

## **Morality and Integrity in Cooperative banking**

**J.M. Groeneveld<sup>1</sup>, June 2011**

### **Abstract**

Governments and society are calling for fundamental changes from financial institutions after the financial crisis. They need to operate with a much greater degree of morality and integrity, a more responsible risk attitude, a longer-term perspective, improved transparency and, last but not least, a much stronger customer focus. International supervision and regulation will be tightened, 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 should abandon the dominant focus on short-term profits.

Interestingly, Cooperative banks have repeatedly and publicly stated well before the break out of the financial crisis that they have always acted in the interest of their customers. They have also stressed that their historical roots and specific governance structure are based on moral and honourable behaviour and closely resemble the currently required 'new' features of the global financial system. It has been explained that the corporate governance of Cooperative banks with member authority and influence implies a consensus-driven approach and avoids any strong fixation on one stakeholder. According to Cooperative banks, the concomitant long-term view and risk-averse stance translate into a more stable and sustainable banking strategy primarily directed towards retail banking. However, their assertions have received little attention from academics, policy makers and the general public in the last decades. The Cooperative banking model has remained notably underexposed in recent publications, the press and various reports as well.

The financial crisis offers a good opportunity to verify the long standing assertions of Cooperative banks. If these statements are true, it can be expected that Cooperative banks weathered the crisis relatively well without large scale government support. Indeed, this paper concludes that they have escaped relatively unscathed from the crisis thanks to their specific characteristics and historically and deeply embedded moral and ethical values. These aspects are still dominating the business orientation in their traditional home markets. In this respect, Cooperative banks have clear advantages over other banks for the coming five years. But one has to bear in mind that Cooperative banking is not by definition better than other banking models and after all, past performance is not a guarantee of future success. The main conclusion is that Cooperative banking is not a panacea for post-crisis banking in general, but should be viewed as an interesting alternative to the Shareholder Value banking model that has been in the spotlight for most of the time in recent decades.

*Key words: cooperatives, banking*

*JEL Classification Numbers: A20, B10, G21, L25, P13*

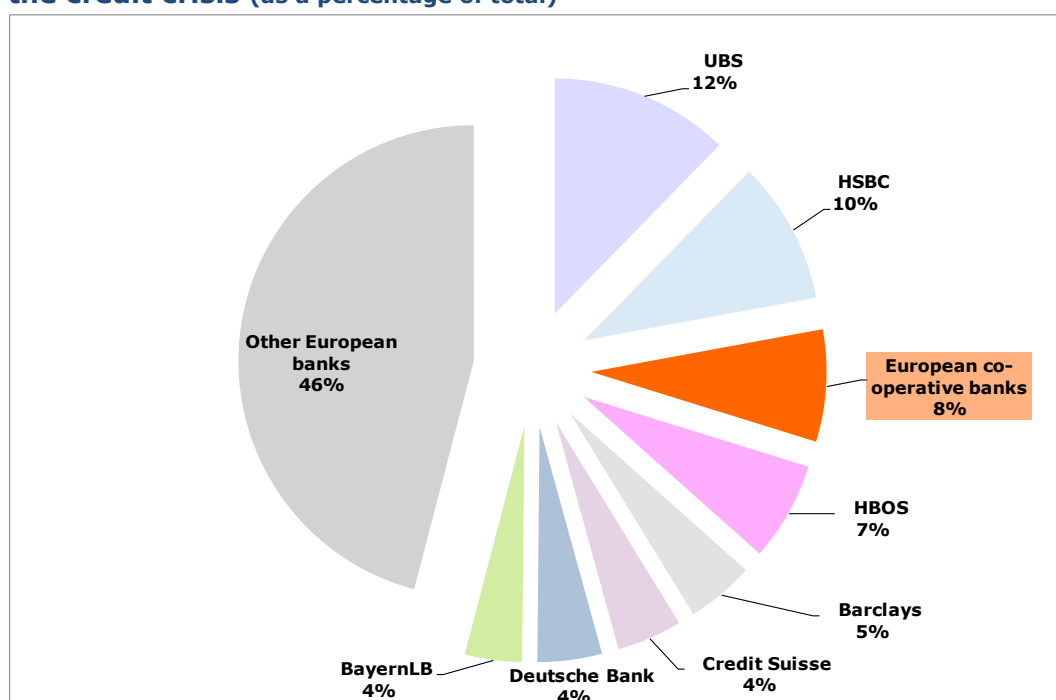
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## Introduction

The financial perils for countries and banks are not over yet. The situation is far from stable and public confidence in financial institutions is still weak. However, it has caught the attention of supervisors, politicians and academics that European Cooperative banks came through the crisis of 2007-2008 in better shape than many commercial banks. All European Cooperative banks together are responsible for 8 percent of all direct losses and write downs of the entire European banking sector as a result of the credit crisis (Chart 1). Without any doubt, this is a large amount in euro's, but compared to their average market shares of around 20 percent, this is a relatively small percentage and still bearable. Consequently, Cooperative banks did not need large scale government support to survive and kept relatively good access to the public money and capital markets in the middle of the crisis (Groeneveld and De Vries, 2009).<sup>2</sup> Moreover, European Cooperative banks slowly but steadily strengthened their home market positions over the last decade, i.e. also during and after the credit crisis (EACB, 2010). Average market shares of European Cooperative banks as well as member-to-population ratios continued to increase in the financially and economically turbulent years 2008-2009.

**Chart 1 Direct losses and write downs of European banks as a consequence of the credit crisis (as a percentage of total)**



**Source:** Annual reports, press releases and Bloomberg data.

**Explanation:** the aggregated losses and write downs of European banks as a direct consequence of the credit crisis amount to around € 430 billion. Indirect effects, like the large uncertainty between banks, government interventions in the banking sector and the sharp global recession with the resulting increase in private and corporate failures, are left aside.

<sup>2</sup> In a number of countries, the Cooperative banks also received support as part of a support package for all banks (e.g. Crédit Agricole) or because of exceptional circumstances, in Eastern Europe for instance. The banks operating in that region have been hit hard by the collapse of the economy.

The characteristics and achievements of Cooperative banks in the past few years have remained notably underexposed in recent publications, the press and various reports. Kalmi (2007) ascribes this to the prevalence of the Anglo-Saxon banking model aimed at profit and shareholder value maximization in the last decades. Cooperative banks were just not considered the most efficient, vibrant, or innovative institutions for a long time (Kodres and Narain, 2010). However, an increasing academic and policy interest in the Cooperative banking model has emerged in recent years (Ayadi et al., 2010; Fonteyne, 2007; The Economist, 2010; Čihák and Hesse, 2007).

In addition to other existing articles, this contribution primarily focuses on the question why European Cooperative banking groups performed relatively well in recent years compared to many other banks. This article asserts that the historical Cooperative basis with the associated specific features can largely explain their relatively good performance in recent years. The stable and solid Cooperative banking part in their home markets appears to be largely responsible for this. It is also argued that the required future behavioral characteristics of the global financial system closely resemble the traditional core values – like respect, integrity, professionalism and sustainability – and resulting long term orientation of Cooperative banks.

### **Box 1 Definition of morality and integrity<sup>3</sup>**

In this article we apply the following definitions of morality and integrity.

**Morality** is a sense of behavioral conduct that differentiates intentions, decisions, and actions between those that are good (or right) and bad (or wrong).

**Integrity** is a concept of consistency of actions, values, methods, measures, principles, expectations and outcomes.

The set-up of this article is as follows. Section 2 pays attention to the expected fundamental changes in banking stemming from the credit crisis. In Section 3, we sketch the roots and evolution of Cooperative banks. In Section 4, it is argued that these differentiators of Cooperative banks are still observable and impact on their financial structure and other quantitative indicators. As a result of their origins, Cooperative banks have a deeply rooted moral and honorable base. The key issue is whether this foundation is acknowledged and recognized by their customers and the general public in their daily operations and client contacts. Section 5 contains the main results and conclusions.

## **2. Impact of financial crisis on 'the rules of the game', business principles and business models in banking**

The financial crisis has led to new rules, new business principles and new business models in banking (Table 1). To start with, the financial crisis has given rise to intense discussions about reforming the regulatory and supervisory regimes in the US and in Europe.<sup>4</sup> Recently, the Basel Committee on Banking Supervision (BCBS, 2010) announced higher capital and liquidity requirements for banks as preventive

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<sup>3</sup> Source is Wikipedia.

<sup>4</sup> For example, Financial Stability Forum (2008), G-20 (2009a/b), The de Larosière Group (2009).

measures to reduce the likelihood of future crises. Key is that regulation and supervision should be reformed to encourage a financial system that better mitigates systemic risks (Kodres and Narain, 2010). Important elements in many proposals are strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets and reinforcing international co-operation among regulators and supervisors. Even without regulatory reform, many institutions are rethinking their risk taking activities and how they can better align risk taking with employee compensation. Hence, there will be a much greater focus on risk and governance issues. The power of risk managers will increase in the decision making process and in the determination of the overall risk appetite of financial institutions.

**Table 1 Main effects of the financial crisis for the entire banking industry**

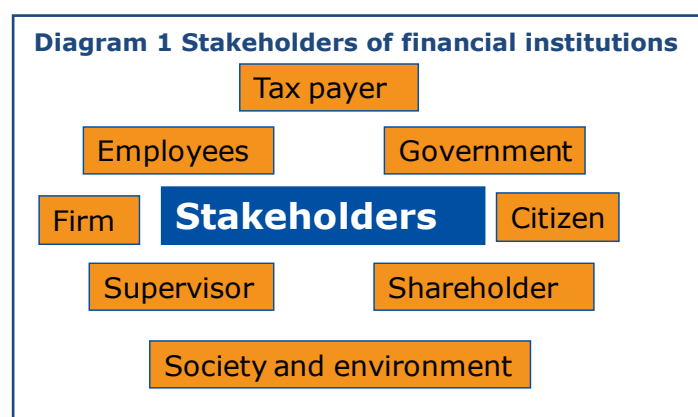
<b>Main effects</b>	<b>Characteristics of the new financial system</b>
1. New rules of the game	<ul style="list-style-type: none"> <li>- Corporate governance, clear attention to risk management</li> <li>- Compensation schemes to introduce the right incentives</li> <li>- Tighter supervision and regulation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

Source: Rabobank analysis.

Tighter regulation and supervision are necessary, but not sufficient. It is particularly important that the business principles of the financial system change drastically in order to restore confidence and maintain 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 morality and integrity, 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. By late 2008, proposals have accordingly been put forward for healthier and more modest executive and employee compensation structures in the financial services industry (Financial Stability Board, 2009).<sup>5</sup> 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 has to be given to collective and sustainable interests.

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. 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 has taken place as banks refocus their activities on their original home markets (ECB, April 2010). 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

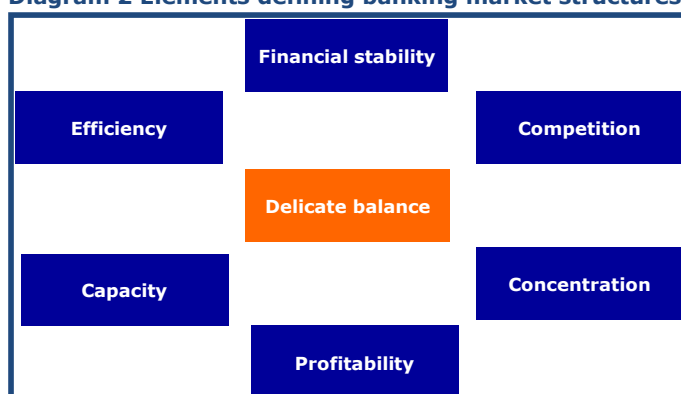
<sup>5</sup> Periodically, the FSB is performing reviews of the steps taken or planned by its member jurisdictions to implement these principles. Notwithstanding different starting points in terms of pre-existing national frameworks addressing compensation issues and the degree of misalignment with prudent risk-taking, the FSB concludes that, on the whole, material progress and a movement towards convergence across jurisdictions have taken place (FSB, 2010).

borders and consequently to a reversal of the European financial integration process in banking.

Due to the narrowing range of products and activities, fee and commission revenues have decreased and the dependency on interest income has increased. Large parts of the shadow banking system and some large international financial conglomerates are dismantled and a move back towards retail banking is taking place.<sup>6</sup> 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.

In conclusion, banking models are becoming simpler, more risk averse and more transparent. Another salient feature is the expected 'return to retail banking' of many players. These new elements, whether enforced or not, will undoubtedly

**Diagram 2 Elements defining banking market structures**



Source: Rabobank

contribute to the restoration of financial stability, which is an important factor of banking structures. These structures are generally defined in terms of financial stability, competition, concentration, capacity, efficiency and profitability (diagram 2) and all defining elements will change considerably in the years to come.

### 3 The origins and evolution of Cooperative banking

#### 3.1 Origins of Cooperative banks

The history of many Cooperative 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). For instance, these groups could only obtain loans at exorbitant interest rates from money lenders.<sup>7</sup> Most Cooperative banks were established following the ideas of Hermann

<sup>6</sup> Retail business is defined as financial products and services distributed through physical and non-physical networks to retail customers and SMEs.

<sup>7</sup> The practice of charging excessive interest rates was an ordinary characteristic of the era. According to some early reports, annual rates in excess of 30% were not uncommon in Germany (Guinnane, 2001, p. 368).

Schultze-Delitzsch (1808-83) and Wilhelm Raiffeisen (1818-88). Independently from each other, they started to promote the idea of credit Cooperatives, with Schultze-Delitzsch focusing on helping small business owners and artisans in urban areas and Raiffeisen seeking to assist the rural poor.

Moral sense and ethical considerations clearly played a dominant role in the set up of Cooperative banks. It was about offering opportunities for financial inclusion to large groups in society. In economic terms, Cooperative banks were originally established to correct market failures 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 Cooperative banks. Beginning in Germany, the Cooperative banking concept gradually spread to the rest of the continent and to the Nordic countries.

Despite the fact that they addressed similar issues, different Cooperative 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 Cooperative banking was initiated, nurtured and supported by outside forces, e.g. governments. Consequently, the form, appearance, organisation and operation of Cooperative banking groups differ across countries and over time. They vary in terms of their attitudes to membership and their interpretation of Cooperative values (Oliver Wyman, 2008). Hence, the Cooperative banking model does not exist (Van Diepenbeek, 2007).

### 3.2 *Evolution of Cooperative banks*

The original 'raison d'être' of Cooperative 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 Cooperative 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 Cooperative banks and their members. The increasing complexity of financial services provision and the establishment of subsidiaries for international activities corporate and investment banking required professionalization of management and the associated establishment of central institutions where decisions are increasingly taken. Finally, the comparative disadvantages that non-Cooperative 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.

It is definitely not true that all Cooperative banks managed to survive the ravages of time. Quite a few Cooperatively organised banks were unable to adapt to technological, social or competitive changes and consequently disappeared or now just live a marginal existence. Many countries never had a Cooperative sector of any significance, because the Cooperative ideas did not find very fertile soil as a result of cultural factors. In other countries, Cooperative banks chose to be acquired by other banks or to transform themselves into private banks. However, most European Cooperative banks evolved in the course of time from local credit Cooperatives via national (network) organisations into internationally active banking groups. These developments were partly prompted by regulatory requirements or the necessary realisation of economies of scale and higher efficiency levels from a competitive point of view.

In their domestic home markets, Cooperative banks were engaged in consolidation, diversification, domestic acquisitions, and launching new distribution concepts. Regarding the motives for internationalisation, some Cooperative 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 Cooperative financial organisations have argued that the internationalisation 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. In short, mature Cooperative banks re-invented themselves in the course of time to counter factors constituting a threat to their existence. This way they gradually became less distinguishable from their commercial bank competitors, being active in non-retail activities and expanding across domestic frontiers (Ayadi et al, 2010). Hence, the Cooperative orientation of (international) Cooperative banking groups diminished, but remained the primary focus of the original Cooperative banking part in the home market.

#### **4 Distinguishing features of Cooperative banks**

European Cooperative banks have undergone tremendous transformations and developments since their establishment more than a century ago. Until the most recent global credit crisis emerged, it was fairly difficult to differentiate themselves from their commercial competitors and they were sometimes criticised for 'spoiling' the market conditions for other banks (PA Consulting Group, 2003). Financial products, prices and services are almost identical across banks and banks were at that time perceived as equally safe and financially sound. Indeed, the European Association of Cooperative Banks (EACB, 2005, 2006, 2007) as well as the International Cooperative Banking Association (ICBA) have put a lot of effort in emphasizing the divergent and special nature of Cooperative banks in various reports before 2008.

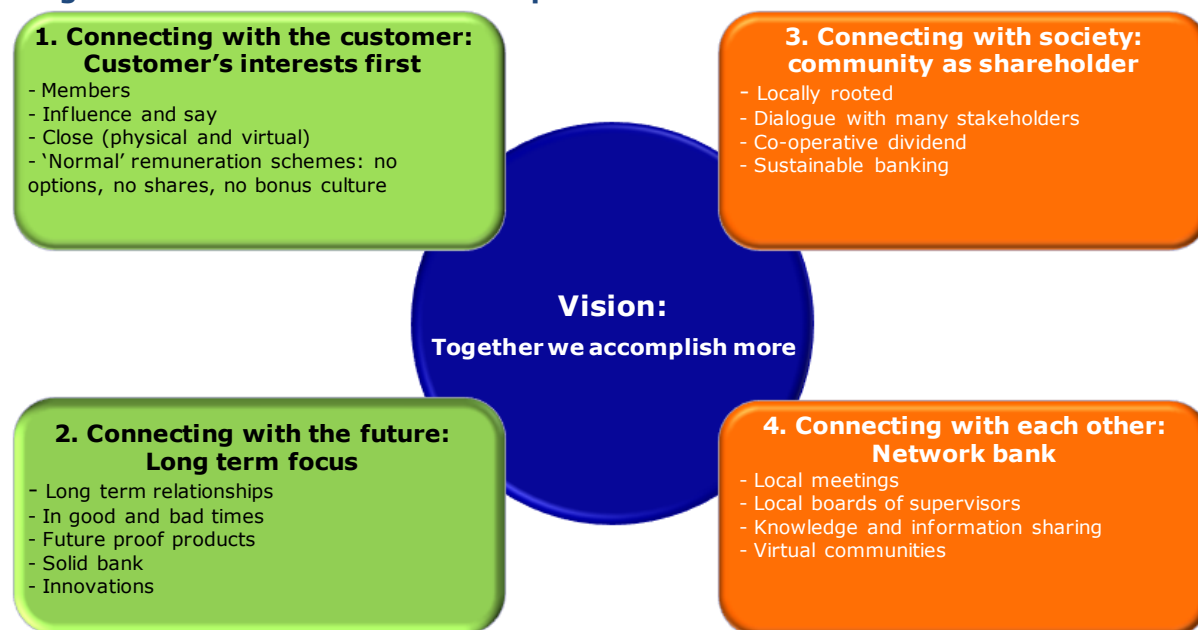
These documents have a predominantly qualitative character, since 'hard' data on a wide range of issues concerning Cooperative banks are not readily available. All these reports stress that the mission, vision and considerations of Cooperative banks have basically remained the same since their creation. For instance, the EACB (2005) states that:

*"The primary mission of Cooperative banks is to promote the economic interest of their members, who are their customers. Cooperative 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 Cooperative banking in a new phrasing. Apparently, the customer has always been and is still 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 should sound quite awkward to Cooperative banks. The passage above also suggests that Cooperative banks have an 'impact presence' on the banking market. 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 Cooperative banks and society and the structural characteristics of banking markets (see diagram 2). Such a causality is hard to demonstrate empirically, as it really only manifests itself on the entry or exit of a large Cooperative bank or during financial crises (Groeneveld and Sjauw-Koen-Fa, 2009). But it also works the other way round: society and the market environment influence Cooperative banks. Another implicit EACB claim is that Cooperative banks apply an external and long term orientation. They are not aiming at – short term – benefits of their operations, services and products for members/customers and themselves, but also want to contribute to economic and social well being in local communities. This longer term perspective and priority to collective and sustainable interests are precisely the behavioural changes which the public, politicians and regulators are demanding from financial institutions following the credit crisis.

According to existing documents and reports, morality, integrity and ethics are entrenched in the existence of Cooperative banks. Indeed, Cooperative banks are *de facto* different banks regarding their history, structure, organisation form and business objective. We have concretized these statements by splitting the traditional Cooperative ideas into four dimensions (diagram 3). This enables us to place the discussion into a more actual perspective.

**Diagram 3 Basic and historical Cooperative views**



Source: Rabobank analysis.

The aspects mentioned in the green boxes 1 and 2 are specific features of Cooperative institutions which stem from their legal governance structure or can actually be corroborated by empirical data to some extent.<sup>8</sup> It appears to be much more difficult to substantiate the proclaimed differentiators of the orange boxes 3 and 4, though it is a fact that all Cooperative banks have mechanisms in place to formalize the connections with customers and stakeholders in society in various ways. But they are certainly not unique in this respect. Based on empirical evidence, existing literature and policy reports as well as Rabobank's experience, several 'unique and defining characteristics of Cooperative banks' can be discerned which are linked to the elements in boxes 1 and 2.

#### 4.1 Specific corporate governance: member authority and influence

It is a fact that members, who are also customers, own the entire Cooperative banking organisation and are able to influence its decision-making in a multi-stage organisational form. In order to align the institution's objectives with its members' interests, the governance is built on the democratic principle of 'one member, one vote'. Members have a more direct say in the local member bank's policy, for instance on the branch office location, opening hours, services and sponsoring activities. In the Cooperative core of the organisation in the home market, member authority entails a more consensus-driven approach and automatically prevents a strong fixation on just one stakeholder. To strike a balance between divergent interests among various stakeholders requires a long term orientation based on morality and integrity. Such a behaviour is accompanied by a longer term and risk-averse view, which translates into a more stable banking approach focused on retail banking. With their strong local ties and large networks, Cooperative banks are in

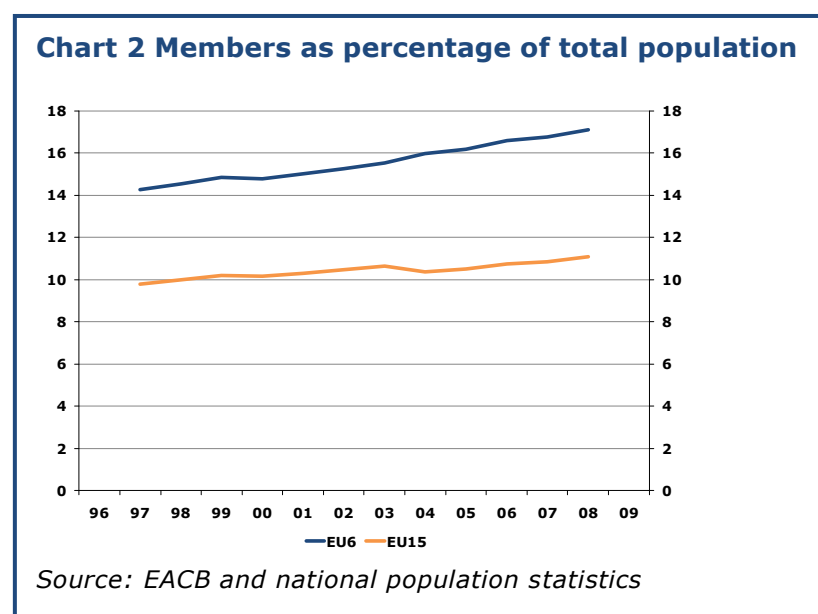
<sup>8</sup> In October 2010, CEBS issued a consultation paper on "Guidelines on Remuneration Policies and Practices". Member states and banks are expected to implement these guidelines by 1 January 2011. These guidelines have to be made suitable for Cooperative banks.

theory also better equipped to assess the creditworthiness and risks of customers at a local level.

**Box Remuneration at Rabobank**

A linked question concerns the remuneration model. According to Rabobank’s annual report for 2009, ‘the remuneration structure within the organisation has never been such that it might encourage the irresponsible risks being taken’. At Rabobank, the remuneration of the executive board distinguishes between salaries, variable compensation and pension provisions. No variable compensation is awarded in the form of an option and/or as share packages. A short-term and long-term (long term being three years) variable compensation of 15% of fixed income exists for the executive board. A variable compensation component exceeding 30% of fixed income is paid only to a small number of individuals in highly specialised positions within Rabobank International.

Contrary to the limited attention for the Cooperative banking model among academics and policy makers in the recent past, this model has been rather

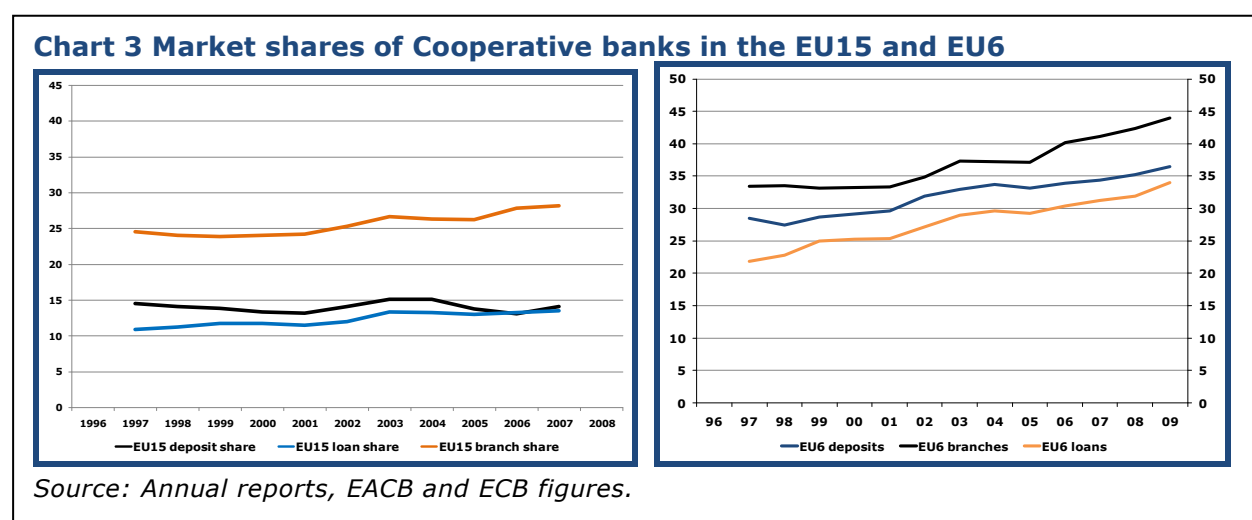


successful, as measured by the rise in the member to population ratio (Chart 2) and in domestic market shares. If the number of members would drop considerably, this would eventually erode the legitimacy and an important discriminating feature of Cooperative banks. In six EU countries where Cooperative banks have domestic market shares of more than 25 percent,

the member to population ratio increased by 3 percentage points to 17.5 percent in 2009. The countries include Austria, Finland, France, Germany, Italy and the Netherlands (henceforth EU6). In the fifteen original member states of the European Union (EU15), the ratio increased by 1.5 percentage points to 11,5. The underlying reasons for the increasing popularity are hard to isolate and are of a financial and immaterial nature.<sup>9</sup> The ratios merely indicate that Cooperative banks have succeeded in attracting new members with their products, services, Cooperative business models or other distinguishing features. It should be noted that compulsory membership has been abolished in most European countries some 20 years ago. Before that, customers had to become members if they wanted to apply for a credit or loan from a Cooperative bank.

<sup>9</sup> 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.

Regarding market shares, European Cooperative banks were able to gradually strengthen their position in the loan and deposit markets over the last decade and in the financially turbulent years 2007 and 2008 (Chart 3). This trend continued in 2009. The rise in market shares has been due to exogenous factors and acquisitions of other financial institutions. It may also be noted that the figures lead us to conclude that the loan-to-deposit ratio is somewhat higher for Cooperative banks than for private banks. This partly reflects their traditional strong position to attract local deposits.



The market shares for deposits and loans are significant, but below the market shares for branches. The market shares for branch offices are in both EU15 and EU6 approximately 10 percentage points higher than those for deposits. Over the last decade, Cooperative banks have gained branch market share for two reasons. The first is that Cooperative banks in France, Italy and Spain have expanded their branch office networks either organically or via acquisitions. The second explanation is that Cooperative banks in eight EU countries have slimmed down the number of branch offices to a lesser extent than their competitors in the context of cost-cutting or efficiency programmes. As a result, Cooperative banks have strengthened their local presence. Against the background of the expected 'return to retail banking' of many financial players in the coming years, Cooperative banks can take advantage of this fact. Amidst of the crisis, the possession of a dense branch network has proven its value. Customers viewed Cooperative banks as safe havens and transferred substantial volumes of deposits to Cooperative banks, leading to the visible increase in deposit market shares. The increase in loan market shares in recent years was partly attributable to the solid capitalisation of Cooperative banks. They were better able to continue lending to the private sector in the crisis, whereas many commercial banks could not attract funding without some form of government support.

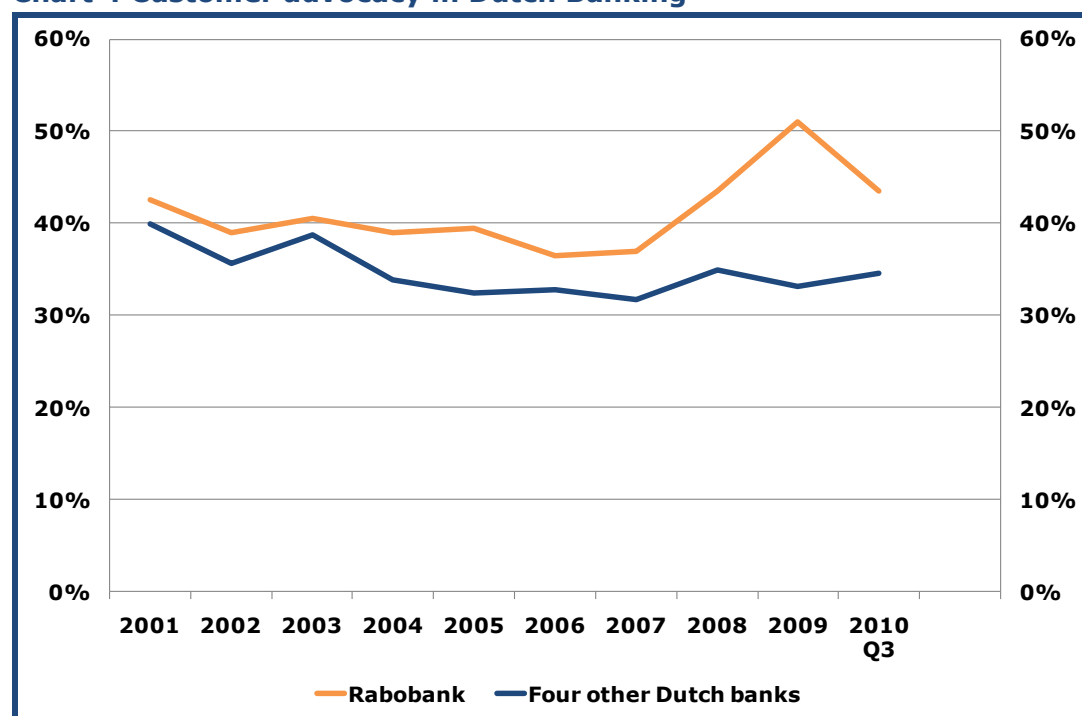
#### 4.2 Customer focus

As elaborated before, Cooperative banks frequently publicly state that they do not aim at maximising profits but customer value (EACB, 2005). However, this assertion is difficult to substantiate with 'hard data' or empirical evidence. Hence, the perception and appreciation of customers of the proclaimed customer centricity of Cooperative banks are unknown, which is quite unsatisfactory for both researchers, policy makers and Cooperative banks themselves. One could argue that customer

satisfaction is ultimately visible in member to population ratios, market shares or financial performance of Cooperative banks, but obtaining direct insights and opinions from customers would provide more powerful evidence. It is all about the perception of customers whether Cooperative banks 'walk their talk'. Or in other words, keep their promises and treat their customers fairly.

Up to now, we were only able to obtain information about customer satisfaction for the Netherlands (Niemeyer, 2010). This type of research is carried out among many customers of different banks. Particularly, answers to survey questions about customer advocacy offer the opportunity to verify this issue. Chart 4 shows the development of customer advocacy in the Netherlands since 2001. The Cooperative Rabobank has always had the highest customer advocacy score of the five Dutch banks included in Chart 4. But interestingly, this score peaked in the middle of the financial crisis in 2008. Customers apparently noticed that Rabobank was a different bank, when the entire Dutch banking sector was faced with various scandals, bankruptcies and in need of large scale government support. Hence, Rabobank has acted a stabilizing factor in the national financial system during the crisis.

**Chart 4 Customer advocacy in Dutch Banking**



Source: Forrester.

Explanation: customer advocacy is derived from answers to the following statement: "My main bank does what's best for me, not what's best for its profits at my expense." It concerns the percentage of respondents who agree or strongly agree with this statement regarding their main or primary bank.

#### 4.3 High capitalisation, high rating and low funding costs

The long term orientation of Cooperative banks is partly reflected in the way they use their profits. They barely distribute profits but add it to their reserves or the banks' own funds. Consequently, Cooperative banks are some of the more highly capitalised institutions in Europe as a result of their unique model and ownership structure. Cooperative banks accumulate capital by design, as their original purpose

was to overcome a shortage of capital for their chosen activities. Cooperatives 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 Cooperative bank failure. Finally, high capital reserves and high ratings provide Cooperative banks with opportunities to obtain relatively cheap capital market funding, because this entails less risks for other creditors and thus lower risk premiums. The available evidence also supports the argument that Cooperative banks have relatively easy access to a fairly cheap, risk-free and stable funding source, i.e. a relatively large deposit base. This contributes to a healthy balance sheet composition and high credit ratings (Fitch, 2001 and Moody's, 2003).

#### *4.4 Profit as a necessary condition*

Based on the long-term focus on customer value and member influence, Cooperative banks claim that they do not aim to maximise short-term profit.<sup>10</sup> While healthy profitability is an important necessary condition for Cooperative banks to safeguard their continuity, to finance growth and credit, and to provide a buffer for inclement times, profit is not a goal in itself.

#### *4.5 Stable 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 Cooperative banks. The knowledge that capital cannot be easily replaced by external sources after considerable losses stimulates Cooperative bank managers to apply a relatively low risk appetite.

#### *4.6 Proximity to customers: dense branch networks*

Cooperative banks have relatively large branch networks (chart 3), providing Cooperatives with an important, albeit declining, comparative advantage in retail markets. Cooperative banks are literally and figuratively closer to their customers and know those customers well through participation in numerous social networks. This is because the Cooperative 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.

#### *4.7 Qualifications of the Cooperative banking model and governance*

These observable and actual features are generally considered benefits for Cooperative banks, but it is fair to make some important qualifications (Fonteyne, 2007). Firstly, it has become more difficult for members to monitor the organisation due to the increased organisational complexity of Cooperatives in which management is carried out by dedicated professionals. It is also argued that member

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<sup>10</sup> The line of reasoning of PA Consulting Group (2003) that Cooperative 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. Cooperative banks simply have a profit target that is based on the objective to serve customers on a continuity basis.

ownership makes decision-making slower or hinders innovation and adjustment to new developments. In addition, members would have a reduced incentive to stimulate an optimum use of the high capital base (or excess capital), because they mostly 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 outside the traditional core of the Cooperative banking groups. Evidence of these suspicions can be found in their foreign operations. The entry of foreign, and thus fairly unknown markets could ultimately endanger the traditional Cooperative heart of the organisation. Indeed, a rough historical examination reveals that most losses and write downs of Cooperative banking groups originate outside the Cooperative heart of the organisations.

Secondly, the introduction of external shareholders into a Cooperative system creates tensions regarding control. If capital is only provided by members, the voting power as member of a Cooperative 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 Cooperative banks in the future. In the longer-term, Cooperative 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.

Despite these caveats, the identified differentiators must be treasured. However, it should be remembered that these advantages are valueless if customers and members are unsatisfied with the quality and range of products and services offered, their pricing and the applied distribution concepts. In this case, it would be useless to put a lot of effort into membership programmes. In fact, customers and members have to notice the proclaimed comparative advantages and differences in the attitude of employees or business culture in practice. Members and customers rightfully do not accept qualitatively poor products and services or bad pricing – possibly due to inefficient operations – which would in fact conflict with the Cooperative objective of delivering customer value.

Apart from extreme situations like the current crisis, the Cooperative business model demands cost and revenue levels for retail banking activities that do not deviate substantially from the standards of the banking industry. Otherwise, Cooperative banks will simply be wiped out by competitors which offer better services and/or prices. However, the deviation range or price/quantity sensitivity of customers may vary over time and across countries. For instance, in turbulent times, Cooperative banks may have a '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 Cooperative 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.

## **5 Summary and conclusions**

The rules of the game, business principles and business models in the global financial system will change drastically. Radical behavioural changes of many financial firms, and particularly those that received some form of state aid, are needed. On this point, European Cooperative banks seem to compare favourably with their commercial competitors. Based on qualitative and quantitative insights, this article argues that intangible aspects form the basis for the strength and relatively good performance of financial Cooperatives before, during and after the credit crisis. Their specific corporate governance with deeply rooted broad economic and social perspectives and their historical attitude based on moral and honest principles seem to provide important partial explanations. Due to both factors, domestic retail banking activities very likely remained the undisputed stable pillars of Cooperative banking groups, despite their (inter)national expansion in many other market segments.

It is not an easy task to pinpoint the exact reasons for this achievement, because the economics, the merits and drawbacks of Cooperative banks are difficult to examine. One reason is that Cooperative banks, while still emphasizing their commitment to their roots and principles, largely differ from what these institutions were in the past. Today, they are a very heterogeneous group of financial institutions with divergent Cooperative governance structures that expanded beyond their traditional businesses. Another reason is that their assessment cannot be based solely on economic or financial performance, since they have been created for other purposes than that of being successful in economic or financial terms.

With the expected difficult market conditions in banking, it is important that Cooperative banks convincingly demonstrate their main differentiators to all stakeholders, meaning that their assertions are credible and perceptible. For instance, they can point to the benefits and implications of their specific governance and healthy liquidity and capital positions, which are necessary but not sufficient preconditions for their viability. But more importantly, clients have to notice that Cooperative banks put the customers' interests first. This leads to the conclusion that the degree of alignment between the daily behaviour of the people allied with Cooperative banks, i.e. employees, managers, supervisory boards, directors and customers, on the one hand and their formulated mission, core values and code of conduct on the other hand largely determines the extent to which Cooperative banks stand out from commercial banks in the opinion of customers. Hence, more efforts should be devoted to monitoring the clients' perception and appreciation of the attitude of financial Cooperatives which is traditionally based on morality and integrity. The success of every financial institution ultimately depends on 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, attitude, knowledge and competences of employees.

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