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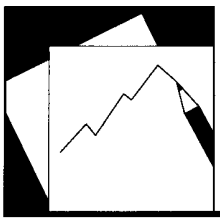

IMF Working Paper

Cooperative Banks in Europe—Policy Issues

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Abstract

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This paper explains the continuing success of European cooperative banks through evolving comparative advantages. It points out that a cooperative is built around an intergenerational endowment without final owners, which creates particular governance challenges. Risks include the use of the endowment for purposes other than members' best interest, such as empire-building, and attempts at appropriation. The risk of empire-building is reinforced by mechanisms that foster capital accumulation and asymmetric opportunities for consolidation. The paper concludes that some form of independent external oversight of corporate governance is warranted and that cooperatives need mechanisms enabling them to better manage their capital.

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Contents Page

I. INTRODUCTION AND SUMMARY

1. Since the 19th century, cooperative banks have been an important feature of the European banking landscape.[2] On present trends, this is likely to remain the case at least well into the 21st century, as most cooperative banks seem healthy and many of them are increasing their market shares. Nevertheless, the importance of cooperative banks, the implications of their specific nature, and the dynamics of their interaction with other types of banks have at times escaped fitting attention among policymakers and in the literature. This paper attempts to help remedy this.

2. The paper argues that the success of cooperative banks can be explained by their evolving comparative advantages. Originally devised to overcome problems of asymmetric information in favor of borrowers, their current success appears driven to a significant extent by problems of asymmetric information in favor of banks. As consumer-owned institutions, cooperative banks have a comparative advantage in gaining the trust of their customers.

3. Nevertheless, cooperative banks face fundamental challenges rooted in their institutional set-up. Most cooperatives were designed from the outset to perpetually accumulate capital. This was done by defining members' ownership rights as applying only to the notional value represented by paid-up membership shares (and any capitalized dividends) and by limiting the disbursement of profits. As a result, the economic value of a cooperative, net of debts and the nominal value of member shares, constitutes an intergenerational endowment without final owners. It is available to current members, under the implicit or explicit understanding that they will further grow the endowment and pass it on to the next generation of members. In this interpretation, cooperative bank managers can be seen as custodians of this endowment.

4. The existence of such an owner-less endowment constitutes a major challenge to the governance systems of a cooperative. It reduces members' incentives to exert effective oversight over management, while at the same time increasing the need for such oversight. In many respects, governance systems may struggle to meet this challenge. These systems were originally designed for small institutions functioning within close communities, but are now being applied with little fundamental change to large, complex, financial conglomerates. Moreover, the functioning of corporate governance mechanisms could be hampered by collective action problems that appear more daunting than in investor-owned companies, the absence or reduced impact of market signals, and in many cases lower disclosure of information.

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[2] Cooperative and mutual forms of ownership have also been—and in some cases still are—important among non-bank financial institutions in Europe and elsewhere, in particular in the insurance sector. While many of the policy issues are similar, the focus in this paper is solely on cooperative banks.

5. In cooperative banks, two important risks may materialize when corporate governance systems fail. First, managers may use the intergenerational endowment for purposes other than members' best interests. In particular, they may use it as a tool for empire-building. Second, there is a risk that inevitable attempts to appropriate (part of) the endowment may succeed.

6. From a financial stability point of view, the competitive dynamics between cooperative and commercial banks merit special attention. Cooperatives can use their low-cost and often abundant capital and the absence of a profit maximization constraint to pursue expansion plans that put competitive pressure on other financial institutions. If, mindful of this risk, prudential authorities insist that cooperatives achieve similar returns on equity as commercial banks, they may end up pushing cooperatives to expand into risky activities that they cannot adequately control. Further financial stability concerns relate to the impact of cooperatives' potentially limited ability to raise capital and features of their business model on their capacity to withstand crisis situations. Within networks of cooperatives, internal solidarity mechanisms should limit the impact of smaller shocks and so should peer pressure and supervision of smaller cooperatives by apex organizations. But this also raises some problems, including possibly insufficient market exit or governance issues. Moreover, the balance of power within networks of cooperatives merits attention.

7. The paper concludes that, in general, cooperatives need more scope to manage their capital, allowing them to better raise and shed capital in function of their needs. Furthermore, improvements are needed to cooperatives' governance systems. Such improvements could include strengthened disclosure requirements; various measures to increase member involvement; mechanisms that allow members to organize themselves and challenge management, in particular on fundamental questions regarding the future and size of the institution; increased minimum investment levels for members; deliberate exposure to market mechanisms; the addition of independent and well-qualified board members; specific prudential oversight; and a clear separation between external and internal governance systems in networks of cooperatives. For cooperatives whose members wish to wind down operations or transform into joint stock corporations, financially sound and equitable mechanisms need to be devised. Finally, policymakers need to ensure that the competition between different types of banks take place on as level a playing field as possible, avoiding policies that may create artificial advantages in favor of a specific ownership form.

8. This paper does not seek to pass any overall judgment on the merits of the cooperative ownership form relative to the available alternatives. It is clear from recent history that all governance forms have both problems and comparative advantages. Nonetheless, comparisons with other governance systems, in particular with joint-stock ownership (commercial banks), are made throughout the paper in order to help identify particular strengths and weaknesses. It is also important to keep in mind that the cooperative sector is very diverse, with big differences across countries and between, for example, big and small cooperatives. This paper did not seek to study this diversity in all its richness,

focusing mostly on the "generic" cooperative instead. This means that not all issues raised are equally relevant to all cooperatives.

9. The paper is structured as follows: Section II analyzes the evolution and outlook of European cooperative banks; Section III looks into the current state of the sector, focusing on the formation of networks and financial performance; Section IV analyzes governance mechanisms and challenges and Section V financial stability issues; Section VI outlines a number of tentative policy conclusions and identifies some topics for further research.

II. The Cooperative Banking Movement—From Small-scale Self-help to Large, Complex Financial Conglomerates

10. This section presents the European cooperative banking sector through the prism of evolving comparative advantages. These evolving comparative advantages explain the sector's emergence, current shape and outlook. First of all, though, the section introduces the concept of cooperative ownership.

A. The Cooperative Ownership Form

11. **Conceptually, the cooperative ownership form is a bottom-up phenomenon with specific features**. The International Cooperative Alliance (ICA, 1995) defines a cooperative as "an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise". In practice and in general, the main features of cooperatives (see, for example, European Commission, 2001) are: (i) free association (of qualifying persons) and withdrawal, resulting in a variable cooperative capital base; (ii) the non-transferability of membership, implying the absence of a market for member shares; (iii) a democratic structure usually giving each member one vote regardless of his or her investment; (iv) profit distribution that is often restricted and is not necessarily proportional to members' shareholdings; (v) ownership rights that are in effect limited to the nominal cooperative capital represented by member shares (and therefore do not extend to the reserves and the total economic value of the cooperative); and (vi) the pursuit of specific member interests rather than profit maximization. Several categories of cooperatives exist, depending on their purpose and the nature of their members (producer cooperatives, consumer cooperatives, worker cooperatives, …). Financial sector cooperatives are usually consumer cooperatives.

12. The coverage of this paper includes European banks that, by and large, are in line with the ICA definition and the features outlined above. In addition to cooperative banks that label themselves as such, it includes credit unions and building societies, as well as Italian *banche popolari* (which in terms of some shareholder rights resemble joint-stock companies).

The discussion in this paper does not apply to savings banks, with the exception of the French *Caisses d'Epargne* since their conversion to cooperatives.

B. The Lifecycle of a Cooperative

Just like commercial companies, cooperatives tend to go through a lifecycle (see Brazda and Schediwy, 2001, and Heflebower, 1980).

13. **Cooperatives typically see the light of day during periods when markets and existing institutions fail to meet people's needs and aspirations**. Brazda and Schediwy (2001) observe that cooperative movements tend to start as a mass phenomenon during periods of want, social crisis and group antagonism. It is therefore no surprise that many of these movements, including in the financial sector, emerged in industrializing and famine-struck 19th century Europe. Initially, cooperatives rely a lot on the commitment of their members, both for labor (volunteer work) and (financial) resources. The reliance on volunteers means that management and governance problems are important challenges at this early stage. Although the initial member base tends to be rather homogenous, members do not necessarily have fully compatible interests. The initial success of a cooperative therefore depends largely on the degree to which its members' interests are aligned, its ability to overcome divergences of interests among its members, and its capacity to serve those interests better than the available alternatives.

14. **During its adolescence, the distance between a cooperative and its members increases and management becomes more professional**. As it grows up, a cooperative enterprise accumulates a pool of human and financial resources that provides it an increasing degree of independence from its members. The enterprise and its business processes also tend to become more complex, specialized and bureaucratic, which makes member involvement in its operations less effective and desirable. With the professionalization of management, economic efficiency becomes a primary concern, leading to a quest for scale economies that often drives a process of consolidation and formation of networks. In the course of this process, the distance between management and members increases. In essence, the cooperative undergoes a metamorphosis of its governance challenges, as its staff and managers emerge as new classes of stakeholders, with interests that are not necessarily aligned with those of members.

15. **The success and life expectancy of a mature cooperative depend on its competitiveness, management, and relations with members**. Brazda and Schediwy (2001) note that emotional loyalty of members towards their cooperative is only partially transmittable over generations. This implies that, as a cooperative matures and becomes long-established, member fidelity becomes contingent on the cooperative's ability to offer products that are competitive in the market and can be especially fragile if members' financial involvement is low. Growing internal divisions, a weakening of collective ideology, and the disappearance of the original *raison d'être* all tend to threaten the survival of mature

cooperatives. Those that remain successful tend to be active in markets with competition and high mark-ups, based on broad group solidarity, managed in a "benevolent authoritarian way" by charismatic leaders, and have shareholdings that represent relatively large investments for their members. Eventually, surviving cooperative movements tend to adopt a business logic and evolve into structures that are either hierarchical or based on loose cooperation on market terms. Similarly, Heflebower (1980) notes that surviving and growing cooperatives typically end up adopting de facto managerial procedures and policies analogous to those of investor-owned corporations.

C. Historical Roots

16. **The cooperative banking sector in Europe was created in response to the economic challenges and deprivation large swathes of the population faced in the 19th and early 20th centuries**. Most continental European cooperative banks were established on the basis of the ideas of Hermann Schulze (1808–83) and Friedrich Wilhelm Raiffeisen (1818–88). Both men were moved by the poverty and misery they observed, especially during the famine of 1848, and noted that ordinary people had no access to credit, except perhaps from usurary lenders. They independently started to promote the idea of credit cooperatives during the middle of the 19th century, Schultze aiming at helping urban small business owners and artisans and Raiffeisen seeking to assist the rural poor. The rationale was similar to the one behind current microfinance initiatives in developing countries, namely to provide people with the tools and resources to collectively and individually help themselves. From Germany the cooperative banking concept gradually spread to the rest of the continent and to the Nordic countries. In the British Isles, cooperative banks have somewhat different historical roots: building societies date back to the 18th century and were associated with a revivalist Christian movement that became popular among working class and lower middle class segments of society. UK and Irish credit unions only appeared during the second half of the 20th century and were based on US credit unions, which themselves were inspired by Canadian adaptations of the German cooperative banking concept (Hansmann, 1996).

17. **While they were generally grassroots organizations, in many cases the development of cooperative banking was initiated, nurtured and supported by outside forces, including governments**. In France, government involvement has been very extensive throughout the history of the cooperative banking sector (Gueslin, 2002), the Finnish cooperative banking sector was set up in a top-down process with government support, and Portuguese agricultural credit cooperatives thank their growth since the 1970s in part to government support (Cabo and Rebelo, 2005). In several countries, including Italy, Belgium and France, the post-Rerum Novarum social catholic movement supported the development of cooperative banks. In addition, many cooperative banks have been set up by, or with the support of, trade unions or agricultural associations and have maintained close links with these organizations.

18. **European cooperative banks flourished because they overcame important market imperfections**. Commercial banks in 19th century Europe were focused on servicing the needs of the emerging industry, wealthy individuals, and governments, and often took excessive risks with their clients' money. Even if they wanted to, servicing poorer layers of the population ran into problems of imperfect and/or asymmetric information and difficult and/or uneconomic enforceability of (small-scale) contracts, problems which still plague rural credit markets in developing countries to this day (Hoff and Stiglitz, 1990). As noted by Hansmann (1996), these problems gave rise to the emergence of two types of institutions: savings banks were established from 1810-1825 onwards, to overcome problems of opportunistic behavior by banks (in particular, excessive risk-taking), while cooperative banks were established from the mid-19th century onwards, to overcome problems of opportunistic behavior by borrowers. Raiffeisen experienced such opportunistic behavior first-hand when he set up his first credit institution, which provided loans to poor people financed by funds collected from wealthy donors. The institution failed as many borrowers could not be made to repay their loans and donors lost interest.

19. **Cooperative banks could overcome these problems because member-consumers financed the institution and were involved in its decision-making processes**. Within small communities, relatively intimate knowledge of each other's credit- and trustworthiness ensured that loans were only provided to borrowers who could be expected to repay them. The financial incentives members had to monitor each other, and the relatively small and homogenous membership base of early cooperatives ensured that peer pressure provided incentives for borrowers to repay, consistent with the analysis of Stiglitz (1990). Beyond financial incentives, social relations among members were also a contributing factor to the success of cooperatives.

D. Evolving Comparative Advantages

As noted by Hansmann (1996), in the long run, the ownership form that manages to satisfy consumers' needs most efficiently (at lowest cost) is likely to prevail. This section argues that the comparative advantages that ensured the early success of cooperative banks have to a significant extent been eroded. However, new ones have emerged.

20. **Cooperative banks have lost much of their comparative advantage in overcoming opportunistic behavior by borrowers**. Hansmann argues that consumer ownership is less efficient when information asymmetries work in favor of consumers, due to the potential for costly opportunistic behavior by the latter. In particular, in consumer-owned firms where consumers are numerous, there are strong incentives for individuals to exploit their informational advantage at the expense of others, since opportunistic behavior at the expense of the firm only costs the consumer a small fraction of the benefit it brings to him. This implies that it was not consumer ownership itself, but rather the involvement of members, the close relationships among them, and the degree to which they were financially exposed that gave cooperative banks their informational and enforcement advantages. These

factors have largely disappeared, as cooperatives have gained scale, the distance between them and their members has increased, and deposit insurance now limits members' potential losses. Moreover, the comparative disadvantages commercial banks faced have also largely been neutralized, because legal and judicial frameworks now offer much better enforceability of contracts and the availability of verifiable information about potential borrowers has increased.

21. **Cooperatives may still have an edge in identifying and serving consumer needs**. In theory, cooperatives are better able to maximize consumer surplus. Hansmann, for example, notes that inefficiencies may arise from firms seeking to satisfy the preferences of the marginal patron (to maximize sales/profits) rather than those of the average patron (which would maximize consumer surplus). In a cooperative, the one-member one-vote system will lead the firm to seek to satisfy the preferences of the median patron, who is closer to the average patron than the marginal patron is. However, in part because the median voter does not necessarily reflect average preferences, Hart and Moore (1998) find that, for consumers, cooperative ownership becomes less advantageous the more competitive a market is and more so the more uniform the membership base is. However, these theoretical considerations are predicated on the assumption that all relevant decisions are made by the full membership base, or at least by a representative sample of members. The reality is very different (see section on corporate governance). Nevertheless, the fact that a cooperative's clients are also its members and are involved in its decision-making, should provide it with an informational advantage over commercial banks. While size and increasing distance between members and management are likely to reduce this advantage, the remarkably high market shares some cooperative banks have in the market segments they target (e.g., farmers in France) seem to indicate that it remains in place to a significant extent.

22. **Cooperatives have a lower cost of capital**. Cooperative banks only need to remunerate the part of their equity that is represented by member shares (this part is henceforth referred to as the "cooperative capital"), not the often much larger intergenerational endowment (which, in accounting terms, partially appears in the books as reserves). Moreover, cooperatives do not remunerate member shares very generously (see below), and need not do so because in most cases members do not acquire shares in the first place for investment purposes. This lower cost of capital should allow cooperatives to sell their products at below-market prices, or, putting it differently, to incorporate their profits into their products. Nevertheless, pressure has increased on cooperatives to raise their profitability to market levels (see discussion below in the section on financial stability). Moreover, the advantages cooperatives have thus far derived from their lower cost of capital are likely reduced by Basel II, which was introduced in the EU by the Capital Requirements Directive, on January 1, 2007. The reason is that Basel II reduces the level of capital banks need for their retail operations. As a result, the cost of capital will become a less important factor in the overall cost of providing retail financial services (see Mercer Oliver Wyman, 2003).

23. **Cooperatives have entrenched retail market positions and loyal customers, but depend more on those customers than other banks**. Cooperative banks typically have strong retail market positions, especially in their target market segment. Moreover, customer-members can be expected to be more loyal than customers of a commercial bank, since the relationship they have with their cooperative is one that goes beyond a pure bank-client relationship. However, with retail markets becoming increasingly competitive, this loyalty does not imply that members will necessarily do all their banking with their cooperative. They can be members and still shop around for the best deal for individual products. In many cases, however, the cooperatives themselves cannot freely shop around for customers. Many are restricted by statute or law to a specific market segment (e.g., a region or profession). Even in the absence of such restrictions, cooperatives' democratic nature and historic focus on a specific market segment may make it difficult for them to reach out to other market segments. Hence, cooperatives' fate may be linked rather deterministically to the fate of the market segment they were historically set up for, and these market segments are not always flourishing. Commercial banks, on the other hand, face no such restrictions. In particular, they have more flexibility and freedom to selectively target high value added customers.

24. **Extensive branch networks give cooperatives an important, albeit declining, comparative advantage in retail markets**. Cooperatives thank their strong and entrenched retail market positions in part to disproportionately large branch networks. Although rationalizations have occurred, often these have not been as drastic as those of commercial banks and some cooperative banks have expansion strategies that are based on a further buildup of their branch networks. As a result, in many countries the market share of cooperatives, as measured in terms of branch networks, has increased in recent years (Table 1). These branch networks are also typically spread differently than those of commercial banks. In France, for example, commercial bank branches are mainly located in the cities, while those of cooperative banks are to a much greater extent located in the countryside. On the downside, extensive branch networks constitute a large fixed cost, which cannot easily and quickly be reduced during lean times, especially under continental European labor laws and with employees being members of the firm. In a world in which physical presence is becoming less relevant, branches also no longer provide the same degree of comparative advantage as they once did. This point was already made in pre-internet times by Black and Dugger (1981).

Table 1. Cooperative Banks—Market Shares of Branch Networks

(branches of cooperative banks, in percent of total bank branches)

	1994	1997	2000	2003
Austria	…	49.8	50.7	52.6
Finland	37.5	41.0	41.4	40.0
France 1/	57.5	60.8	60.3	59.7
Germany	39.1	39.4	39.6	39.9
Greece	…	0.9	1.6	2.4
Italy	…	27.8	27.5	22.3
Netherlands	…	25.9	40.5	40.3
Portugal	…	10.8	11.5	12.8
Spain	8.7	9.2	10.0	11.3

Sources: OECD – Bank profitability report; and IMF staff calculations
1/ Including savings banks, before and after their conversion to cooperative banks in 2000.

25. **Cooperatives tend to have loyal employees that are close to their customers, but they may have a lower ability to pay market prices for top talent**. Employees who are members of the cooperative that employs them are likely to be relatively loyal. Involvement in decision-making (and the higher degree of job security that this typically entails) may also encourage employees to invest more in firm-specific human capital (Becht et al., 2002). Employees also tend to be close to the cooperative's customers. Juvin (2005) notes that a cooperative's employees and clients "speak the same language". They are people with similar backgrounds and employees often stay in their own region for their entire career. In return for their involvement in decision-making, job security, in many cases a share in the cooperative's profits, and the possibility to have a career in one's own region, employees may accept to work for lower salaries. Employee loyalty also enhances a cooperative's returns on investment in training. Many cooperatives invest significantly in the training of their workforces, in part as a substitute to purchasing external human capital. However, the greater focus on retail activities and typically flatter pay scales than at commercial and investment banks may make it more difficult for cooperative banks, especially smaller ones, to attract top talent. This may be a handicap in developing certain lines of business, such as sophisticated financial market activities. This is one of the reasons why some cooperative groups have opted to conduct such activities through separate joint-stock entities.

26. **A key strength of many cooperatives is their ability to mobilize and retain deposits**. With their large branch networks, loyal customers, and overall strength in retail markets, cooperatives usually have a disproportionate share of retail deposits. This typically results in comfortable levels of liquidity, high deposit-to-loan ratios, and a tendency for cooperatives to be net lenders in interbank markets. Table 2 shows that, as of end-2004, French cooperative networks had lower loan-to-deposit ratios and higher ratios of interbank lending to interbank borrowing than large commercial banks and that all but one of the cooperative networks were net lenders on the interbank market. The table also shows that the

loan-to-deposit ratio of German cooperatives is much lower than that of the banking system as a whole and large commercial banks in particular. As a corollary, German cooperatives tend to be net lenders in interbank markets to a much greater extent than other banks.

Table 2. France and Germany: Loan-to-Deposit Ratios and Interbank Positions

(In percent, unconsolidated basis 1/)

	Interbank lending/ interbank borrowing	Loans/ deposits
Large French commercial banks	64.8	124.1
Caisses d'Epargne	164.1	60.9
Banques Populaires	83.4	113.8
Crédit Mutuel	134.5	100.3
Crédit Agricole	100.6	101.6
All German banks	141.6	122.8
Large German commercial banks	103.3	131.5
German cooperative banks (excluding central banks)	196.1	84.3

Sources: *Commission Bancaire – Analyses Comparatives*, *Deutsche Bundesbank - Monatsbericht*, and staff calculations.
1/ Data are as of end-2004 for France and November-2005 for Germany.

27. **In many cases, cooperatives have a comparative disadvantage in accessing financial markets**. Cooperatives not only have problems raising capital (see further down), they may also be less able to borrow in financial markets. Many small cooperatives lack the expertise and scale to do so, and their retail lending may not always be suitable for securitization, syndication, or central bank refinancing. Toporowski (2002), for example, notes that UK building societies were marginalized by constraints on their ability to raise capital and by commercial banks' ability to generate much higher loan growth through debt issuance in financial markets.[3] However, this comparative disadvantage appears to be lessening, as legal restrictions on cooperatives' financial market activities have mostly disappeared, cooperative networks or integrated groups typically have built up the wherewithal and scale to access financial markets through their apex bodies and/or specialized subsidiaries, and markets for the securitization of retail loans are developing rather rapidly. However, the latter trend is a bit of a double-edged sword for cooperatives. While it provides them increased possibilities to refinance their large loan portfolios, it also reduces the comparative advantage their deposits provide them.

[3] However, UK building societies functioned in a legal context that was much more restrictive than the ones in which most continental cooperative banks operate now.

28. **Cooperatives have a fundamental and increasingly relevant comparative advantage in overcoming problems of opportunistic behavior by banks**. Hansmann argues that consumer ownership of firms can be efficient in situations characterized by problems of "lock-in" (i.e., the inability to leave a long-term relationship at low cost), risks related to long-term contracting (e.g., in life insurance), information asymmetries in favor of the firm, or other factors that give firms significant (ex-post) market power (e.g., a natural monopoly). In such cases, consumer ownership has significant benefits because it reduces the firm's incentives to exploit these advantages. Financial products have become very complex, and financial institutions have enormous resource advantages over their retail customers. This has led to new forms of information asymmetries and ex-post market power of the kinds listed above. Given furthermore that consumer protection laws cannot always be relied upon to fully protect consumers and provide them with cost-effective ways to seek redress, the trustworthiness of institutions has become an essential criterion in consumers' choice of bank. Consumers want to be able to trust the advice their bank gives them and sign documents without (their lawyer) having to read the fine print. The facts that cooperatives are owned by their clients and state publicly that they do not seek to maximize profits give them an edge in portraying trustworthiness. Cooperatives are well aware of this, and many of them point out in their marketing that they are "different". As a result, customers may even be willing to pay a premium for financial products provided by a cooperative bank, because the risks and monitoring costs involved are (presumed) to be less. In sum, and using John Kay's words, cooperatives have a competitive advantage in establishing trust (Kay, 2006). However, an advantage in establishing trust does not alter the fact that trust is easy to lose. Kay observes that when mutual financial institutions become large and pursue growth and diversification, they tend to lose their trust advantage because they start to act as commercial institutions.

E. Outlook

29. **From a lifecycle perspective, most European cooperative banks have reached an advanced level of maturity**. Their original *raison d'être* now has a reduced relevance, because improved legal and institutional frameworks have alleviated the market failures cooperatives overcame and commercial banks now generally cater to a universal clientele. The distance between management and members has increased, in part because the increasing complexity of financial services provision required a professionalization of management. This trend has been reinforced by cooperatives' efforts to reap economies of scale and scope through mergers and through the creation of networks in which decisions are increasingly taken at the center. Many of these networks have turned into large, complex, financial conglomerates that have little in common with the small-scale self-help organizations they descend from.

30. **In this context, a debate has emerged on the question how the European cooperative banking sector should evolve**. Questions regarding the direction of its future have been raised both within and outside the sector (see, for example, Belaisch et al., 2001,

De Bruyn and Ferri, 2004). In some European countries—such as Denmark, Sweden, the U.K., and Belgium—cooperative banks have transformed into commercial banks. However, most cooperative banks seem disinclined to give up their cooperative status. They argue that as cooperatives they continue to provide value to their clients and members, that their ownership form offers specific advantages, and that they contribute importantly to Europe's development, competitiveness and employment policies (EACB, 2004). A new European Cooperative Society (SCE) statute became applicable on August 18, 2006, providing an optional 28th regime (alongside national regimes) that will make transnational cooperatives possible.

31. **The sector's entrenched market positions and comparative advantages are no guarantee for continued success in rapidly evolving markets that require adaptability**. The European banking landscape is changing rapidly. Progressing cross-border integration and new technologies are making markets more competitive and contestable. In this context, cooperatives' branch networks may lose much of their relevance going forward. Moreover, some of the market segments that cooperatives used to focus on are declining in importance, and consumer loyalty and homogeneity are only likely to decrease further. The challenge cooperative banks face going forward is to adapt to these changing circumstances while retaining as much as possible the comparative advantages they have. In this regard, the large fixed costs related to the branch networks and the traditions of employee involvement and job security could pose particular challenges. Further consolidation and integration are seen as necessary by many within the sector (for the case of Germany, for example, see Kotz and Nagel, 2002), not in the least to improve cooperatives' ability to adopt new technologies. However, past experience shows that, in the process, important comparative advantages may be lost, in particular the closeness to customers that was the driving force of cooperatives' success in the past.

III. The Cooperative Banking Sector Today

32. The most important features of the European cooperative banking sector as it is now are its organization in networks and the increasing integration of these networks. This section discusses this trend toward integrated networks, as well as the sector's financial performance.

A. Integrating Networks

33. **Cooperative banks can realize important benefits by forming networks**. Forming networks allows the pursuit of economies of scale and scope, as well as the provision of a safety net or mutual support mechanism that can compensate for the risk concentration an individual cooperative with a homogenous member base faces. Desrochers and Fischer (2005) conduct a cross-country survey on the level of integration of systems of financial cooperatives and its effect on measures of performance. They classify networks into three categories, depending on their level of integration: atomized systems, consensual networks,

and strategic networks. They note that lateral contracts between cooperative partners involve risks that counterparts will behave opportunistically to appropriate the rent generated by the alliance (appropriability hazard, AH). The higher AH is, the higher the need to introduce cooperative adaptation mechanisms and hierarchical features. Moreover, cooperatives face organizational costs in the form of expense preferences, sub-goal pursuit (a risk which increases with increasing diffusion of ownership and, in the case of cooperatives, with the size of the institution) and bounded rationality. By integrating in networks, cooperatives can reduce procurement costs but this requires organizational structures to control AH. However, controlling for AH by (integrating more deeply or) merging increases the risk of expense preferences. They find that (i) integration tends to reduce the volatility of efficiency and performance; (ii) integration appears to help control measures of managers' expense preferences; and (iii) despite the high costs of running hub-like organizations in highly integrated systems, these systems economize in bounded rationality and operate at lower costs than less integrated systems.

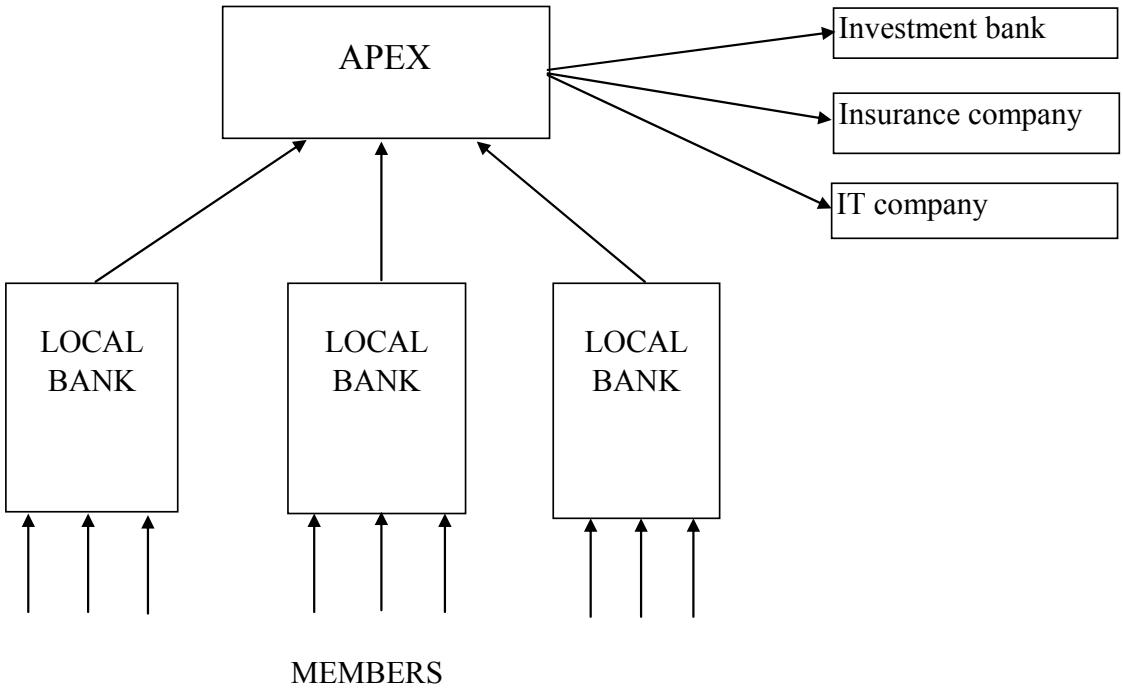
34. **The vast majority of European cooperative banks are organized in such networks, which vary from loose associations to cohesive groups**. These networks can be organized as relatively flat organizations, or as multi-leveled structures including (an) in-between level(s) of regional groups or associations. Di Salvo (2005) distinguishes four models:

- groups that have centralized/concentrated systems at the national level (the Netherlands, Portugal and Finland);
- groups that have centralized/concentrated systems at the regional level (France);
- groups that are legally integrated, but have decentralized systems (Germany and Austria); and
- decentralized systems with voluntary integration (Spain and Italy).

35. **Within these networks, the trend has been towards increasing integration and decision-making being concentrated in the apex**. Di Salvo (2005) notes that the quest for scale economies has led cooperative banks to cede functions and production processes to higher-level organizations, especially since the 1960s. However, this has led to a concentration of power at the higher levels. In some cases, the services provided by these higher levels are rather limited. They may involve advice to members, education and training, and representing members to the outside world, including policymakers. In other networks, the apex organization is a bank itself, which acts as a "central bank" for the member cooperatives. It centralizes excess liquidity, redistributes it, places any remaining surpluses in financial markets, and in many cases even runs a consolidated Asset-Liability Management policy for the group as a whole. Apex organizations further provide IT, product development, marketing and other services in which economies of scale are important. They

also act as holding companies for joint-stock subsidiaries, which often include insurance, asset management, investment banking, and IT firms. A stylized structure of a two-level cooperative network is provided in Figure 1. A discussion of the main features of European cooperative networks is provided by Contamin and Roche (2005).

Figure 1. Stylized Structure of a Two-level Cooperative Network



36. **Mutual support arrangements are important features of these networks**. Many of the networks organize some kind of internal support and/or deposit insurance scheme, which commits members to varying degrees of solidarity. In some highly integrated groups, member banks have a legally binding liability for each others' debts. In Germany, solidarity is institution-based, taking the form of financial support to troubled banks. In loosely integrated networks, internal solidarity may not go beyond a common deposit insurance scheme or a limited central fund for liquidity support. Depending on national legislation, the network's internal support mechanisms can be either a substitute for or a complement to the national deposit insurance scheme for the banking system.

37. **Apex organizations are often involved in supervising the cooperative banks that are members of their network, sometimes supporting the work of national supervisors**. As noted above, controlling for the risk of AH requires the adoption of hierarchical features. Moreover, the existence of mutual support arrangements requires matching disciplining

mechanisms to reduce the risk of moral hazard. The logical location of these hierarchical and disciplinary mechanisms is at the apex. Supervisory authorities have also weighed in. Faced with the challenge of supervising hundreds or even thousands of small cooperative banks, they are in many cases relying on support from the apex organizations. In some important cases, apex organizations have been granted delegated supervisory powers by the prudential authorities. The modalities under which they have done so differ from country to country. In France, for example, delegated supervision by the apex organizations is conducted alongside supervision by the *Commission Bancaire*. In general, delegation of authority also reflects recognition that small cooperative banks do not require the same level of attention from supervisors as large complex banking groups with extensive financial market activities. Some networks are so deeply integrated that the supervisory authorities consider them as a single banking group for prudential purposes, thus in effect considering the relationships between the member cooperatives as equivalent to internal governance mechanisms.

38. **Quite a few of these networks have evolved into large, complex, financial conglomerates, some of which are now among the largest banking groups in Europe**. With increasing centralization of activities and decision-making, many apex organizations have come to resemble the managerial top of an integrated group, a tendency which has only been reinforced by the use of apex organizations to encourage consolidation among member cooperatives, expand the group into new activities, or acquire competing commercial banks. As a result, many of these networks have evolved into de jure or de facto integrated financial groups, three of which are now among the ten biggest banking groups in the euro area, as measured by equity (Table 3: Euro area's ten largest banking groups by equity, December 2005). There is no indication that this trend is about to abate: the German cooperative sector is planning further integration into what may become Germany's largest banking group,[4] and in November 2006, two French cooperative groups merged their investment banking and financial market activities, thus forming one of the euro area's largest banking groups. Cooperative banking groups have also become increasingly active across borders: one Austrian group is now among the largest banking groups in central and eastern Europe and a Dutch group aims to become the world's leading provider of agriculture and food-related banking services.

[4] In February 2006, Fitch granted the German cooperative banking association (*Finanzverbund*) a single consolidated rating.

Table 3: Euro Area: Largest Banking Groups by equity, December 2005

(In millions of euros–cooperative groups marked in bold)

Bank	Equity	Assets
Crédit Agricole	**52,205**	**1,170,349**
Banco Santander Central Hispano	42,556	809,107
BNP Paribas	39,745	1,258,079
UniCredito Italiano	39,275	787,000
Deutsche Bank	29,927	992,161
ABN AMRO	24,947	880,804
Société Générale	24,855	848,417
Rabobank Group	**24,257**	**506,234**
ING Bank	20,736	834,035
Groupe Caisses d'Epargne	**20,181**	**594,132**

Source: Fitch

B. Financial Performance

39. **Comparing the efficiency of cooperative and commercial banks is inherently difficult because both types of institutions pursue different objectives**. Commercial banks seek to maximize their profits, which renders efficiency calculations relatively straightforward. One just needs to compare the profits generated with the inputs used. Cooperative banks, however, pride themselves in the fact that they are not profit maximizers. Instead, their purpose is to maximize their members' consumer surplus, and this may be complemented by additional objectives that seek to contribute to the well-being of stakeholders other than member-consumers (e.g., employees). These objectives are difficult to measure and quantify. Nonetheless, most of the available literature does not consider this fundamental measurement problem and simply compares the financial performance of both types of institutions.

40. **Differences in business models further complicate comparisons of financial performance of cooperative and commercial banks**. Measures of financial performance are not simply comparable across different types of financial institutions, because they are influenced by the business model an institution pursues (for a discussion, see Vittas, 1991). Some business models rely on high leverage ratios to achieve high returns on equity from low returns on assets. Other business models combine high returns on assets with low leverage to arrive at similar returns on equity. Cooperative banks have a business model that is in many ways resource-intensive. It requires significant investment in retail infrastructure and human resources, and therefore comes with a relatively high and inflexible cost base. However, these investments allow the typical cooperative to achieve high returns on assets,

allowing it to be profitable at relatively low leverage ratios. While resource-intensive and not without vulnerabilities, this has in many cases proven to be a viable business model, at least thus far. In sum, to judge cooperatives' financial performance, they need to be compared to peers with a similar business model, i.e., commercial banks with a retail focus. The literature often does not make allowance for these differences in business models.

41. **Cooperatives' lower cost of capital allows them to pursue objectives other than profit maximization**. Under the assumptions that cooperative banks have access to the same production technology as their commercial brethren and that markets are competitive, the lower remuneration their capital requires gives them scope to pursue other objectives. To maximize consumer surplus, they can provide goods and services to customers/members at below-market prices. In the words of Juvin (2005), value added is incorporated in products and services, rather than in profits for shareholders. This does not necessarily need to take the form of lower sticker prices, but could also, for example, materialize in the provision of banking services in remote areas where this cannot be done profitably (at prices customers would be willing to pay). However, if governance mechanisms do not function properly, the scope to pursue other objectives may also be used for less desirable purposes. Such purposes could include not applying the most efficient production technology available, i.e., allowing X-inefficiencies to persist; providing above-market remuneration for management and/or employees, in the form of higher wages, perks, lower working hours, or lower productivity per hour; allocating part of the cooperative's surpluses to parties other than the members; and maintaining unnecessarily high levels of equity. The available evidence does not support the argument that cooperatives remunerate their managers at above-market rates. As mentioned above, the more egalitarian cooperative culture provides a strong counterweight.

42. **Experience in the US shows that consumer ownership of financial institutions does not necessarily lower efficiency**. The US experience provides useful insights, because many Savings and Loans Associations (S&Ls) converted from mutual (i.e., consumer-owned) to investor-owned status during the second half of the 1970s and the 1980s, and because the behavioral and other consequences of these conversions are the subject of an extensive literature. Akella and Greenbaum (1988) find that mutuals tend to expand deposits and loans beyond profit-maximizing levels. Mester (1991) finds evidence of diseconomies of scope at mutual S&Ls. In a later paper (Mester, 1993), she finds that, allowing for different production technologies, investor-owned S&Ls are less efficient than mutual S&Ls. Smith, Cargill and Meyer (1980) and Smith (1984) argue that credit unions can have a borrower or saver orientation, and that this will determine their loan and dividend rates (and therefore also their measured financial performance). Overall, the literature does not indicate overwhelming inefficiencies or agency problems at consumer-owned US financial institutions.

43. **The results of empirical research are consistent with cooperative banks having a specific business model, but do not indicate systematically lower efficiency**. Brunner, Decressin, Hardy and Kudela (2004) find no compelling evidence that cooperative banks in

France, Germany, Italy and Spain are less effective at managing revenues and costs than commercial banks. However, they find poor revenue mobilization at Spanish cooperatives, a mild degree of underperformance among German cooperatives, but also better cost control among Spanish and Italian cooperatives than among their commercial bank peers. Gurtner, Jaeger and Ory (2002) note that French cooperative banks, with the exception of the former savings banks, have better efficiency ratios than their commercial peers, although the latter have cut their costs more significantly in the course of the 1990s. Lower labor productivity at French cooperative banks is matched by lower salaries, which may in part reflect these banks' retail orientation. On the other hand, employees receive a higher share of profits as compensation, which gives them an incentive to improve profitability. Kotz and Nagel (2002) find that, as the banking sector has become increasingly competitive, German cooperative banks have lost market shares and seen their profitability and efficiency decline. Nevertheless, they still have high interest margins and returns on assets compared to other types of banks in Germany. Altunbas, Evans and Molyneux (2001) find little evidence that investor-owned banks in Germany are more efficient than their cooperative and public-sector counterparts, although they do find that the latter have slight cost and profit advantages, which may be due to a lower cost of funds. Valnek (1999) finds that mutual building societies in the U.K. have higher returns and risk-adjusted returns on assets and lower reserves for loan losses than other banks. Overall, these results support the view that cooperatives have a business model that makes intensive use of a relatively low overall level of assets to achieve high rates of return on those assets[5], and that they are mostly successful in implementing this business model. However, the literature does not indicate a systematic "efficiency deficit" at cooperative banks.

44. **OECD data generally confirm the existence of a specific cooperative business model**. The coverage and definitions of the OECD bank profitability data vary between countries, and the data are mostly on an unconsolidated basis[6]. Hence, a commercial bank subsidiary of a cooperative bank is typically classified under commercial banks while its cooperative parent company is classified under cooperative banks. This is especially relevant in interpreting data related to France (for a general discussion on measurement problems with market shares of cooperative banks, see Appendix 1). The data show that cooperative bank market shares, as measured by assets (Table 4), are significant, but below their market shares on other indicators, such as branches (Table 1). Market shares by assets do not show a clear trend. They are declining in some countries but rising in others. The data are consistent with the above-mentioned hypothesis of a specific cooperative business model that relies on the intensive use of assets. This is demonstrated by the ratio of assets to bank branches, which is universally and significantly below the same ratio for the banking system as a whole

[5] Doing so may involve using a relatively high level of real assets, in particular branches. Cooperatives may therefore have a high ratio of real to total assets (see further down).

[6] For a full description of the data, see OECD, 2004, "Bank Profitability – Methodological Country Notes".

(Table 5). Clearly, cooperatives spend more money on branches (and most likely staff and other resources) to manage a given level of assets. This more intensive use of assets results in significantly higher net interest margins on assets (Table 6). The downside, however, is that cooperatives are more dependent on interest income for their profitability (Table 7). Nevertheless, even when including non-interest income, cooperative banks tend to achieve higher returns on assets than other banks (Table 8), although this finding is somewhat less universal than the preceding ones. Finally, with the exception of France, efficiency ratios tend to be somewhat higher on balance, indicating lower efficiency. However, the differences with other banks are typically rather low and not consistent across countries and time (Table 9).

Table 4. Cooperative Banks—Market Shares of Assets

(In percent of total banking system assets)

	1994	1997	2000	2003
Austria	…	29.4	29.5	35.6
Finland	18.5	17.5	16.2	15.9
France 1/	28.4	27.9	28.1	24.1
Germany	14.3	12.4	9.8	10.3
Greece	…	0.2	0.3	0.6
Italy	…	17.0	16.8	14.9
Netherlands	…	21.2	29.0	26.7
Portugal	…	3.5	3.4	3.5
Spain	3.0	3.5	3.7	3.9

Sources: OECD – Bank profitability report; and IMF staff calculations

1/ Including savings banks, before and after their conversion to cooperative banks in 2000

Table 5. Cooperative Banks—Assets per Branch

(In percent of banking system assets per branch)

	1994	1997	2000	2003
Austria	…	58.9	58.1	67.5
Finland	49.2	42.7	39.1	39.8
France 1/	52.2	47.0	46.5	40.4
Germany	36.5	31.4	24.9	25.8
Greece	…	23.9	19.4	26.7
Italy	…	61.3	61.2	67.1
Netherlands	…	81.7	71.6	66.2
Portugal	…	32.4	29.8	27.1
Spain	34.7	38.2	36.8	34.3

Sources: OECD – Bank profitability report; and IMF staff calculations

1/ Including savings banks, before and after their conversion to cooperative banks in 2000

Table 6. Cooperative Banks—Net Interest Income

(In percent of total assets)

	1994	1997	2000	2003
Finland	3.41	3.10	3.47	2.58
France 1/	1.86	1.31	1.26	1.62
Germany	3.16	2.77	2.45	2.53
Spain	4.57	3.88	3.37	3.00
Differences with banking system total				
Finland	1.77	1.32	1.56	1.19
France	0.58	0.46	0.27	0.72
Germany	0.98	1.04	1.14	1.19
Spain	1.51	1.36	1.19	0.89

Sources: OECD – Bank profitability report; and IMF staff calculations
1/ Excluding savings banks before 2000

Table 7. Cooperative Banks—Share of Net Interest Income in Total Income

(In percent)

	1994	1997	2000	2003
Finland	67.77	55.38	63.19	67.65
France 1/	71.47	55.52	54.14	56.61
Germany	81.73	79.76	74.64	73.46
Spain	92.27	88.46	81.78	80.33
Differences with banking system total				
Finland	14.62	0.95	6.38	26.23
France	9.12	8.68	15.03	13.35
Germany	0.95	3.34	10.49	0.53
Spain	13.73	17.70	17.54	10.66

Sources: OECD – Bank profitability report; and IMF staff calculations
1/ Excluding savings banks before 2000

Table 8. Cooperative Banks—Returns on Assets

(In percent)

	1994	1997	2000	2003
Finland	-1.27	0.69	1.50	0.62
France 1/	0.22	0.29	0.36	0.60
Germany	0.31	0.26	0.19	0.26
Spain	1.10	1.22	1.06	0.82
Differences with banking system total				
Finland	-0.05	-0.05	0.50	-0.99
France	0.28	0.10	-0.18	0.14
Germany	0.04	0.03	-0.01	0.36
Spain	0.50	0.47	0.25	0.13

Sources: OECD – Bank profitability report; and IMF staff calculations
1/ Excluding savings banks before 2000

Table 9. Cooperative Banks—Efficiency Ratios

(Operating costs/income, in percent)

	1994	1997	2000	2003
Finland	123.12	82.69	60.94	68.44
France 1/	67.73	66.11	67.24	63.96
Germany	65.92	68.69	72.67	67.72
Spain	61.12	61.62	58.79	60.56
Differences with banking system total				
Finland	-16.77	9.33	4.04	18.36
France	-3.55	-2.67	1.23	-0.04
Germany	5.12	4.59	3.97	-4.84
Spain	1.41	0.18	-2.23	6.26

Sources: OECD – Bank profitability report; and IMF staff calculations
1/ Excluding savings banks before 2000

Table 10. Italy: Selected Bank Performance Indicators

(Averages 2002–04, in percent 1/)

	Banking system	*Banche Popolari*	*Banche di Credito Cooperativo*
Non-performing loans/total loans	6.6	5.5	6.5
Bad debts/total loans	4.6	3.7	3.0
Net interest income / total assets	2.2	2.5	3.2
Gross income / total assets	3.5	3.8	4.1
Share of non-interest income in total income	38.2	35.8	21.8
Operating expenses / Gross income	59.4	59.4	67.8
Loan losses / total assets	0.48	0.44	0.25
Return on equity	7.9	7.6	6.7
Solvency ratio	11.4	10.1	17.8

Sources: Banca d'Italia and staff calculations
1/ The figures exclude a number of banks which do not report income statement data.

45. **The evidence suggests that cooperative banks may be less aggressive in cutting their costs than their commercial peers**. Mercer Oliver Wyman (2003) finds that demutualized building societies in the U.K. significantly decrease their costs-to-assets ratios two years after demutualization, as compared to two years before. However, their analysis does not indicate whether this really reflects improved efficiency (the interpretation provided in the paper) or is merely the mathematical result of faster balance sheet growth after demutualization and a switch to a different business model.[7] Over the past ten years, while

[7] UK building societies face significant restrictions on the types and amounts of assets and liabilities they can take on, and those restrictions fall away with demutualization. This allows a former building society to grow its balance sheet more rapidly, e.g., by issuing debt securities. A bigger balance sheet in itself does not indicate better cost efficiency, though.

French commercial banks have reduced their staff by about five percent, cooperative networks (excluding affiliated commercial banks) have increased theirs by almost 15 percent.[8] On the other hand, cooperative banks' average cost per employee is lower. And while the overall number of bank branches in France has remained broadly stable over the past 20 years, one of the cooperative groups has increased its branch network by more than 50 percent between 1984 and 2004.

46. **There is evidence that cooperatives engage in less risky activities, in part by leveraging their ability to overcome problems of asymmetric information in credit provision**. Analyzing evidence for cooperatives in a large number of countries, Čihák and Hesse (2007) find that cooperative banks are more stable than commercial banks.[9] The Swiss Raiffeisen banks withstood the real estate crisis of the early-1990s much better than other banks, although this may in part reflect the fact that the crisis was concentrated in urban real estate. French cooperative banks suffered less than commercial banks during times of banking stress in the 1980s and 1990s. And Italian credit cooperatives have suffered lower loan losses than other Italian banks in recent years. Gurtner, Jaeger and Ory (2002) argue that lower costs for credit risk are a factor in the better efficiency of French cooperative banks. As a percentage of total assets, provisions tend to be somewhat higher at many cooperatives (Table 11), but this is typically more than explained by the higher ratio of loans to assets.

Table 11. Cooperative Banks—Net Provisions

(In percent of total assets)

	1994	1997	2000	2003
Finland	0.01	0.01	0.26	0.35
France 1/	0.49	0.30	0.21	0.21
Germany	0.61	0.43	0.50	0.59
Spain	0.63	0.23	0.45	0.51
Differences with banking system total				
Finland	0.04	0.00	0.16	0.22
France	-0.08	0.01	0.02	0.02
Germany	0.07	0.09	0.18	0.08
Spain	-0.16	-0.20	0.09	-0.02

Sources: OECD – Bank profitability report; and IMF staff calculations
1/ Excluding savings banks before 2000

[8] See CECEI, Annual report 2004, p. 213.

[9] Čihák and Hesse suggest that the greater stability of cooperative banks may in part be the result of their ability to vary the degree to which they retain (underlying) profits or distribute them in the form of consumer surplus.

IV. GOVERNANCE

This section discusses corporate governance in modern cooperative banks. After a brief introduction, it outlines the basic challenges before discussing the functioning of specific governance mechanisms and complications that present itself in networks. It then looks into governance issues from a cost-benefit perspective before concluding.

A. Introduction

47. **The corporate governance challenge facing modern organizations has two dimensions**. The first is the external dimension caused by the separation between ownership and control of a firm, as identified by Berle and Means (1932). The second dimension is the problem of internal control within a firm, i.e. the need to ensure that the staff implement management's decisions and policies, and act in the best interest of the firm.

48. **Corporate governance challenges in cooperatives have largely escaped attention in the mainstream literature and among policymaking bodies**. While corporate governance issues in commercial enterprises have received ample attention in the literature and media—especially in view of well-publicized corporate scandals in recent years, much less ink has flowed debating issues of corporate governance in cooperative organizations. As noted by Cornforth (2002), the "governance of cooperatives and mutuals is relatively undertheorized." Relevant work by international standard setters and policymaking bodies also does not pay specific attention to cooperatives. Although much of what it says is applicable to unquoted firms, the OECD Principles of Corporate Governance (OECD, 2004) focus on the external governance dimension in publicly-traded companies. The Basel Committee's work on corporate governance (Basel Committee for Banking Supervision, 2005a) focuses on the internal dimension of corporate governance in banks, and the same applies to coverage of corporate governance issues in Basel II (Basel Committee for Banking Supervision, 2005b). For supervisors of cooperative banks, this implies that potential governance risks may escape attention or be misunderstood.

49. **The corporate governance literature typically approaches the external governance problem in a principal-agent framework**. As outlined in Becht, Bolton and Roëll (2002)'s literature overview, the manager is an agent who acts on behalf of principals (employees, shareholders, creditors, suppliers, clients and others). In a shareholder-centered system, the shareholders are seen as the (primary) principals and the fiduciary duty of the managers is to defend their interests. In a stakeholder system, managers are expected to act on behalf of other categories of principals as well. Boards and external auditors act as intermediaries or representatives of the principals. In such a set-up, dispersed shareholdership is a major source of corporate governance problems, due to collective action problems and problems ensuring that the basic interests of all relevant constituencies are represented. Although the literature identifies a number of mechanisms to overcome these problems (see

below), it also points out that many of these mechanisms are of limited effectiveness and/or may create new governance problems.

B. Basic Challenges

50. **Managers of a cooperative bank are custodians of an intergenerational endowment without owners**. Under most European legislations, including the new European Cooperative Society (SCE) statute, members are only entitled to receive the nominal value of their member shares (including any accumulated dividends) when they withdraw their membership or when the cooperative is liquidated. In the latter case, any remaining funds must typically be passed on to another cooperative or be used for charitable purposes. This means that members have no legal claim on the cooperative's net economic value, i.e., the total market value of its assets (including brand, customer base, and such), minus its debts and the nominal value of member shares. As a result, this net economic value has no final owners beyond the cooperative itself. The way cooperatives were designed is such that this net economic value is in essence an owner-less intergenerational endowment that is available for use by current members, under the implicit or explicit understanding that they will grow it further and pass it on to the next generation of members. The managers of a cooperative have direct control over this endowment and can therefore be seen as its custodians.

51. **Managers need to look after the interests of various constituencies of stakeholders**. While current members share some characteristics of shareholders in a joint-stock company, the founding fathers of the cooperative movement clearly had much broader intentions than letting cooperatives maximize "current member value". In part by limiting members' ownership rights, they designed the cooperative ownership form to achieve certain social objectives and benefit an entire class of people. In a sense, a cooperative is a bit of a hybrid between a company and a foundation. This implies, among other things, that the cooperative concept is based on a "stakeholder" view of the world in which managers, as agents, need to reconcile the interests of various constituencies of principals. However, there are two important complications.

52. **There is significant overlap between the different constituencies**. Members have certain ownership rights, but are also the cooperative's clients, depositors, and borrowers. In most cases, employees are members as well. This may facilitate decision-making when the interests of these different constituencies align, but may complicate it in the inevitable instances when they do not. To better manage some of these conflicting interests, UK building societies explicitly distinguish borrowing members from non-borrowing ones.

53. **Some of the stakeholders are hard to identify and impossible to involve in the cooperative's governance's mechanisms**. The "intergenerational endowment" nature of a cooperative's net economic value implies that all potential members, including future generations of potential members, are stakeholders of the cooperative. These potential

members are often defined by a specific "common bond," in essence a precondition for membership. The common bond can be residency in a specific town or region, a common employer, or a profession, among other things. However, in many modern cooperatives, there is no clearly defined common bond. As agents, managers should be concerned about the interests of these absent principals, which may require them to weigh the interests of future members against those of current members. However, it is quite a challenge for any governance system to ensure that the interests of absent stakeholders are given sufficient weight.

54. **Cooperatives' basic governance mechanisms were designed for small groups of people within close-knit communities, but are now being applied to large conglomerates**. Just like political democracy could not be applied in the same way in large nation-states as in Greek city-states, cooperatives' democratic governance mechanisms face problems of applicability at different scales. At present, it is by no means clear that they have been adapted to function well at the scale that many modern cooperative banks have achieved. In particular, collective action challenges appear daunting in large cooperatives.

55. **Market forces play a lesser role in fostering good governance in cooperative banks than in joint stock corporations**. Fama (1980) argues that a firm can be seen as a collection of factors of production, each facing market discipline from their own factor market. The factor shareholders contribute is risk-sharing, and since they can diversify their portfolio over many different firms, they may not be willing to engage in the management of individual firms. In this view, management discipline is provided primarily through the market for management talent and by shareholders' ability to express their views on the quality of management through the market for risk-bearing (capital markets). In cooperatives, however, such market discipline functions much less freely. The market for cooperative managerial talent is much less active and money-driven than its commercial equivalent. In addition, membership typically involves little financial risk, a member's relationship with the cooperative is much broader and complex than a simple investment, and members may face conflicting interests when they are also depositors and/or borrowers. Hence, membership withdrawals are unlikely to be as effective a disciplining mechanism as sales of shares by shareholders in a listed company. Not only as risk-bearers, but also as clients, members are often more loyal than clients of commercial banks. Finally, members that are also employees may face a reduced risk of being subjected to market discipline, especially in the context of European labor markets.

56. **Price signals and market monitoring are normally absent for individual small cooperatives, but cooperative groups and large cooperatives can seek market exposure**. The immediate feedback and disciplining effects created by a market price and the daily monitoring that comes with public listings (by analysts, media and institutional investors) are normally missing in cooperative banks. However, larger cooperatives or networks of cooperatives can subject themselves to similar market discipline by issuing publicly-traded debt securities, through borrowing in interbank markets, or (more indirectly) by listing the

shares of a joint-stock subsidiary, and many have done so.[10] Most large cooperative banking groups in Europe have issued at least some sort of publicly-traded securities, are active in interbank markets, and have obtained ratings from rating agencies. As a result, many large cooperatives and, in some cases networks, are regularly reviewed by rating agencies, which is another disciplining device.

57. **Lower financial reporting and disclosure standards may exacerbate information asymmetries in favor of managers**. The lack of a listing on a regulated market means that the disclosure requirements that typically come with such a listing do not apply to cooperatives. Legal and statutory requirements are also often less stringent for cooperatives than for other companies. On the other hand, by seeking access to financial markets, many large cooperative groups have subjected themselves to the rather strict reporting and disclosure standards that this requires. This disclosure may only apply to parts of the group, though, and information about the consolidated financial situation of the entire group often remains difficult to obtain.

58. **Prudential authorities are important stakeholders and play a significant role in corporate governance**. To some extent, prudential supervision can compensate for deficiencies in the corporate governance mechanisms of banks. However, this risks creating a circular problem, in the sense that bank shareholders or members may rely on supervisors to monitor managers and become complacent about corporate governance issues, while supervisors increasingly rely on market discipline (exerted by a bank's owners). The third pillar under Basel II formalizes this reliance on market discipline.

C. Governance Mechanisms in Cooperatives

The literature (e.g., Becht, Bolton and Boël, 2002) identifies a number of mechanisms that can help overcome external governance problems. This subsection investigates how some of these mechanisms function in cooperative banks. It starts with a discussion of the basic governance mechanism used in most organizations, an elected board of directors, before moving on to more specific complementary mechanisms.

Basic mechanism: election of a board that represents members' interests

59. **Alongside the general weaknesses of the elected-board-based governance mechanism, there are specific challenges in cooperatives**. Becht et al. (2002) note that among the deficiencies of this mechanism are the problem of "who monitors the monitor" and the risk of collusion between the agent and the delegated monitor. They conclude that boards are rarely sufficiently independent from management. Regarding cooperatives, there is a literature discussing member participation at annual meetings, board elections, and the

[10] Italian *banche popolari* can even list their member shares.

functioning of boards (among others, Cornforth (2004), Lees (1995), Lees and Volkers (1996), Silvertsen (1996), and Spear (2004)) upon which the discussion below draws.

60. **Boards may have limited democratic legitimacy and be biased in favor of specific constituencies**. Consistent with their democratic principles, boards in cooperatives are elected on a one-member/one-vote basis. This implies that, in mature and large cooperatives, members have few incentives to vote. Voting may require a degree of effort (e.g., physical presence at the annual meeting) that is disproportionate to the influence a single vote buys. The same problem affects small shareholders in commercial companies. However, large shareholders in commercial companies can aspire to having some influence and have more incentives to exert that influence. Small shareholders may free-ride on their efforts, calculating that the interests of all shareholders (maximization of shareholder value) are aligned anyway. In cooperatives, different constituencies of members have different interests, depending on the nature of their relationship with the cooperative. Hence, although all members have an equal vote at the annual meeting, members with special or disproportionate interests in the policies of the cooperative have more incentives to put up the efforts needed to attend—and vote at—the annual meetings. Member-employees are one such special interest group. If employees tend to be disproportionately present at annual meetings, a cooperative bank may start to resemble a worker cooperative rather than a consumer cooperative. (Large) borrowers constitute another such interest group, raising the possibility that limited attendance at annual meetings may result in borrower interests weighing disproportionately on the cooperative's policies. In small communities, local politicians can often use their connections and ability to influence large numbers of people to obtain disproportionate power in local cooperatives, turning them into semi-public financial institutions. Finally, there is a possibility that groups with specific ideological or other objectives may be overrepresented at annual meetings.

61. **Member participation and attendance at annual meetings varies significantly, depending on the efforts undertaken by managers and boards.** Many cooperative banks have vibrant member participation and well-attended annual meetings (see, for example, Juvin, 2005). This is especially the case for smaller cooperatives that are still closely connected to their base. However, there is also evidence that member participation in cooperatives (financial or other) is often very limited. Spear (2004) shows that member participation in board elections of UK consumer cooperatives was below one percent in most cases and between one and five percent overall, with larger and older organizations tending to have lower participation levels. McKillop et al. (2002) find average member participation of two percent in the annual meetings of Irish credit unions. According to representatives of the cooperative banking sector, typical participation rates for European cooperative banks are in the five to eight percent range, which implies large absolute numbers of participants.

62. **It may be difficult for members to influence decisions at the annual meetings.** Information asymmetries, procedures, and practical difficulties for members to organize themselves without the cooperation of management may make it difficult for them to

challenge management. When applicable, proxy votes tend to be given overwhelmingly to the chairperson (Spear, 2004). As a result, uncontested board elections are often the norm. While similar problems exist in commercial companies, they are likely to be more daunting in cooperatives, in part because of the absence of large shareholders.

63. **Adverse selection problems not only affect attendance at annual meetings, but also the (self-)selection of candidates for board membership**. The factors that determine the incentives members face in deciding whether to attend the annual meeting also affect their incentives in deciding whether to volunteer for a position on the board. Moreover, just as in commercial companies, management often has the ability to propose candidates of their own choosing (Pflimlin, 1996). In many cooperatives, members simply vote on a board composition that is proposed to them by management (Gurtner, Jaeger and Ory, 2002).

64. **Lay board members may lack the ability to effectively supervise senior managers**. Whereas board members in commercial companies tend to be selected from within the business community and thus have extensive business experience, knowledge, and networks, in cooperatives many board members are laypeople without the necessary background to effectively support and question management. As a result, boards tend to become passive receivers of information and the organization tends to become management-driven (Silvertsen, 1996). The increasingly complex activities cooperative banks are engaging in exacerbate this problem.

65. **The cooperative may lack scope to pursue certain objectives through board member selection**. The constraints on the selection of board members (who must typically come from within the membership) imply that cooperatives have less ability to use their boards as a tool to create external links with other organizations (Cornforth, 2004). In some cooperatives this effect is mitigated by the board's ability to co-opt external members.

66. **Management performance is harder to measure and monitor**. Because cooperatives tend to pursue a diversity of goals and managers have to look after the interests of different constituencies, there is no simple quantitative gauge of management performance (such as profits) in cooperatives. As a result, boards may have difficulties accurately assessing and monitoring this performance.

67. **Cooperatives, especially smaller ones, may have problems attracting sufficient managerial talent**. Small cooperatives in which democratic processes work well and personal involvement of members is high may end up with crucial management jobs being undertaken by non-professionals. Cooperatives that hire professional managers may have difficulties attracting good quality managers if their remuneration policies do not allow them to pay market rates. The fact that cooperatives cannot offer stock-based compensation plans may be a handicap in this regard. Cooperatives frequently seek to overcome these challenges by offering training and education to managers, both as a means to raise the quality of management and as an incentive.

Specific mechanisms

The literature identifies a number of specific governance mechanisms that can support the effectiveness of the board-based governance system. This section discusses the functioning in cooperatives of five of these mechanisms, namely, the market for corporate control, blockholders, delegated monitoring, executive compensation contracts designed to align the interests of managers and shareholders, and lawsuits. The discussion is focused on stand-alone cooperatives. Additional considerations that apply within networks are discussed in the next section.

68. **The market for corporate control cannot function in the case of cooperatives**. The non-transferability of cooperative shares precludes the possibility of a hostile takeover bid and therefore the disciplining effect this possibility may exert. Joint-stock subsidiaries of cooperatives could in theory be subject to hostile takeover bids, but in practice this possibility is typically precluded by the cooperative parent(s) holding a majority stake. However, Becht et al. (2002) note that the market for corporate control often does not work and may in any case be undesirably disruptive. Adams and Mehran (2003) note that the market for corporate control rarely works for banks.

69. **Blockholders do not exist**. In many countries, blockholders are the dominant form of corporate governance arrangement in commercial companies. Blockholders are large shareholders, who have the resources, incentives and voting power to actively and continuously monitor managers. Small shareholders may choose to rely on these blockholders to defend the interest of all shareholders. However, blockholders are often primarily concerned with their own interests. If they pursue these interests at the expense of those of smaller shareholders, the governance challenge is simply transformed rather than resolved.

70. **Delegated monitoring can work, but is often absent**. Delegated monitoring refers to the monitoring of managerial performance by third parties such as institutional investors and large creditors. While there is no reason why this could not work for cooperatives, in practice there is often no abundance of potential delegated monitors (abstracting from prudential authorities, see above). Many cooperatives are highly liquid and therefore do not need to borrow from third parties, and the membership/investor base typically does not include institutional investors. On the other hand, as noted above, quite a few European cooperatives have sought financial market exposure and accepted the delegated monitoring that this implied.

71. **Executive compensation contracts may be more difficult to bring in line with member interests**. Executive compensation contracts that are designed to align managers' interests with those of shareholders have long been used as a corporate governance mechanism in commercial enterprises, with results that have not always generated universal enthusiasm (for a critical assessment, see Bebchuck, Fried, and Walker, 2001). For

cooperatives, however, designing such contracts faces a number of difficulties. Stock-based compensation plans are generally not possible, and the cooperative ideals and culture are unlikely to tolerate monetary incentives at anything near the scale of what has become customary in the commercial sector. More fundamentally, the breadth, diversity and measurement challenges of "member interests" make the design of such contracts difficult. Nonetheless, it should be possible to design compensation contracts that include variable compensation in function of managers' success in realizing well-defined and measurable objectives considered crucial for the success of the cooperative.

72. **Member lawsuits are unlikely to serve as a disciplining mechanism**. The combination of clearly defined fiduciary duties and the threat of lawsuits to enforce them is an important governance mechanism in the US context (Becht et al., 2002), albeit one that is not without disadvantages and is of questionable net benefit to shareholders. However, it is generally less applicable in Europe and would have to overcome daunting collective action problems in the context of a cooperative. For a typical member, joining a lawsuit is not a cost-effective undertaking, given the limited financial investment that is at stake, the costs involved, and the low expected value of any compensation that might be granted. Only members with special interests may have sufficient incentives to engage in a lawsuit, and in doing so they may not seek to let the general interest of members prevail.

D. Governance in Networks of Cooperatives

73. **Membership of a network may significantly reduce corporate governance risks at the level of individual cooperatives**. Several of the corporate governance mechanisms discussed above work better within networks. Within a network, there are two kinds of delegated monitors. First, the apex organization often has explicit responsibility and significant powers to monitor member cooperatives. Second, peer pressure within networks plays a significant and probably mostly positive role in ensuring good practices in the management of individual cooperatives. Moreover, within a network, there is often some sort of internal market for corporate control, in the sense that poorly performing cooperatives are likely to be "encouraged" to merge with better performing ones, leaving management of the latter in charge. There is an important downside to this market for corporate control, though, because such mergers may weaken the strong performers. As noted above, Desrochers and Fischer (2005) find evidence of a reduction in governance costs as a result of integration in networks.

74. **For cooperative networks as a whole, corporate governance challenges become significantly more complex**. Managers and board members of local and regional banks in hierarchical networks face conflicting forces. As shareholders of the apex entities, they are supposed to ensure that the actions of the apex are in the best interest of the membership base, in other words to make external governance work. However, depending on the degree of integration within the network, they also function within the group's internal governance mechanisms, which have the apex at the top. As a result, their future career prospects and the

degree to which their bank can prosper may depend on maintaining a good relationship with the managers at the apex. The (delegated) supervisory functions that the apex performs over regional and local banks may further affect the willingness of mid- and lower-level managers/board members to challenge the apex. In effect, their position merges aspects of being employees within a hierarchical organization headed by the apex, being bankers facing prudential supervision from the apex, and being shareholders of the apex. Facing these conflicting forces, the latter role may not always receive appropriate prioritization. Pflimlin (1996) provides a view from the trenches on how governance mechanisms work in cooperative groups.

75. **The interference between top-down and bottom-up governance mechanisms in hierarchical networks may affect the coherence and stability of such groups**. As noted above, the ability of managers and board members to exert effective shareholder control over the apex is questionable. Depending on specific governance mechanisms and dynamics within groups, risks also exist in the other direction. Apex organizations may have a reduced degree of control over middle and local levels, in comparison with hierarchical commercial organizations. Parts of the group may retain a significant degree of independence that allows them to act in ways that affect the stability and performance of the group as a whole. This risk is likely to be higher in networks that are characterized by large differences in size between the member banks. Large member banks may not be willing to give up a degree of autonomy that would be optimal for the network as a whole and for small banks.

76. **Conflicting interests and priorities may test the interplay between top-down and bottom-up governance mechanisms**. Di Salvo (2005) notes that there is a risk of divergence of interests in multilayered cooperative groups, and this risk may increase in function of the distance between management and the member base and with the number of relevant stakeholders. However, mechanisms can be put in place to reduce these risks (e.g., direct consultation mechanisms between the member base and central management). Juvin (2005) notes that an institutional conflict is at the heart of a cooperative banking group, between the retail side (i.e., local cooperatives) and the production side (i.e., the center). The former ask for high quality and low prices, the latter for profitable volume. In some networks, retail banks are allowed to sell competing products to their clients, rather than or alongside the ones produced by their own central institutions.

77. **Cooperative banking groups adopting a hybrid nature may change fundamentally**. Putting an important part of a cooperative group's activities in a listed subsidiary may affect the behavior and nature of the group in fundamental ways. Kaplan de Drimer (1997) argues that the involvement of outside (non-user) investors in a cooperative risks subverting their cooperative nature by giving undue participation and influence to external elements at the expense of the general interest of user-members. It also risks increasing managers' and other administrators' powers, as they may ally themselves with the outside investors. One could add that the pressure of daily variations in the share price and certain forms of performance-based pay schemes make such an outcome more likely.

E. A Cost-benefit Perspective

Another way of investigating corporate governance challenges is to look at the incentives the different actors face. It should be particularly enlightening to investigate what incentives principals face in their oversight of agents. This section attempts to do so by looking at governance through the prism of a cost-benefit analysis, as seen from the perspective of members.

78. **Governance costs come in various forms**. Hansmann (1996) identifies three broad categories of ownership/governance costs: agency costs, which consist of costs related to monitoring management and the costs of managerial opportunism; costs of collective decision-making; and costs of risk-bearing. In the long run, he argues that successful organizations are those that manage to minimize these costs. The discussion below applies Hansmann's conceptual framework, but regroups the cost categories under two headings: costs of making governance mechanisms work effectively (costs of monitoring management and costs of collective decision-making) and costs that may materialize when they do not work effectively (costs of managerial opportunism and costs of risk-bearing). The discussion also explicitly considers some negative costs (benefits).

Costs and benefits related to effective governance mechanisms

Monitoring costs

79. **The dispersed ownership that characterizes cooperatives increases monitoring costs, thus reducing incentives for members to engage in effective monitoring**. For a given level of effectiveness, monitoring costs increase due to duplication, as compared to commercial companies with more concentrated ownership. Moreover, because efforts by an individual owner have the character of a public good for others and because the effectiveness of an individual member's efforts is likely to be very limited, it is rational for members of large cooperatives to refrain from undertaking thorough monitoring.

Costs and benefits of collective decision-making

80. Hansmann defines costs of collective decision-making as those that result from heterogeneity of interests among the owners. He identifies four forms:

- **Costly decisions**: are decisions that are inefficient in the sense of not maximizing the welfare of members as a group. In cooperatives, such inefficient decisions can arise because the median member, whose preferences tend to determine the outcome of a vote, has different preferences from the weighted average member (with the weights being the interest each member has in the decision). For example, in a cooperative in which 60 percent of members are depositors and 40 percent are borrowers, the depositors could systematically vote for policies that maximize their gains, rather than for policies that would maximize the combined gains of both depositors and

borrowers. Costly decisions can also be the result of a minority gaining control over the political process and pursuing its own interests rather than the interests of members as a group. As discussed above, this is a genuine risk in cooperatives, given the low incentives for members to get involved in their governance.

- **Costly process**: among the costs of the collective choice process, Hansmann identifies the time and effort required from owners to make decisions and the possibility of voting cycles. One could add to that the opportunity costs that may be generated by lengthy decision-making processes: business opportunities may be lost or problems that are damaging the firm or threatening its survival may be left unaddressed. In cooperatives, such costs may be substantial, especially when the annual meeting takes place only once per year. On the other hand, the costs of decision-making processes is contained to a significant extent by the degree to which powers are delegated to the board and management. In large networks of cooperatives, the situation for the network as a whole becomes more difficult and processes may be even more costly, though.

- **Resolving conflicts**: the resolution of conflicts among different (constituencies of) members can take a long time or even be impossible, unless there are very specific rules for doing so.

81. **Benefits of participation**: collective decision-making also has important benefits. In many situations, it can produce better and better informed decisions that will be implemented with more zeal by everyone involved. In cooperative banks, consumer participation in decision-making can be a great strength if it assures that the cooperative's policies and products are kept in tune with the (perhaps rapidly evolving) needs of members. As discussed above, the involvement of member-employees in decision-making also provides significant benefits.

Costs that may materialize when governance is not effective

Costs of managerial opportunism

82. **The costs of managerial opportunism can come in various forms, some of which are especially relevant in cooperatives**. In Hansmann's conceptual framework, the costs of managerial opportunism are those that result from failure to monitor managers with perfect effectiveness. Such costs can range from outright theft to the foregone benefits that would have been possible with a more competent or harder working management team. While the risk of criminal prosecution is likely to put limits on managerial opportunism, a wide range of possibilities exist for managers to take advantage of their position without significant risk of prosecution. The nature of cooperatives, and in particular the existence of their owner-less endowment, renders a number of risks especially relevant:

- **Managers could pursue interests other than the general interest of members**. Such interests could be those of a particular constituency of members, public policy interests, or the interests of outside parties that are in one way or another connected to the managers. In hybrid groups, there is a risk that managers may favor the interests of listed subsidiaries of the group over those of the group as a whole and its membership.

- **A growing endowment gives management the temptation and resources to engage in empire-building**. Hansmann points out that one form of managerial opportunism is the risk of excessive retention of earnings, which is encouraged by managers' desire to retain or build their empire. As noted above, most cooperatives have a built-in tendency to retain the bulk of their earnings. Managers do not normally have an incentive to change this. Instead, they are more likely to seek to expand the cooperative's business beyond what is in the best interest of members. In doing so, they may engage the cooperative into ventures that are undesirably risky from the membership's point of view. The risks related to empire-building are discussed more in detail in the next section, on financial stability.

- **Managers may seek, or fail to prevent, appropriation of (part of) the cooperative's intergenerational endowment**. Enjolras (2000) notes that the main source of inefficiency in non-profit organizations appears to stem from the private appropriation of collective resources by a minority of stakeholders. There are various ways in which managers can appropriate the collective resources of a cooperative, in particular (the fruits of) its intergenerational endowment. A particular risk in hybrid cooperative groups is that the endowment is put at the disproportionate disposal of outside investors. However, above all, there is a risk that managers may seek or support demutualization, regardless of whether this is in the best interest of members.

Demutualization

83. **A decision regarding demutualization is inevitably affected by the potentially large gains it may give to various constituencies**. Demutualization refers to the process of converting a cooperative to an investor-owned for-profit company, usually a listed joint-stock company. While demutualization can be value-creating if it allows a former cooperative to grow faster and become more profitable, it typically amounts primarily to a redistribution of wealth, mainly at the expense of past and future generations of members.

- **In most cases, demutualization amounts to the appropriation of a cooperative's intergenerational endowment by its members at the time of the operation**. Simply converting from a cooperative to a joint-stock company status and exchanging member shares for shares in the joint-stock company amounts to a significant extension of members' ownership rights, from the nominal value of cooperative shares to the full market value of the cooperative's net assets.

- **Members also face costs, though, as they lose the future benefits the cooperative would have provided them as members and consumers**. Davis (2001) argues that demutualization is much more favorable to older members than to younger members, because the value of future benefits offered by the cooperative is much higher for the latter. As a result, under a democratic voting system, the survivability of a cooperative depends on a majority of its members being below the "preference switching" age. In the model that he presents, conditions that are conducive to survival are a large competitive advantage (i.e., achieving a higher real rate of return than competing banks), a long membership tenure, and a low growth rate of reserves (i.e., the competitive advantage should be largely disbursed to members in one form or another, instead of being kept as retained earnings). Davis also notes that high capital adequacy requirements may encourage demutualization, by increasing the size of the retained reserves.

- **For managers, demutualization typically implies an upward trend break in their remuneration and wealth**. Managers at listed joint-stock companies are usually significantly better paid than those at cooperatives of similar size and profitability. At the time of demutualization, managers typically receive a new remuneration scheme and in many cases also grants of shares and/or stock options. The weaker the cooperative's governance mechanisms, the more generous this package is likely to be. Shiwakoti (2005) finds that demutualization of building societies in the U.K. appears to have led to faster growth in management compensation without commensurate improvement in management performance.

- **Demutualization attracts speculators**. In UK building societies, membership requires nothing more than the opening of an account and the maintenance of a token minimum amount in that account. During the demutualizations of the 1990s, thousands of speculators opened accounts with building societies that they saw as likely candidates for demutualization (mainly the larger ones). As new members, they often helped tilt the balance in favor of demutualization.

84. **The constituency that loses most—future generations of members—is not involved in the decision-making process, creating a bias in favor of demutualization**. Unless managers and current members altruistically defend the interests of future members, these interests are likely to be ignored.

85. **Governments have felt compelled to act in defense of future generations of shareholders, often in relatively heavy-handed ways**. The ethical questions surrounding demutualization have contributed to very restrictive legal frameworks in many countries, often making demutualization all but impossible. In the U.K., the widespread speculation ("carpetbagging") that characterized the demutualizations of building societies in the 1990s and its perceived injustice led to a backlash that included amendments to the Building Societies Act and to building societies' statutes. These amendments made demutualization

more difficult and less profitable for (recent) members (Pedelty, 1999). French law and the new SCE statute stipulate that, in case of demutualization, a cooperative's reserves need to be transferred to another cooperative or used for purposes of general interest. The new SCE legislation also does not contain any provisions allowing for direct conversion to a for-profit company. It only provides mechanisms for winding up an SCE or for converting it into a cooperative under the national legislation of one of the member states.

86. **Evidence that demutualizations are beneficial to consumers is far from overwhelming**. Drake and Simper (2003) find evidence that demutualization improves efficiency, financial performance and technological innovation, but they also find that the UK banking market has become less rather than more competitive since demutualization. Ashton and Letza (2003) find that mutual building societies provide savers higher rates of return than proprietary firms and demutualized former building societies. Marshall et al. (1997) find that demutualization has led to branch closures in poorer areas.

87. **Demutualization can happen by stealth, which avoids a lot of the controversy but raises different questions**. Cooperatives can put their activities in a joint-stock subsidiary and sell shares in this subsidiary or merge it with another company. As a result, the cooperative can eventually end up becoming a minority shareholder in its former business. The problems with this form of demutualization are that governance issues may persist, the cooperative holding company may have a hard time justifying its continued existence and retaining its members (since it no longer delivers any services) and good-quality managers (who do not have much to do), and investors in the joint-stock company may resent the power the cooperative can exercise as large or dominant shareholder.

88. **Institutional reforms may reduce the incentives for demutualization**. On the basis of a review of the literature on demutualizations in the US, Chaddad and Cook (2004) conclude that future waves of demutualizations could be prevented if institutional innovation could address the two main structural weaknesses of cooperatives, namely governance and access to capital.

Costs and benefits of risk-bearing

89. **Members of a cooperative typically bear little risk, which has upsides and downsides**. Hansmann points out that the costs of ownership also include costs related to the right to residual earnings, in particular the costs of bearing risks associated with the enterprise. In this area, cooperatives are in a very particular situation, because these risks are borne in the first instance by the cooperative's intergenerational endowment. Members of cooperatives often also do not receive high rates of remuneration on their investment, as profits are in part added to the endowment. In sum, members do not face much risk—downside or upside—because of the buffer function provided by the endowment.

90. **In some countries, members carry risks beyond their membership contribution**. In Switzerland and Germany, members of cooperative banks are personally liable for losses,

subject to a limit that exceeds the value of their member shares. It is not clear, though, that this liability can be called upon in practice.

F. Balance of Governance Considerations

91. **On balance, the incentives for management to take advantage of governance weaknesses do not seem matched by incentives for members to make governance mechanisms work**. With no ownership rights over the cooperative's intergenerational endowment and low costs of risk-bearing, members face few incentives to undertake costly efforts to participate in governance mechanisms that are in many cases ineffective and characterized by a public-good nature. For managers, though, the presence of this endowment provides incentives to exploit corporate governance weaknesses in order to build empires or appropriate part of the endowment.

92. **Competitive markets exert a disciplining effect on a cooperative but also reduce the incentives for members to participate in its governance**. The more competitive a market is, the less consumer surplus there is likely to be gained from participating in the governance mechanisms of a cooperative. It is often simply much more cost-effective to go buy from the competition. Although banking tends to be an oligopolistic market that is at times characterized by rather high profit margins, in many cases there is not enough to be gained for a member of a cooperative from seeking active involvement in its governance.

93. **Governance challenges have led to the demise of quite a few cooperatives, although many others have prospered**. The governance challenges discussed above have manifested themselves throughout the history of cooperative banks in Europe (see, for example, Pedelty, 1999).[11] However, the success and longevity of many cooperative banks indicates clearly that these challenges are not insurmountable.

94. **Even more than is the case for commercial organizations, the success or failure of cooperatives may depend on the people who run them**. Many cooperatives are run by managers who genuinely want the best for their firm and derive satisfaction from generating benefits for members and employees. Such non-monetary drivers of motivation are usually not captured in theoretical models based on the assumption that people seek to maximize their own income/consumption. In this regard, Hansmann (1996) notes that pride and moral suasion provide important motivation to managers to work for the best interest of their firm, and that many organizations have thrived without (effective oversight by) owners. Given this, difficulties for owners to exercise direct control may "only result in a modest amount of organizational slack, at least when compared with any realistic alternative." Juvin (2005)

[11] For example, the Irish Registrar for Credit Unions noted in his 2004 Annual Report that "Poor governance standards or management disputes have, in general, been the fundamental cause of crises in the credit unions that came to our attention."

remarks that social standing and an elevated feeling of utility can be seen as part of the "remuneration package" of managers of cooperatives. Chaves and Sajardo-Moreno (2004) emphasize the importance of selecting a specific type of managers, which they label "Social Economy Managers," rather than "Business School Managers."

V. Cooperatives and Financial Stability

95. **Prudential authorities need to be conscious of the specific risks cooperative banks face, as well as of the potential impact they may have on the banking system as a whole**. The most important of these specific risks are related to the combination of the governance challenges and the constraints cooperatives face in managing their capital.

A. The Experience Thus Far

96. **Cooperative banks generally have lower incentives to take on risks, and this seems to be confirmed by experience**. The lack of a need to maximize profits and the absence of many of the factors that lead rational managers in joint-stock banks to adopt short-term horizons (see Rajan, 1994) means that cooperative banks have lower incentives to take on risk[12]. Much of the available evidence is consistent with this prior. During the US savings and loans crisis, investor-owned S&Ls fared much worse than mutual S&Ls, because they had tended to pursue more speculative investment policies (Hansmann, 1996). Hansmann concludes that, in general, investor-owned banks are much more willing to speculate with depositors' funds. Chaddad and Cook (2004) also find that demutualized financial institutions have adopted riskier strategies. Cooperative banks in France and Switzerland fared generally better than commercial banks during the banking problems of the early 1990s. Gurtner, Jaeger and Ory (2002) note that cooperatives typically have more risk-averse clients, who may prefer member shares in a cooperative over more risky assets such as stocks in joint-stock companies. However, it is also possible that members underestimate the risk they expose themselves to.

97. **Cooperative banks may be more vulnerable to certain shocks, including credit quality and interest rate developments, but possibilities to manage these vulnerabilities are increasing**. Old-fashioned intermediation is cooperatives' core business. Hence, while they may still have a bit of an edge in managing credit risk, cooperative banks typically have a lot of such risk. Moreover, the credit risks they face tend to be correlated with each other due to cooperatives' focus on a usually in at least some ways homogenous member base. As noted above, cooperatives' business model also relies more on one particular source of revenues (the interest margin), which is likely to imply higher vulnerability to interest rate

[12] Following Rajan's analysis, longer managerial horizons could have externalities in the sense of cooperative banks being less prone to procyclical bank behavior that may exacerbate business cycles.

developments. Overall, while cooperative banks may generally be stable (see Čihák and Hesse, 2007), they do tend to be vulnerable to certain types of instability. The Spanish cooperative banking sector suffered a significant shake-out and the demise of its central institution during the banking crisis of the 1980s. Swedish cooperatives suffered significant losses during the banking crisis of the early-1990s. Portuguese cooperatives have had persistent problems with nonperforming loans, and financial problems have occurred at smaller cooperatives in several European countries in recent years. However, developments in financial markets, in particular the increased opportunities to hedge against interest rate risk and securitize loan portfolios, should allow cooperatives to reduce and better manage the risks they face.

98. **Cooperative banks may have more difficulties adjusting to adverse circumstances and changing risks**. The Swedish cooperative banking sector did not survive the crisis of the early 1990s in a cooperative form, and the need to restore capital was a major factor in the decision to demutualize (see Brunner, Decressin, Hardy and Kudela, 2004). A cooperative's typical business model comes with a relatively high fixed cost base. With employees involved in decision-making, it may be hard to cut these costs quickly when needed. On the positive side, employees-members may be more loyal and motivated, and therefore more determined to pull the firm through times of hardship rather than abandon it. Cooperatives' business and depositors are also more stable, allowing them to thrive with a higher (fixed) cost base. Beyond conjunctural developments, the risk of technological change rendering the cooperatives' branch-based strategies obsolete needs to be taken seriously. Risks have also materialized when cooperatives ventured onto unfamiliar terrain (e.g., derivatives markets).

99. **Democratic decision-making may come at the expense of the speed and quality of decision-making needed to thrive under rapidly changing circumstances**. In cooperatives in which members are routinely involved in strategic and managerial decisions, the outcome may be indecisiveness, conflict, slow adaptability, and an inability to jump on business opportunities or take tough decisions in a timely way.

B. Building Empires?

Capital and growth dynamics

100. **Most cooperatives are designed to perpetually accumulate capital, thus building an ever-larger intergenerational endowment**. At the time they were set up, a shortage of funds was typically one of the most important challenges cooperatives faced. To remedy this, mechanisms were put in place to ensure capital accumulation. As discussed above, this led to the creation of an intergenerational endowment that in most cases constitutes the bulk of a cooperative's equity and that keeps on growing as long as the cooperative remains profitable. Now, a century and a half after the cooperative banking movement started, in many cases the shortage of capital problem is no longer present, but the mechanisms that ensure capital

accumulation remain in place. This section argues that cooperatives are caught between their capital-accumulating set-up, pressures to achieve similar profitability as commercial banks, and the already sizable equity they have built up throughout their history.

Cooperative banks face specific challenges in managing their capital:

- ***They have limited control over their cooperative capital, although over many decades this has typically been rather stable***. Since in most cooperatives members can withdraw their membership and ask to have their shares reimbursed, cooperative capital (the part of capital to which members' shares represent a claim) is variable and cooperatives could theoretically face a "run on capital". In practice this has not been an issue, given the buffer provided by the intergenerational endowment and considering lengthy withdrawal mechanisms and the unconditional rights that some cooperatives have to refuse redemption.[13] In many cooperatives, there is a minimum level of capital below which redemption is refused. When it issued IAS32, the IASB changed the basic accounting treatment of cooperative capital, reclassifying it in principle as debt rather than equity. After intensive discussions with representatives of the European cooperative banking sector, in particular the EACB, the IASB issued a clarification (IFRIC 2) of the conditions under which cooperative capital should be classified as equity or debt.[14]

- ***They often face binding restrictions on their pay-out policies***. At many cooperatives, there are statutory or legal restrictions that put limits on shareholder remuneration. For example, Swiss *Raiffeisen* banks are legally not allowed to pay more than six percent interest on the notional value of member shares; some French cooperative banks cannot pay more than the government bond yield; *Rabobanks* do not pay dividends to members because membership is free of charge[15]; and the Italian banking

[13] In the Swiss *Raiffeisen* banks, members are entitled only to the lesser of the intrinsic and par values of their shares, and they have to wait until the approval of the accounts of the fourth financial year after their membership withdrawal before they receive their reimbursement. They are also liable up to SFr 8,000 in case of insolvency of their *Raiffeisen* bank. In German cooperative banks, members have an obligation to provide additional capital in times of need, up to a certain level (Kotz and Nagel, 2002). Membership in Dutch *Rabobanks* is free, so there is no risk of any "run on capital". In other cooperatives, cooperative capital is so limited compared to the reserves, that any "run on capital" is unlikely to cause insurmountable problems.

[14] IFRIC 2 states that members' shares that would be classified as equity in the absence of the members' right to request redemption are equity if either of the following conditions is met: (a) the entity has an unconditional right to refuse redemption of the members' shares; (b) redemption is unconditionally prohibited by local law, regulation or the entity's governing charter. However, provisions in local law, regulations, or the entity's governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members' shares being equity (see: http://www.iasplus.com/pressrel/2004pr31.pdf).

[15] However, the Rabobank Group has set up a joint-stock entity that issued regular shares to members, the proceeds of which were made available to the group on a deeply subordinated basis and count as equity in the consolidated accounts. Dividends are being paid on those shares.

law requires that credit cooperatives add 70 percent of their annual profits to their reserves and three percent to a solidarity fund.

- ***They can face severe difficulties raising capital in times of need.*** Provided there is a prospect of future profits, joint-stock companies can always issue new shares and sell those at market price when the need to shore up equity arises. Cooperatives, by contrast, can only raise new cooperative capital by increasing their membership or by asking existing members to buy more shares. They can also issue certain kinds of securities and, in many cases, mobilize capital from their network in times of need. However, both raising new capital and tapping alternative sources of funding come with potential problems. First, members may not be well placed to provide capital when needed. They typically pay very little for their shares and buy them to gain access to the benefits the cooperative offers rather than as a financial investment (with low dividends and no potential of appreciation). As a result, they may not have any incentive to buy more than the minimum number of shares needed (a sort of "membership fee"). The lack of diversification at small cooperatives and the high degree of overlap between their member and clients also means that in times of difficulties many members may not be in a position to provide significant amounts of fresh capital. Furthermore, in many cases there are legal and/or statutory restrictions on the total value of shares a member may hold. Second, issuing other securities is from various perspectives not as attractive as raising cooperative capital. Among other things, such securities often require a relatively high remuneration. In both approaches, decision-making procedures to raise new capital may be cumbersome and time-consuming.

- ***Even in the absence of restrictions, there may be few incentives to pay out a significant share of profits.*** Cooperatives are not at risk of seeing their share price traded at a discount because of dissatisfaction with their pay-out policies. And since shareholdership in a cooperative is not usually driven by investment considerations, members are unlikely to care enough about the level of dividends they receive to organize a "member revolt," which may be difficult to begin with.

- ***Expansionary policies can put significant pressure on cooperatives' solvency and liquidity.*** Unless an acquisition takes the form of a merger with another cooperative, it cannot be financed through the issuance of new equity. Acquisitions and other expansion projects therefore typically have to be paid through the issuance of debt or out of a cooperative's liquid assets, thus causing a deterioration in its balance sheet. Some cooperatives have resorted to listing joint-stock subsidiaries in order to get around this problem. Gurtner, Jaeger and Ory (2002) downplay the problem somewhat, at least in the case of French cooperative banks. In their view, cooperatives may have problems raising large amounts of capital quickly, but it is usually relatively easy to place new member shares with members, and this can be

done at lower cost than a capital increase for a joint-stock company and without risks related to the mood of the stock market.

101. **Given these circumstances, even in the absence of any restrictions or empire-building aspirations, it is rational for cooperatives to accumulate large reserves by retaining earnings**. The somewhat fickle nature of cooperative capital means that cooperatives' solvency, likelihood of survival (in the absence of external support), and ability to grow all depend on having a significant buffer of reserves. They may therefore opt to maintain, on average, higher levels of capital than their commercial bank peers.

102. **Although there are exceptions, pay-out ratios at European cooperative banks are typically significantly lower than at other banks** (Table 12, Table 13, Table 14 and Table 15). Among the exceptions are the German cooperatives (Table 12) and quite a few Italian *banche popolari*, many of which have their shares quoted on the stock market (Table 15). By contrast, Italian credit cooperatives pay out much less in dividends and maintain a much higher level of capital than commercial banks or *banche popolari*. It also worth noting that cooperatively-controlled conglomerates often have significant minority interests that require a market rate of remuneration. Indeed, French cooperative groups have much higher pay-out ratios for their minority interests than for their members (Table 14), even more so than their commercial peers. This implies that, if profits are equally distributed across the group, over time the share of minority interests in the group's consolidated capital would tend to shrink.

Table 12. Cooperative Banks—Pay-out Ratios

(In percent)

	1994	1997	2000	2003
Finland	0.00	7.25	5.33	11.29
France 1/	31.82	31.03	25.00	3.33
Germany	67.74	73.08	110.53	69.23
Spain	30.91	25.41	27.36	28.05
Differences with banking system total 2/				
Finland	n.m.	-15.73	-22.67	3.22
France	n.m.	-42.65	-23.15	-46.67
Germany	4.78	7.86	35.53	n.m.
Spain	-22.42	-21.26	-22.02	-22.68

Sources: OECD – Bank profitability report; and IMF staff calculations

1/ Excluding savings banks before 2000

2/ n.m. = comparison not meaningful, due to banking system losses resulting in a negative pay-out ratio for the banking system as a whole

Table 13. Selected European Cooperative Banking Groups—Capital Dynamics

(In percent)

	CAR 2004	ROE 2004	Average Capital Growth Rate	Average Pay-out Ratio	Observation period used for capital growth rate	Observation period used for pay-out ratio
Crédit Agricole	10.4	8.6	7.5	23.8	2001-2004	2001-2004
Banques Populaire	11.7	10.1	16.8	12.8	1999-2004	1999-2000
Caisses d'Epargne	12.5	10.7	11.5	N/A	1997-2004	N/A
Crédit Mutuel CEE	N/A	10.7	16.0	N/A	1997-2004	N/A
Rabobank	11.4	8.1	11.5	4.6	1997-2004	1997-2004
Raiffeisen Switzerland	N/A	10.0	11.4	3.8	1997-2004	2001-2003
Raiffeisen Luxembourg	N/A	7.8	6.8	0.0	1997-2004	1997-2004
OP Bank Group	15.8	10.8	21.2	17.4	1997-2004	2002-2004
Crédito Agrícola	N/A	13.8	31.5	0.0	1997-2004	1997-2004

Sources: Bankscope, staff calculations, banks' annual reports

Table 14. France: Pay-out Ratios of Banks

(Consolidated basis, In percent)

Institution	Overall	Share of Group	Minority Interests	Period Covered
Commercial banks:				
Société Générale	34.7	32.6	62.5	*1997-2003*
BNP Paribas	32.8	30.2	59.8	*1996-2002*
Crédit Lyonnais	35.2	29.3	60.5	*1997-2002*
CCF	55.1	53.2	125.9	*1997-2001*
Cooperative banks:				
Crédit Agricole	12.3	10.6	81.7	*1999-2002*
Caisses d'Epargne 1/	n.a.	7.6	n.a.	*2001-2002*
Crédit Mutuel 2/	12.9	10.2	25.9	*2001*
Banques Populaires	17.1	9.1	64.5	*2000-2001*

Source: Staff calculations based on banks' annual reports

1/ The observation period for Caisses d'Epargne is limited to 2001-2002, because it adopted its cooperative form only in 2000 and did not pay any dividends during 1998-2000.

2/ Crédit Mutuel Centre Est Europe only. Information on the pay-out behavior of the entire Crédit Mutuel group is not available in the consolidated annual report.

Table 15. Italy: Bank Capital Dynamics

(2002–04, in percent 1/)

	Banking system	*Banche Popolari*	*Banche di Credito Cooperativo*
Dividends / total assets	0.21	0.23	0.04
Allocations to supervisory capital / total assets	0.26	0.24	0.78
Return on equity	7.9	7.6	6.7
Solvency ratio	11.4	10.1	17.8
Growth in supervisory capital from 2002 to 2004	11.0	15.3	15.2

Sources: *Banca d'Italia* and staff calculations

1/ Averages over 2002–04 period, except for growth in supervisory capital. The figures exclude a number of banks which do not report income statement data.

103. **Low pay-out ratios mean that highly profitable cooperatives can enjoy rapid growth in their capital base, and therefore fast organic growth**. Capital has indeed been expanding rapidly at some European cooperative banks and banking groups (Table 13, Table 15). Because prudential regulations require banks to maintain minimum levels of capital relative to their risk-weighted assets, a bank's ability to grow depends on its ability to increase its capital. Organic growth (i.e., growth that does not require external capital) therefore requires profits and retention of some of those profits. The link between organic capital growth, profitability and the pay-out ratio is given by the formula:

$$\Delta\text{Capital} = \text{ROE} * (1 - \text{POR})$$

Where: ΔCapital = growth rate of capital
ROE = return on equity
POR = pay-out ratio

Comparing two hypothetical banks, one cooperative and one commercial, the equation above implies that they will have the same organic growth rate if and only if their relative profitability and pay-out ratios satisfy the following equation:

$$\text{ROE}_{coop} / \text{ROE}_{com} = (1 - \text{POR}_{com}) / (1 - \text{POR}_{coop})$$

For example, if a cooperative has a pay-out ratio of 10 percent and a commercial bank pays out 35 percent of its profits, the former only needs to achieve 72.2 percent of the profitability level of the latter to realize the same organic growth rate.

104. **While a growing capital base may allow healthy organic growth, it can also lead to undesirable empire-building or forced expansion, even in the absence of attractive opportunities**. When excess capital is accumulated and cannot be disposed of, over time

managers are likely to be tempted or pressured to expand the business in line with the growing capital base. The temptation may originate in managers' tendency to engage in empire-building, a tendency that is the subject of a rich literature. Allen and Michaely (2002), for example, note that dividends and share repurchases appear to be primarily serving the purpose of reducing potential overinvestment by management. Hughes et al. (2003) provide evidence that the risks and costs of empire-building are higher when banks have entrenched managers (i.e., poorly functioning external governance mechanisms). Beyond empire-building, managers may feel pressured to expand the bank's business when capital grows, if only to fend off outside forces (e.g., tax authorities, members, …) which may want to lay claim on the excess capital and avoid showing ROE figures that are excessively low. Supervisory practices may play a role in this. Supervisors monitor ROE as an indication of the soundness of a financial institution. Moreover, as noted above, concern about the health of the banking system in the presence of non-profit-maximizing banks has led some supervisors to demand that cooperative banks achieve similar profitability levels as their commercial peers. Faced with a growing capital base and no means to shed excess capital, cooperative bank managers may feel they have no choice but to keep on expanding. As a result, cooperative groups may venture into businesses they are unfamiliar with, or take on challenges that their cooperative nature has difficulties coping with.

105. **Many growing cooperatives still face capital shortages, which has driven them to find new ways to raise capital**. Tremblay (2001) notes that cooperative banking has become much more capital-intensive and, as a result, many cooperative banks have sought additional sources of capital to complement retained earnings. Many French cooperatives have issued non-voting equity, and some cooperatives have experimented with equity-like debt instruments and hybrid types of securities. However, as noted above, such instruments are not as attractive as cooperative capital, let alone reserves.

106. **Overall, cooperatives face fundamental challenges in managing their capital**. They cannot shed excess capital, fully rely on the capital they have, or raise capital as needed, especially in times of crisis. With banking being a very capital-dependent business, this is a fundamental vulnerability.

Asymmetric consolidation

107. **The tendency towards empire-building may be further reinforced by the asymmetric nature of the possibilities for consolidation between cooperative and commercial banks**. Concern has been raised that cooperatives may stand in the way of the consolidation many observers and market participants think the European banking system needs. Belaisch, Kodres, Levy and Ubide (2001), for example, argue that the importance of unlisted banks in the European financial system, especially those without regular ownership, can impede consolidation. Cooperatives can engage in consolidation with commercial banks, albeit mostly on an asymmetric basis.

108. **Mergers between cooperatives and commercial banks can only happen on a mutually agreed basis and may not be appealing to commercial banks**. Hostile takeovers of cooperatives are impossible, but as illustrated by examples in Belgium, Italy and France, a cooperative can put its commercial activities in a joint-stock subsidiary and merge this subsidiary with another joint-stock company. However, this option may not be very appealing to many commercial banks, because it usually means that the merged entity has an unbalanced shareholder structure, with the cooperative being by far the largest shareholder. Hence, in terms of control, such a merger is more akin to an acquisition of the commercial bank by the cooperative, unless the cooperative is sufficiently small relative to its merger partner(s) that it ends up with a non-dominant minority stake.

109. **Consolidation operations between cooperative and commercial banks are therefore most likely to take the form of acquisitions of the latter by the former**. Most of the operations that have occurred in Europe have taken this form. Each of the French cooperative groups has acquired at least one commercial bank, *banche popolari* in Italy have acquired many small commercial and former savings banks, and Austrian cooperative banking groups have been active acquirers of banks in CEE countries.

110. **Mergers between cooperatives can face significant obstacles**. As has been illustrated by hundreds of examples over the past decade, mergers between cooperatives within a same network can normally be done, provided members approve them. However, mergers between banks belonging to different networks may be much harder, because the networks are usually governed by different laws (and by-laws) even within a single country. In addition, banks' operations are, in many cases, closely integrated in the network, which may make it very difficult in practice for a cooperative bank to change its allegiance. This might entail changing brand name, IT systems, management systems and much more. Consolidation can in some respects be easier between networks as a whole, as illustrated by recent operations in France.

111. **Without shareholders that are preoccupied with profit motives, cooperatives may be able to outbid commercial banks in takeover battles**. Given that members are not focused on return on equity and in any case do not own most of the equity, they may not be particularly worried about the price a cooperative pays for an acquisition. From this perspective, management may have more leeway to bid higher prices. A countervailing force exists in the form of the inability of a cooperative to pay for an acquisition with shares.

112. **Cross-border mergers between cooperatives are particularly hard to achieve, but the new European cooperative society (SCE) statute now allows such operations**. Traditionally, differences in the legal frameworks for cooperatives made it practically impossible for cooperatives to engage in cross-border mergers. Ways around this exist, though, and are similar to the ones available to engineer a merger between a cooperative and a joint-stock company (i.e., putting part or all of the cooperatives' activities in joint-stock subsidiaries, which can be merged or in which ownership stakes can be swapped). Networks

of cooperatives also have the possibility to merge (some of) their apex entities. From August 2006 onwards, it will be possible for cooperatives to engage in full cross-border mergers by forming an SCE (see above).

113. **Overall, cooperatives are likely to increase their market share in any consolidation wave**. The basic asymmetry that exists between cooperative and commercial companies' ability to buy each other, in combination with some of the considerations outlined above, makes this virtually inevitable, unless some cooperatives abandon their cooperative statute.

C. Competition Between Cooperative and Commercial Banks

114. **Cooperatives can follow market share-based or capital-based growth strategies, both of which may lead to overcapacity that may need to be resolved through retrenchment of commercial banks**. Competition between cooperative and commercial banks is likely to be beneficial to consumers. In the long run, however, it may affect the structure and stability of the financial system, the impact of which is a subject of debate. Market share-based growth strategies focus on selling at lower prices than the competition (adjusted for quality, location and everything else) and therefore accepting lower profitability. Capital-based growth strategies are based on relatively high organic growth rates of the capital base. Such a strategy requires significant profits because for cooperatives profits constitute the main source of fresh capital. As a result of these expansion strategies, competing commercial banks may face reduced profitability and transition costs and risks (e.g., costs of restructuring and closing branches). Gurtner, Jaeger and Ory (2002) note that continuing accumulation of capital (regardless of needs) may lead to macroeconomic inefficiency, waste and overcapacity in the banking system that may take a long time to work out. The burden of adjustment to such overcapacity may fall almost exclusively on commercial banks. In this regard, Barth, Caprio and Levine (1999) find that a higher degree of government ownership of banks tends to be associated with lower development and higher fragility of financial systems. Goodhart (2004) interprets this result as perhaps indicating that the presence of any non-profit-maximizing banking entities may make financial systems more fragile. Čihák and Hesse (2007) find more nuanced results. Their analysis shows that a high presence of cooperative banks makes weak commercial banks less stable than they would otherwise be. However, given the higher inherent stability of cooperative banks, they find a positive overall impact of cooperative presence on overall banking system stability.

D. Other Prudential Challenges and Concerns

115. **The third pillar of Basel II is less effective in the case of cooperative banks**. The third pillar relies on extensive disclosure to ensure that banks are subject to market discipline. However, as noted above, disclosure practices (and requirements) at cooperatives are often below standards at commercial banks, especially listed ones. Also, even when disclosure is adequate, there are rarely markets that can exert effective disciplining pressure in response.

As discussed above, shareholder pressure cannot be relied upon and many cooperatives do not rely much on interbank markets or debt issuance as sources of funds. Loyal—to some degree perhaps even captive—and insured retail depositors may not exert any effective market disciplining effect either at an early enough stage. Rating agencies, by contrast, are playing an increasing role in monitoring developments, however mostly at the apex level or for networks as a whole rather than individual cooperative banks.

116. **Contagion from cooperative to commercial banks is more likely to take the form of liquidity shocks than solvency problems**. Given their typically high levels of liquidity, cooperative banks tend to be net lenders in the interbank market. In times of stress, they are likely to cut their exposures in the interbank market, which may cause liquidity problems for other banks.

117. **Prudential authorities may face calls to apply different standards to cooperative banks, although an increasingly pan-European approach to prudential policies and practices limits the authorities' room for response, as do anti-state aid and infringement procedures**. Cooperatives' not-for-profit statute, large membership (e.g., 15.5 million in Germany), close involvement in local communities, retail orientation, and links to broader movements imply that they can often count on a higher level of public sympathy and political support than commercial banks. This is only reinforced by cooperatives' disproportionate market shares in terms of deposits and branch networks, and in rural areas where competition between banks is low to begin with. All of this may lead for pressure to "go soft" on cooperative banks, in terms or regulation as well as supervisory enforcement, and may create particular problems in case a cooperative runs into financial difficulties. In Ireland, for example, the Irish League of Credit Unions has lobbied for, and obtained, a specific regulatory and supervisory framework for credit unions that takes into account their not-for-profit orientation and the volunteer nature of much its human resources.

118. **In some cases, risks may arise as a result of not differentiating between commercial and cooperative banks**. The main area where this risk appears to exist is corporate governance. Corporate governance regulations that are tailor-made for commercial banks and fail to take into account the different nature of cooperatives may fail to address the specific risks that exist at the latter.

119. **Given the large number of small cooperative banks, supervisory authorities sometimes rely on the apex organization for supervision**. In many European countries, there are hundreds of small cooperatives, many of which have their headquarters far away from the big cities where supervisory authorities typically have most of their staff. Individually supervising all of these small cooperatives may require a level of resources that most supervisory agencies lack. Also, full-fledged supervision might not even be necessary, given that many of the cooperative banks are not dissimilar in terms of size from branches of large commercial banks, especially in the presence of strong solidarity mechanisms. Relying on apex organizations instead should reduce supervisors' workload, but may upset the

balance of power within the cooperative group in favor of the center. In addition, the apex organization may not exercise its delegated supervisory tasks to the same standards as the supervisor would do itself. Supervisors would thus have to pay close attention to the delegated supervisory activities of the apex and their impact on the internal balance of power.

E. Current Policy Framework

Current policy frameworks appear characterized by a lack of attention for the specific risks faced by, and related to, cooperative banks.

120. **Basel II does not pay specific attention to cooperative banks**. Electronic searches of the November 2005 update of the Basel II document (Basel Committee on Banking Supervision, 2005b) for the words "cooperative" and "co-operative" do not yield any relevant results, while the word "mutual" only shows up followed by "fund". Corporate governance issues discussed in the document relate mainly to internal control procedures within financial institutions, rather than to external control over management. Similarly, the Basel Committee's most recent publication on corporate governance for banking organizations (Basel Committee on Banking Supervision, 2005a) does not contain any cooperative-specific discussion.

121. **Recent initiatives to improve corporate governance have focused on listed companies**. Sarbanes-Oxley and other initiatives have had mostly only indirect effects on cooperative banks. Given cooperative banks' economic importance and large member and depositor bases, this lack of attention appears mainly the result of the absence, thus far, of a cooperative Enron.

122. **Cooperative banks have mostly escaped close attention in European Financial Sector Assessment Programs (FSAPs), given these exercises' focus on systemic issues**. There are some notable exceptions, though, the main ones being the FSAPs for France and Germany (see Appendix 2). Cooperative-specific attention mainly focused on mutual support and deposit insurance mechanisms, efficiency, and financial sector consolidation issues (between cooperatives as well as between cooperatives and other banks). In a few cases, FSAPs provided some gentle encouragement towards demutualization.

VI. A Tentative Agenda for Reform and Further Research

Thanks to their evolving comparative advantages, cooperative banks look set to remain an important feature of the European banking landscape for the foreseeable future. Their presence alongside other types of banks can be expected to continue to be beneficial to consumers. On current trends, they may well continue to gain market shares, especially in retail markets. However, to safeguard these successes, change appears necessary in two important areas: cooperatives' corporate governance systems and their ability to manage their

capital. But whereas the need for change in these areas is apparent, the concrete form these changes should take is not. Further research will be needed to find the best way forward.

A. Addressing Corporate Governance Challenges

123. **While a range of solutions have been proposed to overcome governance challenges in cooperatives, there is not much clarity on their effectiveness**. Cornforth (2004) notes that, because there exists relatively little theoretical work on the governance of cooperative and mutual associations, many of the proposals to improve governance in such organizations have been impractical and/or ineffective. Chaves and Sajardo-Moreno (2004) note that internal and external control mechanisms that can be implemented have great weaknesses. However, corporate governance problems in commercial companies are rather intractable as well, and the doubtful effectiveness of many potential solutions has not stopped them from being tried out or imposed. Just like in commercial companies, the effectiveness of individual measures may be limited, but the combined impact of a package of measures can be significant.

124. **Based on the literature and on the discussion in this paper, a number of measures could be considered to improve governance**. While many of these measures can only be implemented by cooperatives themselves, public authorities—in particular prudential authorities—can play an important role in encouraging their adoption. At a fundamental level, good governance requires transparency, clear definition of responsibilities and lines of accountability, and adequate representation of stakeholders. The following measures could help achieve these objectives in practice:

- In many cooperatives, there is a need for greater transparency and disclosure. As deposit-taking institutions with numerous and dispersed members, disclosure standards at cooperative banks should be at least as demanding as for listed companies. Networks with a significant degree of integration should report on a consolidated basis.

- Consideration could be given to requiring a separation of external and internal governance mechanisms in networks, for example through parallel organizational structures, in order to minimize interference between them.

- Efforts are needed to avoid the risk that large or growing cooperatives become disconnected from (some of) their stakeholders. Mechanisms that establish or facilitate a continuous dialogue between managers on the one hand and members and other stakeholders on the other may help preserve some of the comparative advantages that were behind cooperatives' past success.

- Voluntary self-regulation could resolve a lot of governance issues, but may be insufficient in itself. There is already a lot of self-regulation going on within cooperative networks. However, to avoid any complications due to problems that may be inherent to the networks themselves, self-regulation at a higher level might provide added value.

- By exposing themselves to price mechanisms, market signals, and delegated monitoring, cooperatives can improve their governance, visibility, and access to financial markets.

- Increasing members' minimum investment or making them liable for part of the losses may give them greater incentives to participate in the cooperative's governance.

- Legislation and cooperative statutes should provide members with the means to organize themselves independently from management and ensure that they can effectively challenge management at the annual meeting. In particular, members should have possibilities to make some sort of game-ending and downsizing decisions, even without the approval of management.[16]

The functioning of boards could be improved through a range of practical measures, many of which are already applied in some cooperatives:

- Co-opting non-members or appointing independent directors could provide boards with valuable expertise and improve their oversight of management.

- Election committees and other means of independent vetting could improve the quality of candidate board members. However, care would need to be taken that such means do not impede the democratic functioning of cooperatives.

- Training and support for board members and members can help reduce information asymmetries that favor management and improve the quality of board decision-making.

- Tailored incentive structures for management can help align their interest with those of other stakeholders. While more complicated to design than many compensation plans in commercial companies, incentive structures linked to specific strategic or management objectives should be possible.

125. **Some kind of independent external oversight may be needed to ensure that cooperatives take the interests of all stakeholders into account**. The existence of a sizable intertemporal endowment coupled with the inability to identify or involve all relevant stakeholders creates a fundamental risk that represented stakeholders will seek to appropriate the endowment, at the expense of the unrepresented ones. Addressing this risk seems to warrant some kind of independent oversight, in particular with respect to fundamental decisions affecting the endowment.

[16] In this regard, Bebchuk et al. (2004) argue that the owners of a firm should be able to take fundamental decisions, such as "rule-of-the-game" decisions, "game ending" decisions, and "scaling down" decisions. This would reduce problems of empire building and free cash flow.

126. **Mechanisms could usefully be devised to allow winding down operations of cooperatives or transforming them into joint-stock companies in an equitable way, if and when a majority of members wish to do so and subject to the independent oversight proposed above**. Options include imposing a windfall tax on members; distributing the shares in a demutualized company among members in proportion to their length of membership and/or the volume of business they have conducted with the cooperative; closing the cooperative for new membership in the run-up to demutualization; and donating the equivalent of the cooperative's reserves to a charitable foundation, in cash or in the form of securities that do not leave that foundation in control of the former cooperative (e.g., non-voting shares, profit-sharing subordinated perpetual debt, or shares that are to be sold in the market within an agreed timeframe).

B. Addressing Financial Stability Issues

127. **Mechanisms should be found that increase cooperatives' ability to manage their capital**. To reduce the risks of empire-building and "forced growth," cooperatives need to have options to shed excess capital. Various mechanisms could be thought of, including higher pay-out ratios and donations to other cooperatives or charitable purposes. However, in designing such mechanisms, equity and governance challenges (who chooses the recipients of any money?) will have to be taken into consideration.

128. **To improve cooperatives' ability to survive crisis situations, they need to have options to raise capital quickly when the need arises**. Within networks of cooperatives, such mechanisms exist, but correlated risks and increasing integration within networks raise the possibility that the network or sector as a whole might need an equity injection, as happened in Sweden in the early 1990s.

129. **To the extent possible, a level playing field needs to be established between cooperative and commercial banks**. This requires in particular that any legal or regulatory prerogatives that one category enjoys over the other, such as exclusive distribution rights for certain financial products, be removed. Since the 1980s, most such prerogatives have been removed.

130. **Prudential authorities need to mindful of, and manage, the financial stability implications of cooperative banks' capital-share or market-share based expansion strategies**. Doing so may require them to attach relatively low weights in their assessments to the profitability of cooperative banks, as measured in terms of return on equity. However, any slack in terms of profitability needs to be to the benefit of members or other stakeholders, in transparent ways, and should not pose a stability threat to the rest of the banking system. Providing cooperatives with mechanisms and encouragement to shed excess capital might be the most effective solution, though.

131. **Managers of cooperatives and prudential authorities must be mindful of the possibility that the cooperative governance form may be at a comparative disadvantage in certain risky activities**. Various features and challenges discussed in this paper could

contribute to such disadvantages, including less effective market discipline, information asymmetries in favor of management, potential difficulties attracting top talent, the possibility that laymen may exercise significant managerial or oversight functions, potentially slow democratic decision-making, lower flexibility, low incentives and possibilities for members to monitor management, a traditional retail orientation, and the incentives produced by the presence of an owner-less endowment.

132. **Cooperatives and their prudential supervisors need to pay attention to their cost bases and the degree to which these are inflexible on the downside**. From this perspective, branch-based expansion strategies may increase the risks cooperatives could face during downturns.

133. **There is a risk of increasing tension between the cooperative and market dimensions in hybrid groups**. While there are significant benefits for cooperatives to organize part of their activities in joint-stock companies and expose themselves to market discipline, such hybrid groups risk ending up "stuck in the middle," having to make compromises between their different stakeholders and not being able to fully enjoy the advantages of either governance form. Benefits to members may be cut back in order to increase profits and/or the cooperative's joint-stock securities may not be valued as highly as those of equivalent joint-stock securities from purely commercial groups.

134. **Cooperative banks have good reasons to count on continued success, provided the challenges outlined above can be overcome**. The sector, policymakers, prudential authorities, and researchers all have important roles to play in making this possible. For public policymakers and prudential authorities, perhaps the main challenge is to take into account the specific nature of cooperatives in their analysis and decision-making. For researchers, cooperative banking is an underexplored area relative to its economic weight. This paper points to a number of potentially rewarding areas of research:

- Theoretical, policy, and managerial aspects of the dynamics of cooperatives' intergenerational endowments and the incentive structures they generate;
- Competition between various ownership forms in banking and the financial stability implications of this competition;
- The organization of independent oversight of cooperatives in ways that do not create unnecessary bureaucracy, undue influence, or excessive restrictions on the management of cooperatives;
- The governance and managerial challenges and dynamics presenting themselves in hybrid cooperative/joint-stock groups;
- Governance issues within networks of cooperatives; and
- Further analysis of basic corporate governance mechanisms in cooperatives and possible improvements to these mechanisms.

APPENDIX 1—MEASURING THE IMPORTANCE OF COOPERATIVE BANKS

A number of factors contribute to a tendency to underestimate the importance of cooperatives:

- ***Total asset measures of market share tend to understate the importance of cooperative groups in domestic retail markets***. Cooperative banks typically are less active in financial and interbank markets and have less international activities than their commercial peers. As a result, they tend to have smaller balance sheets for a given level of domestic retail activity. Therefore, their market shares as measured by deposits, credit and branch networks tend to be higher than those based on total assets. The Swiss *Raiffeisen* group, for example, represents only about 4.3 percent of the country's banking system in terms of assets[17]. Yet, it has the biggest retail branch network in Switzerland, 12.4 percent of the domestic credit market, and 13 percent of domestic deposits. The group *Crédito Agrícola* represents less than three percent of the Portuguese banking system's assets, but it has almost six percent of the system's deposits. Cooperative banks in Spain held 3.8 percent of banking system assets at end-2004, but 4.9 percent of loans and 5.9 percent of deposits. And German cooperatives only held about nine percent of banking system assets as of end-2003, but their market share of domestic deposits was close to 19 percent.

- ***Unconsolidated data can only understate the market share of cooperative groups***. Published financial system data often provide market share statistics on a company (unconsolidated) basis. This causes a systematic bias in the statistics because commercial banks can be owned by cooperatives, but the reverse is not possible. Unconsolidated Italian banking market statistics, for example, significantly understate the market share of the *banche popolari*, many of which have commercial bank subsidiaries. Similarly, most statistics on market shares published by the French authorities are on an unconsolidated basis and do not reflect the fact that cooperative banking groups own some of the most important commercial banks. *The Cooperative Bank* in the U.K., *Landshypotek* in Sweden, and *Arbejdernes Landsbank* in Denmark are set up as joint-stock financial institutions, but are owned by cooperative entities and/or act in practice as cooperatives. On a consolidated basis, the retail market shares of cooperative institutions, especially of deposits, are quite important (Table 16).

[17] Figures as of end-2004.

Table 16. Cooperative Banks—Estimated Deposit Market Shares

(Consolidated basis, in percent)

50-100 percent	France
20-50 percent	Netherlands, Austria, Finland, Italy
5-20 percent	Germany, Luxembourg, Switzerland, Ireland, Portugal, Spain, U.K.
0-5 percent	Denmark, Greece, Belgium, Sweden
0 percent	None

Source: IMF Staff estimates

- ***Aggregate data do not reflect the importance of cooperatives in specific market segments***. Many cooperative banks have their roots in rural areas, while commercial banks have historically mainly been active in cities. This different geographic orientation still persists to a significant degree. The *Raiffeisen* groups in Austria, Switzerland and Luxembourg, credit cooperatives in Italy, the *cajas rurales* in Spain, and the group *Crédito Agrícola* in Portugal are all disproportionately present in the countryside. The *cajas rurales*, for example, account only for about five percent of the Spanish banking market on various measures, but they control about half the retail market in some rural provinces. Almost 80 percent of bank branches in Paris belong to commercial banks, but in rural regions branches of cooperative networks vastly outnumber those of commercial banks (by a ratio of more than 3 to 1 in regions such as *Alsace*, *Auvergne*, and *Franche-Comté*). It is also worth noting that *Crédit Agricole* has a 90 percent market share in France's agricultural banking market.

- ***Cooperative structures remain, directly or indirectly, key shareholders in some commercial banks***. Although Belgium has seen its two largest cooperative banking groups demutualize through mergers with commercial banks, the cooperative groups that were behind them still exist and are nowadays the largest shareholders in both successor banking groups.

APPENDIX 2—COVERAGE OF COOPERATIVE BANKS IN EUROPEAN FSAPS

Germany: the FSSA noted that (i) cooperative (and public) ownership had precluded cross-pillar consolidation; (ii) exit of troubled cooperative banks had been achieved exclusively through mergers, not liquidations; (iii) stress tests had found that smaller cooperative and savings banks were more sensitive to interest rate risk than the rest of the banking system; (iv) the cooperative pillar had gone furthest in consolidating its wholesale back office and ancillary institutions and there had been experiments to consolidate back office functions and securities settlement systems between savings and cooperative banks; and (v) there was considerable scope for efficiency gains in the cooperative sector, which would in part be achieved by the consolidation the sector was planning. The report recommended changes to the institutional protection scheme for the cooperative pillar and suggested that cooperative banks might wish to explore the merit of transforming themselves into regular companies, which would make it easier to mobilize additional capital. (IMF Country Report No. 03/343)

France: the FSSA noted that (i) mutual groups had been a key driving force in banking sector consolidation; (ii) four of the six large banking groups were organized on a mutual basis, but some of them had created joint-stock affiliates; (iii) capital accumulation had strengthened the banks' resilience, but mechanisms that kept disbursement of profits low made this process harder to control for mutual banks and capital accumulation could encourage expansion through expensive takeovers or risky new ventures; (iv) the riskiness of mutuals' operations was likely to increase as they undertook lines of business removed from local retail banking; (v) the combination of top-down and bottom-up approaches in mutuals' decision-making processes could raise some governance issues, but outside scrutiny had increased in recent years as mutuals had increasingly issued bonds and shares in subsidiaries. The report recommended the removal of obstacles to higher remuneration of members of mutual banks and suggested that it would be useful to reconsider the legal impediments to demutualization. The BCP assessment recommended that the authorities carefully follow initiatives for expansion of large banking organizations, notably for mutual groups. (IMF Country Report No. 04/344)

Switzerland: the FSSA noted that (i) the earnings performance in the Raiffeisen banks had been "particularly good"; (ii) Raiffeisen banks had withstood the 1991-96 real estate crisis very well, losing only 1 percent of their loan volume against 8 percent for the banking system overall; (iii) the Raiffeisen banks had not been included into the stress tests due to data constraints and (iv) the profitability and growth potential of the many small Raiffeisen banks was limited. It saw the main challenges for cooperatives as related to the need to achieve economies of scale and reduce portfolio concentration in mortgages. Necessary investments in new technology and the need to cut costs were likely to result in a further process of cooperation and consolidation. (IMF Country Report 02/108)

Austria: The FSSA noted that cooperative banking groups constituted two of the seven pillars of the banking system and that these banking groups, among others, had formed multi-pillared integrated groups with apex banks and formalized cross-guarantees. A box in the report discussed the sectoral support mechanisms in detail. The report pointed to the high bank and branch density in the country as contributing to the low domestic profitability and efficiency of the banking system. It further noted that the cooperative nature of part of the system may also have played a role. However, it did not explicitly link these two factors (Austrian cooperatives stand out for their large branch networks). (IMF Country Report 04/238)

Netherlands: the FSSA contained no specific recommendations in the body of the report, but noted that the presence of a large cooperative bank in the market may have been a factor in the below-average operational efficiency of the Dutch banking system, despite a high concentration ratio. The AML/CFT assessment noted that the fit and proper tests that the central organization of the Rabobank group undertook on local cooperative banks as a delegated responsibility for *De Nederlandsche Bank* (DNB), were not of the same robustness as those the DNB undertook itself. It recommended that this be rectified. (IMF Country Report 04/312)

Finland: the FSSA contained no cooperative-specific findings or recommendations. It noted the retail orientation of the OP Bank group and mentioned the role of mutual support systems in the cooperative sector. (IMF Country Report 01/214)

Italy: The FSSA contained no cooperative-specific findings, except for a brief discussion of the deposit insurance scheme for credit cooperatives, which it reported to have worked well. (IMF Country Report 06/112)

U.K.: In the context of the FSAP, the authorities had conducted stress tests on aggregated data for building societies and these tests had shown no vulnerabilities. Otherwise the FSSA contained no cooperative-specific findings or recommendations. (IMF Country Report 03/46)

Sweden, Luxembourg, Greece: No cooperative-specific findings or recommendations. (IMF Country Reports 02/161, 02/116 and 06/6)

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