War II, the central organisations became more and more important for the further development of the local member banks. The increasing complexity of financial products as well as the establishment of subsidiaries for international activities, corporate banking, insurance and investment banking called for professionalisation

and a centralised approach. To reach economies of scale and to avoid inefficiencies from growing competition between the local member banks of the two organisations, the two central organisations decided to merge in 1972 to form Coöperatieve Centrale Raiffeisen-Boerenleenbank, known as Rabobank. In this way, the co-operative banking group was also able to improve its competitive position in a further consolidating Dutch banking landscape. This led to a solid national network organisation.

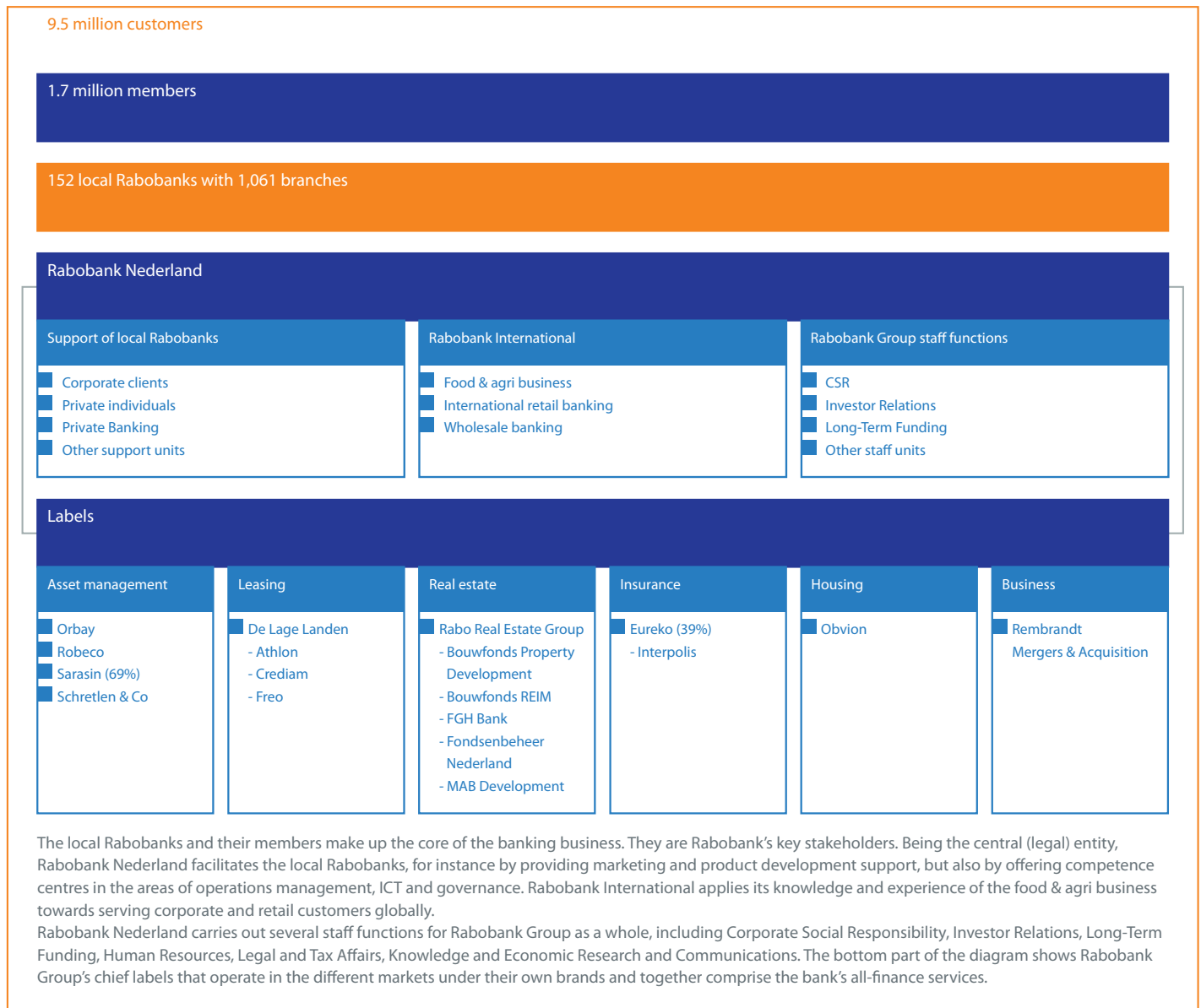
The merger eventually resulted in substantial cost reductions and a favourable scale for large investments to acquire market share and to serve the emerging mass markets and new economic sectors efficiently.

Box 6.1 Governance and comparative advantage of local co-operative banks

Historically, local banks in the Netherlands were autonomous agricultural credit co-operatives, each with its own Board and responsible for its own balance sheet and administration. The Board of Directors and the Supervisory Board received no remuneration (only the cashier received a small salary) and were elected at the annual general meeting. The banks were deeply embedded in the local community and were therefore able to gather relevant information and knowledge about the development of businesses and members/customers. This gave agricultural credit banks a strong competitive advantage in the credit and savings market.

Scheme 6.2 Organisation of the Rabobank Group

Situation at 1 July 2009



Source: Rabobank

Facilitated by regulatory changes, this centralisation of activities and the creation of scale advantages made it possible to diversify and expand financial activities as well as to launch virtual distribution concepts like internet banking. Like its main competitors, the Rabobank Group entered into the fields of private banking, asset management, and life insurance via organic growth, joint ventures or acquisitions (scheme 6.2). The total volume of financial services developed prosperously and financial performance indicators such as solvency, efficiency and profit improved constantly. This resulted in the highest possible credit rating: Triple-A status.

The national and international expansion of the Rabobank Group, the disappearance of the original motives for the establishment of the co-operative banking group and the emergence of large domestic competitors via consolidation¹⁷ provoked a fundamental self-assessment, culminating in the Great Co-operative Debate in the years 1995 through 1997. Since the merger of the two central organisation, the perception

¹⁷ In 1990, ABN merged with AMRO to form ABN AMRO. In 1991, the former 'Nederlandse Middenstandsbank' and 'Postbank' merged with the insurer 'National Nederlanden' to become ING.

was that the co-operative philosophy¹⁸ had been subject to considerable erosion. Local member banks were no longer active in engaging or attracting members. A local member bank acted and operated more and more like a 'private bank'. In this context, some felt that Rabobank could equally well become a listed bank. This would offer Rabobank better development prospects and access to more funding sources to resist the increasing competition. Additional arguments were the rapidly growing costs and the required large investments in new banking technologies.

Though internal sceptics of the continuation of the co-operative banking model remained a minority, they actually pointed out highly relevant questions about the meaning of membership in the context of globalisation of the economy and the added value of the co-operative model in mature financial systems. After intense discussions, it was decided to retain the co-operative identity. This decision was mainly based on the fact that Rabobank was and remains to date an organisation of, and for, enterprising people. A different legal format with fairly uncertain effects would diminish the countervailing power of members' influence on the day-to-day business decisions of professionals managing the co-operative group. The conviction was that there were great opportunities for a viable and strong co-operative bank amidst private banks. It was deemed highly desirable to obtain more and engaged members¹⁹ and to extend the autonomy of the local member banks. The new governance model reconfirmed the core principles of delivering customer value, contributing to social commitment, realising employee value and revitalising the membership policy. It was acknowledged that only a financially sound organisation could meet these ambitions.

¹⁸ The definition of a co-operative remains the same as in the nineteenth century: A strategic alliance of people who are willing to promote each others' material interest and to help each other realise their ambitions. They do this by running a business - the co-operative - jointly and for their collective benefit.

¹⁹ Every customer of a local member bank is free to become a member, but the Board of the bank decides whether or not a customer becomes a member of the bank. Members are engaged in the policy of the bank regarding activities and sponsoring of the local community. A Members Council connects the Board with members. With respect to financial services, members have no substantially privileged position compared to non-members. An exclusive product that only members can acquire is a Member Certificate, which is issued by Rabobank Nederland.

In 1998, Rabobank formalised its strategic ambition to be an Allfinanz services provider in the Netherlands. Since then, new challenges have arisen. In order to maintain its position as Allfinanz market leader, strategic adjustments were necessary (box 6.2). To this end, the Rabobank Group formulated so-called Strategic Frameworks that outlined the future course of action for the upcoming three to five years. The most recent Strategic Framework covers the period 2009-2012 and gives directions for Rabobank's course in light of the effects of the current financial crisis.

Evolution of Rabobank: national-international

Initially, the leading motive for starting cross-border activities was the need to serve customers with international activities and aspirations, especially from the Dutch F&A sector. In the 1970's, this was done through collaboration agreements with banks in the UK (Continental Bankers) and the USA (Bank of America). In order to improve the level of co-operation between European sister organisations, the Unico Banking Group (1977) was established by Rabobank and five other banks. The aim was to support the expansion of the partners' international operations.

Thereafter, Rabobank pursued different international strategies, with varying degrees of success: takeovers, co-operation agreements and alliances with other partners, as well as setting up its own representative offices across the world. The most salient steps and evolutions are presented in box 6.3. Evidently, Rabobank has gone through an interesting, but sometimes difficult learning process, just like other co-operative banks and private banks. Step by step, Rabobank has discovered the international strategy that suits it best. To date, following local customers, taking small, well-considered steps and linking up with existing activities and core competences are the basic principles driving international businesses. A relatively new shoot concerns the activities of the Rabobank Development Program. Under this programme, Rabobank tries to introduce and facilitate agricultural co-operatives in emerging or developing countries. The Rabobank's Dutch model cannot simply be 'exported' to other countries that have different historical backgrounds and legal structures. Today, the Rabobank Group is active in roughly 603 locations spread over 46 foreign countries.

Box 6.2 Strategic Framework

At the turn of the century, a new course was needed as funding became more and more expensive and downward pressure on credit and lending margins led to a structural reduction in the interest revenues. Rabobank tried to compensate for the lower interest revenues by generating commissions from new activities, but this shift was insufficient to fully compensate for the loss of interest income. In close co-operation with Rabobank Nederland, local member banks developed a strategic vision to counter this trend, which can also be attributed to increasingly competitive market conditions and changing customer needs. The 2005-2010 Strategic Framework mentioned three ambitions:

1. Retaining Allfinanz market leadership in the Netherlands.
2. Achieving further growth of and strengthening synergies with subsidiaries and partners.
3. Strengthening the bank's position as a leading international Food & Agri bank.

The underlying business principles of this framework are:

1. Maintaining the co-operative identity (long-term relationships with customers and keeping the member base active by investing in young people).
2. Working towards Allfinanz market leadership in the Netherlands.
3. Working towards a global F&A bank as a natural focus.

4. Maintaining Triple-A status (requires a strong balance sheet, stable profit growth and a tier-1 ratio of at least 10%).
5. High CSR policy standards (maintaining a position as one of the most sustainable banks).

Upscaling and reorganising the operational management and customer service of local Rabobanks were important measures to achieve the goals.

The financial crisis called for a review of the 2005-2010 Strategic Framework, but the business principles remained the same. The crisis led to profit declines for Rabobank International (RI), higher capital requirements and higher costs of attracting external funding, which in turn resulted in the introduction of liquidity mark-ups on transfer prices and strong reduced opportunities for attracting longer-maturity funding. The crisis also gave rise to opportunities in the deposit market, the corporate market, mainly as a result of Rabobank's solid image (Triple-A rating). The strategic review resulted in a few accentuations. The acknowledgement that capital and funding will be scarce in the upcoming years requires a sharper focus on the international food & agribusiness as RI's core business, the integration of physical and virtual channels and the streamlining of processes based on validated best practices.

6.2 Position of Rabobank Group

Financial and economic turbulence

The financial crisis has had a huge direct impact on the Dutch banking sector. The Dutch government and Dutch Central Bank had to take extraordinary measures to safeguard financial stability. For instance, the Dutch part of both ABN AMRO and Fortis was nationalised and many other financial players needed government support in the form of capital injections or state-guaranteed financing programmes. Rabobank fully supports these measures, because financial stability is of utmost

importance for every bank. All in all, fifty percent of the Dutch banking sector received government support. Since the beginning of the financial crisis, Rabobank incurred losses and write-downs of around six percent of its total equity, but did not need any form of aid due to its strong capitalisation.

This massive government intervention has of course had major consequences for the competitive environment and future trends in the Dutch banking sector (Dutch Central Bank, 2009). Partly forced by this government aid, banks are reconsidering their business strategies

Box 6.3 International steps

International retail banking

In the past decades, the retail customers of local Rabobanks have been mainly serviced by so-called international Rabodesks abroad. These desks, with Dutch-speaking staff, help and advise their customers on a wide range of international banking issues in different countries. They typically work closely together with partner banks since it is rather difficult and expensive to build a self-owned retail network in other countries. To date, there are still many differences between European countries regarding the modalities of retail products. From 2002 onwards, there has been an acceleration of out-of-country activities in the field of international retail banking, aimed at securing a solid retail base in a number of strategically important countries and supporting its international direct banking activities. Rabobank has acquired stakes in several retail banks and initiated internet banking activities in a number of countries.

International wholesale banking

In 1996, most of the international wholesale activities were brought together in a new group entity: Rabobank International (RI). This entity has adjusted its main focus and strategy several times, mirroring changes in international trends in banking and the search for the optimal international group strategy.

1. Initially, RI pursued a 'customer focus strategy' based on four geographical areas, three main activities and three sectors. The geographical areas were Europe, North and South America, Asia and Australia and New Zealand. The activities concerned were corporate banking, international private banking and investment banking. The three focus sectors were agribusiness, the food sector and healthcare. It became apparent during the first years of RI that the performance of international activities was much more volatile than that of the domestic retail business. This was clearly and painfully illustrated by the overly ambitious strategy to expand and intensify investment banking activities. It soon turned out that investment banking did not match the co-operative principles and customs of the domestic retail business. Building a significant position in investment banking appeared to be very costly and the required competences were absent. In September 1999, in line with the results of the Great

Co-operative Debate, it was decided that RI would need to cut back its investment banking activities.

2. Another noteworthy episode was the attempt to form a strategic alliance with the German DG Bank, a co-member of Unico, in 1999. The alliance would be in line with the 'multi-domestic concept' that had recently been formulated within Rabobank. This concept meant that the European partner banks - preferably co-operatives - would continue to serve their customers in the domestic market, but at the same time they would work together in a number of product areas where a pan-European scale was deemed necessary. The first step in the alliance with DG Bank would have been to amalgamate all activities in the area of corporate and investment banking. The ultimate aim of this collaboration was to create a single European co-operative financial group. In practice, the venture proved to be too complex, too time-consuming and was beset by too many uncertainties. This project was consequently abandoned in 2000.

3. Just after the beginning of the twenty-first century, RI positioned itself more and more as the world's leading Food & Agri bank. Alongside traditional financing packages, it started to offer highly professional products and advice including financial market derivatives, structured finance solutions, commodity trade finance and investment banking services such as advice on M&A. RI also played an innovative role by stimulating, marketing and trading in agricultural product derivatives such as weather derivatives. In this period, the international ambition was to have at least one office in all important F&A countries and regions of the world and also to achieve a prominent market position among the larger, well-run primary agricultural companies in key agricultural production countries.

4. The most recent strategic reorientation of RI can be attributed to the general effects of the financial crisis on the Rabobank Group. In the 2009-2012 Strategic Framework, a radical focus restriction is proposed for RI, both abroad and in the professional markets. This shift implies a strong curtailment of activities with an elevated operational, reputational or credit risk and the phasing out of lending to non-core customers outside the Netherlands.

and it seems that they are primarily refocusing on retail markets, which is a European-wide phenomenon. Rabobank foresees an increase in competition and hopes that government aid will be terminated as soon as possible.

As has happened in other countries, the reputation of all Dutch banks has been damaged. Public and political discussions about the social role of banks and reforms of the compensation schemes have blazed up. To restore confidence, the sector itself installed an advisory commission (Commission Maas, 2009). This commission has formulated recommendations about governance and risk management, the public role of banks, supervision and regulation, and the future of the banking industry in the Netherlands. In July 2009, the Dutch government published its vision on the future of the Dutch financial sector (Ministry of Finance, 2009). Improvements in banking supervision, higher capital requirements, and acceptable compensation schemes are important elements.

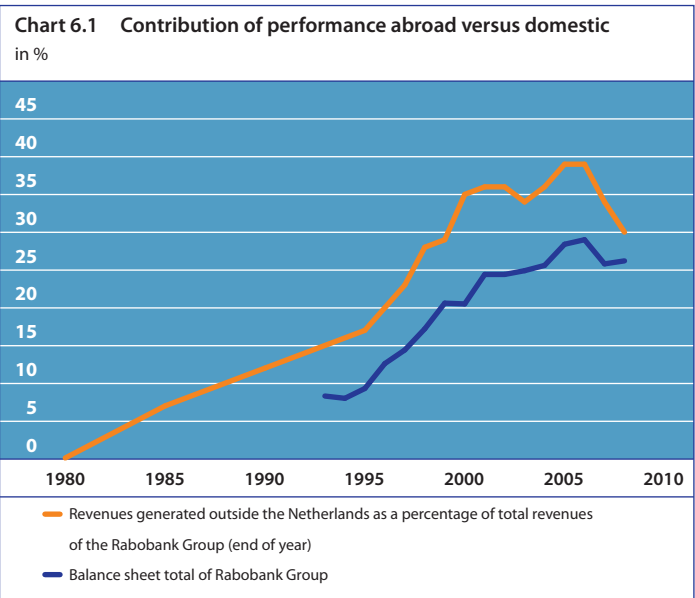
Following the direct effects of the financial crisis, the banking sector is now confronted with an economic recession. Credit losses and write-downs will be unavoidable. Banks are refocusing their activities, improving their risk profile, cutting costs and tightening their credit criteria. The sector will consequently face many challenges in the near future.

Size and position of Rabobank

Of course, Rabobank cannot hide from these difficult financial and economic times and intense debates. Rabobank too is confronted with negative sentiments towards banks. Rabobank is, however, able to explain that it has always steered a prudent course and is notably different from private banks due to its conservative banking model and specific corporate governance based on member ownership. Viewed over a longer period of time, the vitality of the co-operative banking model clearly stands out when looking at the development of members and customers. Over the past ten years, the total number of members grew from 510,000 in 1999 to more than 1.7 million to date. Rabobank currently has 9.5 million customers of whom 7.5 million are located in the Netherlands. Local member banks are owned by 1.7 million members, which equals more than 10 percent of the Dutch population. Worldwide, Rabobank employs around 60,000 employees.

Regarding domestic market shares, Rabobank has succeeded in keeping its originally strong position as market leader in the Food and Agri sector (84%). However, the size of this sector in the Dutch economy has shrunk over time and currently accounts for roughly 15 percent of Rabobank's total loan portfolio. Competitors have tried hard to acquire substantial market shares in these sectors over the years. One of the reasons is that these sectors tend to be relatively stable and less risky than many other economic sectors. In almost all other areas of retail banking, Rabobank has managed to strengthen its position over the last decade (appendix A). The market share for branches exceeds the one for deposits; this confirms the divergent business model of Rabobank, where being 'nearby' customers is an important element. Rabobank has nonetheless cut back on the number of branches as a result of changing customer preferences for virtual distribution channels.

Another strategic goal of Rabobank is to be among the top three of best performing banks in the area of corporate social responsibility. Rabobank was recently ranked as one of the top Corporate Social





Box 6.4 Rabo Development and Rabobank Foundation: a co-operative mission abroad

In line with its co-operative roots and aspirations, Rabobank took the initiative to help partner banks in a number of developing countries on a long-term basis. In most cases, Rabobank takes a stake in these banks in exchange for a seat on the board, in order to be able to influence the partner bank's strategy. Rabobank's contribution is not, nor has it ever been, solely financial. Rabobank also provides input in the form of experience, know-how and expertise. Rabobank is committed to assisting the partner bank in giving small agricultural and commercial companies and private individuals access to affordable credit facilities and other banking services. The partners do not necessarily have a co-operative structure. A number of these banks, however, focus specifically on rural areas and aspire to serve everyone, not just the 'better' market segment. The underlying idea is that partner banks will eventually develop into fully fledged and strong institutions, which in the long term will give Rabobank a presence in countries that are gaining in importance in the world economy, especially in the field of agribusiness.

To co-ordinate and manage the increasing activities in this field, a new subsidiary was established in 2006: Rabo Financial Institution Development B.V. (Rabo Development). To date, Rabo Development holds stakes in partner banks in Africa (Tanzania, Zambia, Rwanda and Mozambique), South America (Paraguay) and China. Technical assistance to these banks is provided by consultants of Rabo International Advisory Service B.V. (RIAS) which was set up in 1989 and has been active in more than 50 countries. Rabobank executed the co-operative mission through Rabobank Foundation which this year celebrated its 35 years of enhancing rural welfare, empowerment and income by assisting recipient organisations to develop into sound institutions. The Foundation is currently active in about 25 developing countries and works in co-operation with microfinance institutions, co-operatives and NGOs.

Responsibility (CSR) banks of the world. The Group has identified four goals for its CSR policy: introducing sustainability in F&A, encouraging new production methods and renewable energy sources, promoting economic participation and diversity and fostering social cohesion and solidarity.

Lastly, the importance of Rabobank's international activities has grown over the last three decades. The uneven expansion and strategic moves abroad are visible in the international assets and foreign revenues as a percentage of total assets and revenues respectively. This shows the diversification of activities. It appears that international activities have a higher risk profile than the activities of local Rabobanks in the Netherlands, with the latter focusing primarily on retail banking. The higher revenues that can be expected are sometimes counterbalanced by a greater volatility in returns caused by the deterioration of particular international markets or a rise in the level of credit or country risks. This is also the case in the current crisis. Most of the losses and write-downs were concentrated in the international activities.

Financial performance of the Rabobank Group

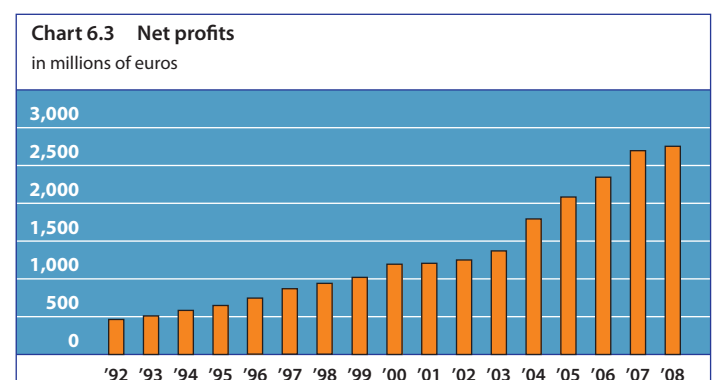
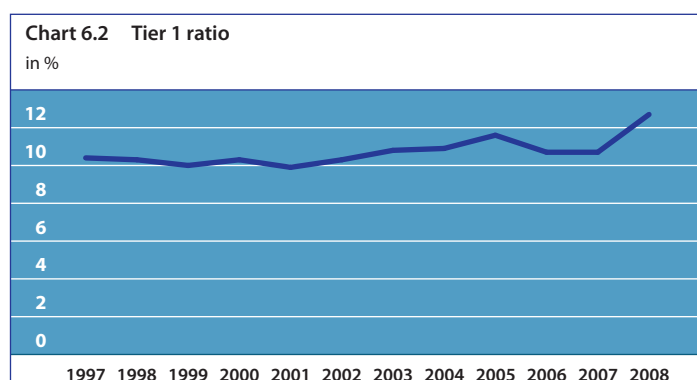
Overall, the financial performance of Rabobank Group is strong. With solid capital buffers Rabobank has recorded stable profit growth and improved efficiency over the last few years. Appendix A shows the key figures of the Rabobank Group. Chart 6.2 shows the tier-1 ratio

(minimum requirement of 8%), whereas chart 6.3 displays the favourable development of net profit in the past decades.

Rabobank has been awarded the highest rating - Triple-A status - from rating agencies Standard & Poor's and Moody's for many years. Determinants of the rating are the risk profile, capital buffer, stability of income flows, market shares, strategy and diversification of the activities. The existence of the internal cross-guarantee scheme is also an important factor. It can be said that this rating has proven extremely important in the current turbulent times. Due to this status, Rabobank has been able to weather the storm very well to date. Rabobank has kept access to the capital markets and is able to preserve its independent position. Customers furthermore consider Rabobank as a safe haven.

6.3 Rabobank in the new financial system

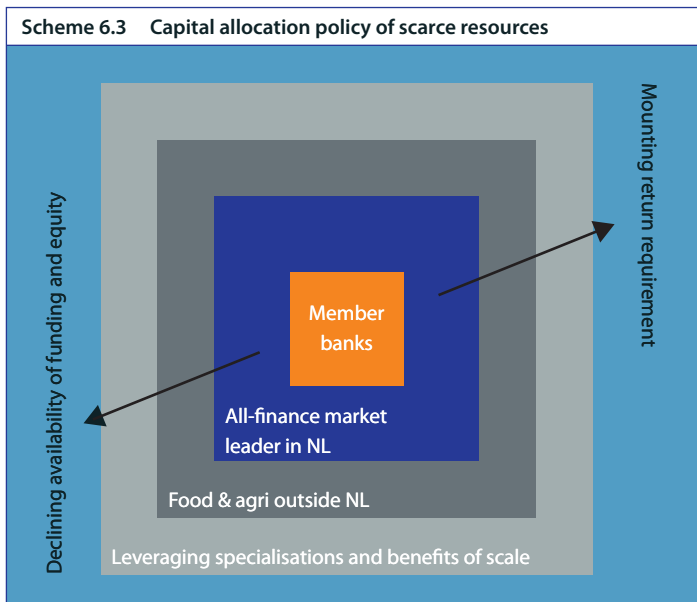
As for all co-operative banks, the external environment has altered dramatically for Rabobank. Competitors of Rabobank in its home market received government support in order to guarantee financial stability. At the same time, initiatives were taken to repair the damaged reputation of banks. New ethics and business models were proposed by the sector, policy makers and regulatory authorities. Due to its specific structure and features, Rabobank already complies with most of the suggestions and recommendations. This opens up new opportunities.



At an early stage, Rabobank recognised the severity of the financial crisis and its implications. In the first half of 2008, Rabobank started a large-scale assessment of the situation which eventually culminated in a revision of its strategic course. This was laid down in the 2009-2012 Strategic Framework. Rabobank has taken into consideration the extraordinary competitive environment and is anticipating remarkable shifts in its competitor's business models and strategic focus. It is expected that they will concentrate more strongly on their domestic retail markets, which have traditionally been the domain of Rabobank. An increase in competition and a greater urge for cost-cutting and efficiency are foreseen. It will no longer be sufficient to employ general cost reduction targets. This time, fundamental choices will have to be made regarding targeted product-market combinations.

The Strategic Framework provides guidelines for the assessment of the possible choices. For the upcoming years, the availability of capital has been identified as the bottleneck for national and international growth. This implies that for operations that are further removed from the Group's core business - co-operative banking - other criteria apply. These activities must meet higher profit targets and must have lower capital requirements. The scarce capital will be primarily used for the member banks (scheme 6.3).

Last but not least, the need for highly educated and qualified staff constitutes a critical success factor. The attitude, competences and knowledge of employees are known to constitute the main distinguishing factors in tomorrow's competition. This point is clearly stressed in the Strategic Framework. Therefore, Rabobank will have to strongly focus on management and employee development.



Appendix A

Key figures Rabobank Group (consolidated, group level)

	IFRS					DUTCH GAAP					
	2008	2007	2006	2005	2004	2004	2003	2002	2001	2000	1999
Volume of services											
(in millions of euros)											
Total assets	612,120	570,491	556,455	506,573	483,574	475,089	403,305	374,720	363,679	342,920	281,218
Private sector lending	408,620	368,709	324,110	278,095	248,958	252,996	235,425	212,323	197,262	179,137	161,074
Due to customers	304,214	276,610	234,917	186,427	177,482	192,123	172,571	171,632	172,174	146,705	127,527
Assets managed and held in custody	183,600	231,800	291,200	224,200	223,400	195,000	184,000	168,000	194,400	166,100	139,800
Financial position and solvency											
(in millions of euros)											
Equity	33,459	31,409	29,377	26,349	23,004	18,143	15,233	14,261	12,380	12,458	11,217
Tier I capital	30,358	28,518	26,391	24,860	21,404	22,621	19,660	17,202	15,092	14,653	13,007
Qualifying capital	30,912	29,190	27,114	25,272	21,205	22,586	19,892	17,414	15,542	15,093	13,650
Risk-weighted assets	238,080	266,573	247,458	213,901	196,052	198,552	182,820	165,843	152,812	142,278	129,801
Tier I ratio	12.7	10.7	10.7	11.6	10.9	11.4	10.8	10.3	9.9	10.3	10
BIS ratio	13.0	10.9	11	11.8	10.8	11.4	10.9	10.5	10.2	10.6	10.5
Efficiency ratio	65.3	69.5	68.5	66.7	67.0	67.0	69.2	68.2	70.7	70.3	70.9
Profit and loss account											
(in millions of euros)											
Total income	11,652	11,022	10,049	9,363	9,222	10,055	9,018	8,564	8,434	7,760	6,806
Operating expenses	7,611	7,663	6,887	6,242	6,177	6,732	6,243	5,839	5,965	5,459	4,826
Value adjustments	1,189	266	450	517	479	514	427	752	539	369	350
Taxation	98	397	367	521	773	957	712	514	532	507	423
Net profit	2,754	2,696	2,345	2,083	1,793	1,536	1,370	1,250	1,206	1,194	1,020
Nearby											
Member banks	153	174	188	248	288	288	328	349	369	397	424
Branches	1,112	1,159	1,214	1,249	1,299	1,299	1,378	1,516	1,648	1,727	1,795
Cash dispensing machines	3,097	3,107	3,139	3,116	3,062	3,062	2,981	2,979	2,889	2,676	2,546
Foreign offices	569	349	330	267	244	244	222	169	137	142	147
Employees											
Number of employees (in fte)	60,568	54,737	50,573	45,580	50,216	50,216	50,849	51,867	52,173	49,711	48,224
Client data											
Members (x 1,000)	1,707	1,638	1,641	1,551	1,456	1,456	1,360	1,108	825	550	510
Market shares											
(in the Netherlands)											
Mortgages	30%	28%	26%	23%	25%	25%	26%	26%	25%	23%	22%
Savings	43%	41%	39%	39%	39%	39%	38%	40%	40%	40%	40%
Small and medium-sized enterprises	39%	38%	38%	38%	40%	40%	39%	39%	37%	38%	38%
Food & agri	84%	84%	84%	83%	84%	84%	85%	83%	87%	87%	87%

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Colophon

The report 'Co-operative banks in the new financial system' is a product of the Economic Research Department of the Rabobank Group in co-operation with the internal departments 'Group Finance' and 'Multilateral Development Banks'. It is part of a comprehensive study about co-operative banks and the impact of the financial and economic crisis on the banking industry. The report is prepared for the 'Duisenberg Lecture' at the annual meeting of the IMF and World Bank in Istanbul, Turkey in October 2009.

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