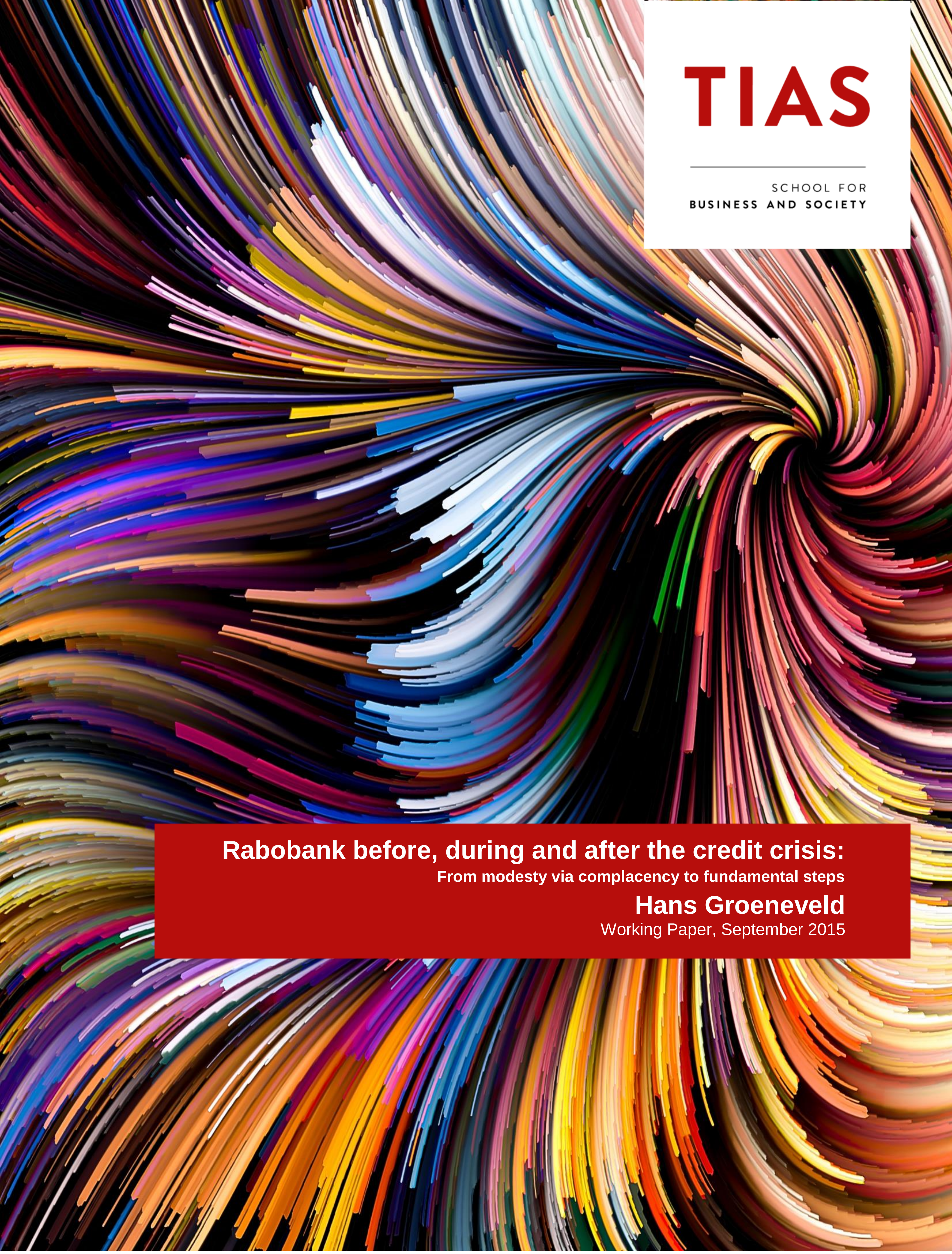

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Rabobank before, during and after the credit crisis:

From modesty via complacency to fundamental steps

Hans Groeneveld

Working Paper, September 2015

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Rabobank before, during and after the credit crisis:

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Abstract

Rabobank survived the financial turbulences of 2007-2010 well and without government support. In 2010, Rabobank even booked the highest net profit in its history. However, Rabobank could not escape from the fall-out of the credit crisis and the break-out of the sovereign debt crisis in Europe a few years later. For instance, the credit crisis triggered economic recessions and changed the business and regulatory environment of banking drastically. Moreover, structural imbalances in the Eurozone came to the fore and the ECB took unprecedented monetary steps which resulted in a very low interest rate environment. In its home market, the whole banking sector lost the lustre of reliability and Rabobank incurred reputational damage due to its involvement in the Libor affair at the end of 2013. The bank took fundamental measures to cope with all these challenges: a further virtualisation of its products and services, actions to increase the reservation capacity and initiatives to reinforce its participation in society to address social-economic issues together with members and customers. In May 2015, member representatives and banking executives decided to reshape the cooperative governance, while preserving the core principles and the cooperative profile.

JEL codes: G21, G30, L25, P13

Keywords: cooperative bank, corporate governance, performance

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1 Introduction

This article focuses on Rabobank, the Dutch cooperative banking group, in the wake of, during and after the credit crisis of 2007-2010 within the context of its historical evolution. Like all other banks, Rabobank has faced many social, economic, technological and regulatory challenges since its establishment some 120 years ago. These include, for example, the World Wars, the Great Depression of the 1930s, the reconstruction of the Dutch economy, the IT revolution and the liberalisation and globalisation of the economy. More recently, the collateral effects of the credit crisis and following economic crises, the formation of the Banking Union and the transfer from prudential supervision from the national to the European level resulted in many short-term as well as longer-term challenges for the banking sector as a whole.

These introductory remarks illustrate the indispensability of a short retrospective to understand why Rabobank weathered the credit crisis of 2007-2010 well[2] and which factors provoked strategic reconsiderations and operational actions afterwards. Hence, this paper does not provide a comprehensive overview of its history nor an in-depth discussion of the – legal and statutory – technicalities of its governance and capital structure. Only those elements are mentioned which are particularly relevant for answering both questions.

Section 2 highlights the organisational evolution up to the most recent developments. Section 3 discusses milestones in the development of its governance since the 1970s in three parts. The third subsection lifts a corner of the veil regarding the most fundamental governance revision in its history: the move to one cooperative bank with one banking license in 2016. Section 4 presents a general picture of its current market position and recent performance. The final section summarizes and concludes.

[2] Most European cooperative banks have weathered current and previous periods of financial distress relatively well (EACB, 2010; Ayadi *et al.*, 2010).

2 Organisational transformation

2.1 The origins

As in many other Western European countries, the first local cooperative banks (henceforth LCBs) in the Netherlands had their roots in the local agricultural sector.[3] Misery and lack of access to affordable loans among farmers prevailed. Social abuse such as buying by instalments and the provision of loans at exorbitant rates were widespread (Van Diepenbeek, 2007). In light of this, an advisory committee appointed by the Dutch government in 1888 emphasised the need for an agricultural credit system based on sound and fair principles. Moreover, this was to be set up by the concerned farmers themselves. The committee recommended the establishment of credit cooperatives based on the principles of the German Raiffeisenbanks. Around 1896, the first LCBs were set up in The Netherlands. Soon after, many other banks were launched throughout the country.

Although every LCB had its own unique historical background, there were also large similarities. For instance, farmers and dignities of the local community were often the bank's founding fathers. In the beginning, each LCB was run by a cashier in his home office, who only received a small salary (according to Raiffeisen's principle of 'sober management'). Moreover, each LCB applied the principle of solidarity. There was unlimited liability for all debts to be borne by all members. It was not necessary to become a member if you wanted to place your deposits at an LCB. Members did not have to capitalise their LCB by buying member shares, which was common practice at almost all other cooperative banks in Europe at that time. Instead, the financial policy consisted of full reservation of realised annual surpluses, and no-redistribution of any surpluses to individual members. Nevertheless, an appropriation of a responsible part of surplus for social and charitable purposes in order to improve local living conditions existed.[4]

As early as 1898, the LCBs started to work together by setting up two central – cooperative – organisations, one in the northern and the other in the southern part of the country. These central banks were not only helpful to overcome the disadvantages of the local banks' limited scale and to foster their development by performing the co-ordinating role of a "banker's bank". They also served as control or audit institutions as well as knowledge centres. These activities on behalf of member banks were executed out of self-interest. Since all member banks operated under the same brand, problems at one LCB could damage the reputation of all other LCBs.[5] In the following years, LCBs flourished due to their strong roots in local communities, their appealing democratic structure and their attractive loan and saving rates as compared to private banks. Since the first LCB in The Netherlands was founded, the number of LCBs and their members increased sharply to more than 1,300 LCBs around 1960.

2.2 The evolution of Rabobank: local-national-international

In the 1950s and 1960s, LCBs gradually transformed into retail banks and began to serve non-members. The latter development was chiefly related to technological developments in payment

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[3] A detailed description of Rabobank's history and development can be found in Mooij (2009).
[4] Rabobank still applies this principle today. Around 3 percent of net profits is re-invested in society via local cooperative funds in The Netherlands and via Rabobank Foundation, which helps to establish and further develop agricultural cooperatives in emerging and developing countries (Rabobank, 2012).
[5] As will be illustrated later on, the reputational risks for LCBs nowadays also depend on the reliability, uprightness and quality of the operations of national and international subsidiaries, especially if they are performed under the Rabobank brand.

services and the increasing demand for mortgages due to the rising popularity of home ownership. Obviously, the homogeneity of the customer base of LCBs decreased accordingly. The central organisations became more and more important for the development of the LCBs. To reach economies of scale and to avoid inefficiencies from growing competition between LCBs of the two organisations, the two central organisations decided to merge in 1972 to form Coöperatieve Centrale Raiffeissen-Boerenleenbank, known as Rabobank. In this way, the cooperative bank group was also able to improve its competitive position in a further consolidating Dutch banking landscape. This led to a national network organisation with a two tier governance structure: cooperative local Rabobanks (LCBs) and their central cooperative Rabobank Nederland (henceforth RN).

The merger of both centrals eventually resulted in cost reductions and a favourable scale for large investments to acquire market share and to serve the emerging mass markets and new economic sectors efficiently. Facilitated by the deregulation of financial services in the 1980s, this centralisation of activities and the creation of scale advantages made it possible to diversify and expand financial activities in other areas. Domestically, Rabobank Group entered into the fields of private banking, asset management, and life insurance via organic growth, joint ventures or acquisitions in the 1990s. All these developments dovetailed with the trend towards individualisation and the need for more customised solutions, stimulated by revolutionary developments in information and communications technology. The centralised support function was conducive to launch virtual distribution concepts, such as internet and mobile banking.

In the course of the 1970s, the first international ambitions were formulated. Initially, the leading motive for starting cross-border activities was the desire to serve domestic customers with international activities and aspirations, especially from the Dutch agricultural sector. In the early 1970s, this was done through collaboration agreements with banks in the United Kingdom (Continental Bankers) and the USA (Bank of America). In order to improve the level of commercial cooperation between European sister organisations, the Unico Banking Group (1977) was established by Rabobank and five other cooperative banks. The aim was to support the expansion of the partners' international operations. Thereafter, Rabobank pursued different international strategies, with varying degrees of success: takeovers, cooperation agreements and alliances with other partners, as well as setting up its own representative offices across the world.[6]

An important step was the concentration of all foreign business of Rabobank Group into a new entity named 'Rabobank International' (RI) in 1996. This was more than just a re-labelling action. Within RI all international activities were united in an organisational entity with a large degree of autonomy from the cooperative domestic banking part. The strategic responsibility for the development of international business was transferred from the Executive Board of RN to the newly established Managing Board of RI. The ambitions were high, e.g. RI soon attempted to develop a large investment banking division in London (Vogelaar, 2012). After only a few years, the investment banking division was cut down substantially. The ambitions of the investment bankers brought on board were not in line with the moderate risk profile and the culture of Rabobank, and LCBs in particular. Besides, the associated remuneration structure in investment banking with substantial bonuses, was at odds with the Rabobank culture. Contrary to the general belief, the escapade into investment banking in the 1990s has on balance generated net profits. However, significant losses did occur in the area of corporate banking of RI at that time. Rabobank did not completely abandon

[6] The most salient steps and evolutions are presented in Groeneveld and Sjauw-Koen-Fa (2009).

investment banking, though. These activities had increased the knowledge and competences of Rabobank and hence a number of investment banking activities has been retained within acceptable cost and risk limits.

More recently, the division ‘Global Financial Markets’ within RI was involved in the so-called Libor affair. With regards to the latter issue, Rabobank Group agreed on financial settlements of EUR 774 million (US$ 1 billion) with various authorities in connection with their investigations into Rabobank’s historical Libor submission processes in October 2013. The supervisory authorities concluded that the internal control mechanisms failed to ensure a correct procedure. It was also pointed out that various responsible executives had not reacted decisively in response to letters from regulators about serious misconduct of a few traders some years before.

This affair is perceived as a black page in the history of Rabobank. It caused great commotion outside and inside the organisation and triggered large organisational changes. Although LCBs had nothing to do with this affair, their reputation was severely impaired and many member councils[7] and local supervisory boards expressed their anger and disappointment. Mainly due to their discontent, the executive board member of RN who was responsible for this part of the international business had to step down eventually, though the Dutch banking supervisors (DNB) and supervisory board of RN had initially allowed him to stay. The chief executive officer resigned when the settlement was made public. In effect, LCBs were associated with this scandal, since the name of ‘Rabobank’ was contaminated in the eyes of the public. These reputational contagion effects underscored the necessity to operate as one Rabobank with one common culture and adherence to identical behavioural standards in The Netherlands and abroad. By the end of 2013, it was decided to manage Rabobank Nederland and Rabobank International in an integrated manner again. The trade names Rabobank Nederland and Rabobank International were abolished and replaced by ‘Rabobank’[8]. The staff directorates and departments of RN and RI were merged and a company-wide culture program was launched.

Libor

Libor is an interest rate benchmark. Libor rates are published daily on behalf of the British Bankers’ Association (BBA) for five currencies in seven maturities ranging from overnight to twelve months (although, during the period covered by the investigation, it was published for ten currencies and fifteen maturities). Libor rates are calculated based on submissions made by banks who sit on panels for each of these currencies. The BBA asks each panel bank to make its Libor submission at: ‘[t]he rate at which [it] could borrow funds, were it to do so by asking for and then accepting interbank offers in reasonable market size, just prior to 11.00 London time.’ Each day, the members of each Libor panel submit their rates to Thomson Reuters, which uses a trimmed averaging process to determine the published Libor rates.

Evidently, the evolution of Rabobank Group was no linear process. Around 1985, the expansion accelerated with the adoption of the Allfinance strategy in the Netherlands and the growing international ambitions. Since then, the composition of Rabobank Group has been adjusted regularly to changing external circumstances and/or ‘strategic reconsiderations’. Group subsidiaries have been acquired/set-up and some of them have been sold or dismantled again after a while. Step by

[7] These councils form the basis of Rabobank’s member-governed organisational structure.
[8] I shall continue to use the abbreviation RN in the remainder of this paper to avoid confusion.

step, Rabobank has discovered the international strategy that suits it best. To date, following local customers, taking small, well-considered steps and linking up with existing activities and core competences are the basic principles driving international activities. During its evolution, the tasks and responsibilities of RN as central service provider for LCBs and as holding company have expanded. The same holds for its supervisory responsibility vis-à-vis LCBs. In September 2015, Rabobank Group consisted of independent LCBs, their central cooperative RN and group subsidiaries (i.e. a number of specialised entities).

3 Salient governance developments

3.1 The causes and outcomes of the Great Cooperative Debate (1995-1998)

In the period after the merger of the two central cooperatives in 1972, the Rabobank organisation expanded steadily both domestically and internationally. The bank developed into an all-round banking organisation, offering its customers and members the complete spectrum of financial services. Simultaneously, the number of LCBs declined continuously due to mergers.

This expansion and mergers between LCBs as well as the emergence of large domestic competitors via consolidation provoked a fundamental self-assessment, culminating in the Great Cooperative Debate in the years 1995 through 1997. Since the merger of the two central organisations, the perception was that the cooperative philosophy had been subject to considerable erosion. Local member banks were fairly passive in engaging or attracting members. The number of members fell from 950,000 in 1979 to 510,000 in 1999. A local member bank acted and operated more and more like a 'privately owned bank'. In this context, some felt that Rabobank could equally well become a listed bank. This would offer Rabobank better growth prospects and access to more funding sources to counter the increasing competition. Additional arguments were the rapidly growing costs and the required large investments in new banking technologies.

Though internal sceptics of the continuation of the cooperative banking model remained a minority, they actually pointed out highly relevant questions about the meaning of membership in the context of economic globalisation and the added value of the cooperative model in mature financial systems. After intense discussions, it was decided to retain the cooperative identity. This decision was mainly based on the consideration that Rabobank has always been and had to remain an organisation of and for the people. A different legal format with fairly uncertain effects would diminish the countervailing power of members' influence on the day-to-day business decisions of professionals managing the cooperative banking group. The conviction was that there were great opportunities for a viable and strong cooperative bank with a critical mass amidst private banks. The bank would enrich the banking landscape with a distinctive business model and philosophy, thereby contributing to diversity in banking. For a firm anchoring in society and for the justification of its existence, it was deemed highly desirable to obtain more and engaged members[9] and to enlarge the autonomy of LCBs. The new governance model reconfirmed the core principles of delivering customer value, contributing to societal development, realising employee value and revitalising the membership policy. It was acknowledged that only a financially sound organisation could meet these ambitions.

Another outcome of the Great Cooperative Debate was the complete abolishment of member liability. The argument was that this liability was only virtual; members have actually never been asked to fulfil their liability obligation, as no LCB has ever gone bankrupt. This step officially sealed the transformation of Rabobank from a member credit cooperative to a customer cooperative. The cooperative principle of 'economic member participation' or of 'mutual solidarity' according to Raiffeisen's principle was completely abandoned.

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[9] Every customer of a local member bank is free to become a member, but the Board of Directors of the bank decides whether or not a customer becomes a member of the bank. Members are engaged in the policy of the bank regarding activities and investments in the local community via cooperative funds. The Member Council appoints the local supervisory Board.

Decisive strategic ambitions since 1998

Following the cooperative Debate, Rabobank formalised its strategic ambition to be an Allfinance services provider in the Netherlands. Since then, new challenges have emerged. In order to maintain its position as Allfinance market leader, strategic adjustments were necessary. To this end, the Rabobank Group formulated so-called Strategic Frameworks that outlined the future course of action for the upcoming three to five years. Various Strategic Frameworks were formulated since 2000. However, the overall ambitions did not change:

1. Strengthening Allfinance market leadership in the Netherlands;
3. Strengthening the bank's position as a leading international Food & Agri bank.

The underlying business principles remained largely unaltered as well. The cooperative profile and concept will be treasured. Rabobank Group's aim is to obtain a high rating (which mirrors the solidity of the bank). Lastly, the Group wants to be among the best performing banks in terms of CSR and sustainability.

To achieve these ambitions, the executive board has formulated four directional themes in 2014. The first theme is customer focus by providing high-quality advice combined with continued virtualisation of services and participation in local communities. The second theme is Rabobank as a rock solid bank. The third theme is the strength of a meaningful cooperative. The fourth theme concerns the empowerment of employees.

3.2 Legally independent LCBs in a highly integrated group (1896-2015)

Among all group-level entities of European cooperative banking groups, RN has been mandated by LCBs with the most extensive responsibilities in the course of many decades. In September 2015, RN performed the following interrelated tasks:

1. Banker's bank for the group;
2. Supporting LCBs (i.e. product development, ICT, marketing HR, etc.);
3. Mandate for the preparation and execution of the Group strategy;
4. Holding company for (inter)national subsidiaries;
5. Delegated supervision over local cooperative banks on behalf of the European Central Bank as from November 2014 (and De Nederlandsche Bank from 1953-October 2014).

Traditionally, RN functions as bankers' bank for LCBs. LCBs are permitted to have accounts only at RN, which is the only place where LCBs can bring their excess liquidity and which acts as treasurer for LCBs. As is the case at most other European cooperative banking groups, the tasks and responsibilities of RN have increased over time. Nowadays, RN provides a wide array of services to LCBs in the form of support, advice and guidance. RN also functions as holding company for the Group and operates its own banking business, which is both complementary to and independent of the business of LCBs. These activities are partly needed for risk diversification, access to public capital markets for funding and for competitive reasons. In this respect, RN has issued (hybrid) capital instruments to acquire additional funding and/or equity for LCBs and/or other group subsidiaries. Since the 1990s, LCBs are confronted with a so-called deposit shortfall, i.e. the local deposit growth was too low to accommodate local credit demand.[10] At the same time, the retained earnings were too small to increase the capital base in line with domestic and international expansion. To bridge

[10] Historical data show that LCBs have operated with sizeable surpluses of deposits in the period 1900-1972. During this time span, the average loan to deposit ratio was around 50 percent.

the deposit and equity gap, RN began to issue various types of hybrid capital market instruments. Consequently, LCBs remained able to meet credit demand of the private sector. The effect was that Rabobank Group became more dependent on wholesale funding and had to comply with the requirements of the financial markets, i.e. to get a credit rating and fulfil stringent reporting conditions. This has consequences for the functioning of the internal governance.

Moreover, RN issued Member Certificates in 2000, 2001, 2002 and 2005, which also classified as hybrid capital instruments. These certificates served a double purpose. They strengthened the capital position – and qualified as core tier 1 capital – and were an exclusive member product. Around 150,000 members bought these certificates, which were not publicly listed but traded on an internal market. By the end of 2013, the outstanding volume of these certificates was EUR 5.8 billion. In December 2013, Rabobank expressed its intention to enhance the tradability of these certificates. By making these certificates available to external investors, institutional investors could buy these certificates as well. This step was partially motivated by the fact that the supply on the internal market had increased significantly in the last quarter of 2013. An important cause was the requirement of the Dutch behavioural supervisor (Autoriteit Financiële Markten; AFM) that LCBs had to draw the attention of all certificate holders to the fact that a member certificate was no risk free savings product, but should be considered as an investment product. LCBs were also demanded by the AFM to advice each certificate holder to limit the share of member certificates in its total investment portfolio to 20 percent.

Since January 2014, these certificates are listed as Rabobank Certificates on Euronext Amsterdam and still count as core tier 1 capital without voting rights. This conversion could have impacted the functioning of the ‘bottom-up’ governance: the legal question arose to what extent the strategy of the group could be freely discussed in local and central governance bodies, because of the potential sensitivity of these discussions on the price of the listed certificates. If members would be for this reason constrained from freely discussing the policy and strategy of the group, it is obvious that the internal working of the democracy and governance would be obstructed. After some months, it turned out that this fear was largely unfounded. This was due to the fact that the yield on these certificates is not related to the profit level and that the certificates holders have no voting rights.

According to the Dutch Financial Supervision Act, RN is also responsible for the supervision of LCBs.[11] From 1953 up to November 2014, RN has performed this so-called delegated supervision on behalf of the Dutch banking supervisors.[12] Economically and organisationally, LCBs and RN form one group, but LCBs have their own banking license. This special supervisory regime is also incorporated in European rules of Article 10 of the Capital Requirements Regulation and article 21 of the Capital Requirements Directive IV. According to this regime, individual LCBs are exempted from the application of a number of prudential requirements, but these demands have to be met at the consolidated level. The application of this article is linked to several conditions: LCBs are permanently affiliated to RN which supervises them, the management of RN is empowered to issue instructions to the management of LCBs, a cross-guarantee system exists, which means that the commitments of RN and affiliated institutions (LCBs) are joint and several liabilities, or the affiliated

[11] The APEX organisations of the Finnish OP Group and the Portugese Credito Agricola Group also exercise ‘delegated’ supervision over the local cooperative banks.
[12] In fact, this is a continuation of the situation before the Dutch Central Bank started to supervise the banking sector. The predecessors of RN already executed this role since the establishment of the initial credit cooperatives in the late 19th century.

institutions are guaranteed by RN. This mechanism stipulates that if a participating entity has insufficient means to meet its obligations towards its creditors, all other participants must supplement that entity's funds in order to enable it to fulfil those obligations. All participants are policyholders in a separate legal entity entitled 'Mutual Insurance Rabobank'.

In practice, the cross guarantee scheme has never been activated. Long before an LCB is about to fail, internal compensation arrangements are 'automatically' triggered. Since RN operates these schemes, it will immediately use them to mitigate identified shortfalls at LCBs with respect to equity, profitability, loan loss reserves and operational and financing losses. This internal financial support system is financed by charging all other LCBs. Hence, RN plays an active role in directing financial support to individual LCBs.

The shared ambitions of LCBs and their central institution RN have resulted in a highly integrated group with mutual risk sharing and necessitated internal supervisory and regulatory rules. In a sense, Rabobank is some kind of cohabitation agreement, where the total of the Group is more than the sum of the individual parts as a result of internal arrangements and close interlinkages between group entities. All kinds of internal financial agreements and settlement procedures were established to ensure smooth capital and liquidity flows within the Group. These factors reduced the scope for local deviations in banking practices and pricing and led to a higher level of alignment of local strategies with the overall group strategy. The freedom to choose how to express cooperative identity, to organise local relationship banking and to participate in local communities has remained predominantly local, though. Due to the tight financial relationships and internal arrangements, Rabobank Group has been awarded with high credit ratings, which secured access to international capital markets in recent turbulent times.

3.3 The possible switch to one banking license and one consolidated balance sheet in 2016

Like the composition of the Group, the governance has evolved over time in response to or in anticipation of all kinds of developments. These modifications in the governance were and still are path and time dependent. Regular adjustments are necessary because the economic, technological social, institutional and regulatory environment and the business model change constantly. When this article was finalised in June 2015, Rabobank was engaged in a fundamental discussion about a new governance structure to be well positioned as a cooperative bank for the future. The transfer of the external supervision from the Dutch Central Bank to the European Central Bank in November 2014 and the installation of a European Resolution Authority as from 2016 were external catalysts for this reconsideration. Internal reasons for exploring possible governance adjustments were various supervisory issues and increasingly complex and burdensome internal rules and financial settlement procedures, which had resulted in a strong rise in audit and compliance costs at LCBs and RN and an excessive internal focus after 2011. One of the reasons was that RN did not succeed in clearly conveying to LCBs whether it acted in its capacity of central service provider or delegated supervisor in recent times. Obscurities in the governance were further amplified by the fact that the elected local supervisory boards had to exercise 'local internal supervision' in a much stricter regulated banking industry. Local supervisors of some LCBs were confronted with internal administrative problems which they could not prevent nor cure; these issues were partly caused by the confusion regarding the different roles of RN. Anyway, some LCBs had difficulties to comply with regulatory requirements concerning customer due diligence on time.[13]

The governance revision intends to fix many of the issues mentioned above simultaneously. In short, the intertwined objective is to strengthen both the cooperative and the banking business. The core feature of the proposal is that all LCBs and RN will merge into one cooperative which operates with one banking license. If approved by the Member Councils of all LCBs in December 2015, LCBs will no longer operate as independent legal entities with an own banking license and own financial statements as from 2016, but will keep their own accounts. Delegated supervision of LCBs by RN as well as the cross guarantee scheme and internal compensation rules will then cease to exist too. Since the proposed changes constitute the most fundamental adjustment in the organisation since the establishment of LCBs, it is obvious that this proposal was the result of long and intense discussions. Initially, some feared that the cooperative identity and local orientation would be ruined by an attempt to centralise all activities. Others argued that the cooperative heritage would be wasted by this proposal.

In May 2015, member representatives in Regional Assemblies and the Central Delegates Assembly felt comfortable with the suggested new structure and were convinced that the advantages would outweigh the disadvantages. Compared to the ‘old’ governance system, the consultative structure will be simplified and less hybrid. The countervailing power of members both at the local and collective level will be strengthened according to the proposals. In The Netherlands, Rabobank will continue to operate as a decentralised organisation of LCBs based on cooperative principles, which are firmly embedded in local communities. Every LCB will be directly represented in the highest governance body of the cooperative, the new General Member Council, by the chairman of its local supervisory board. The new governance model enables Rabobank to comply with future requirements of financial markets and supervisors (bail-in requirements in particular). Furthermore, an enhancement of the (cost) efficiency of the Group is expected, because internal regulatory and compliance costs can be curbed. The new governance structure will require a complete redrafting of all statutes and by-laws. The functioning of the new structure will be evaluated by external governance experts in the next few years.

[13] Documented information about customers aim at ruling out money laundering and criminal activities. In combination with the requirements of the new European Resolution Authority, the longer term tenability of delegated supervision was internally doubted.

4 Present market position and recent performance

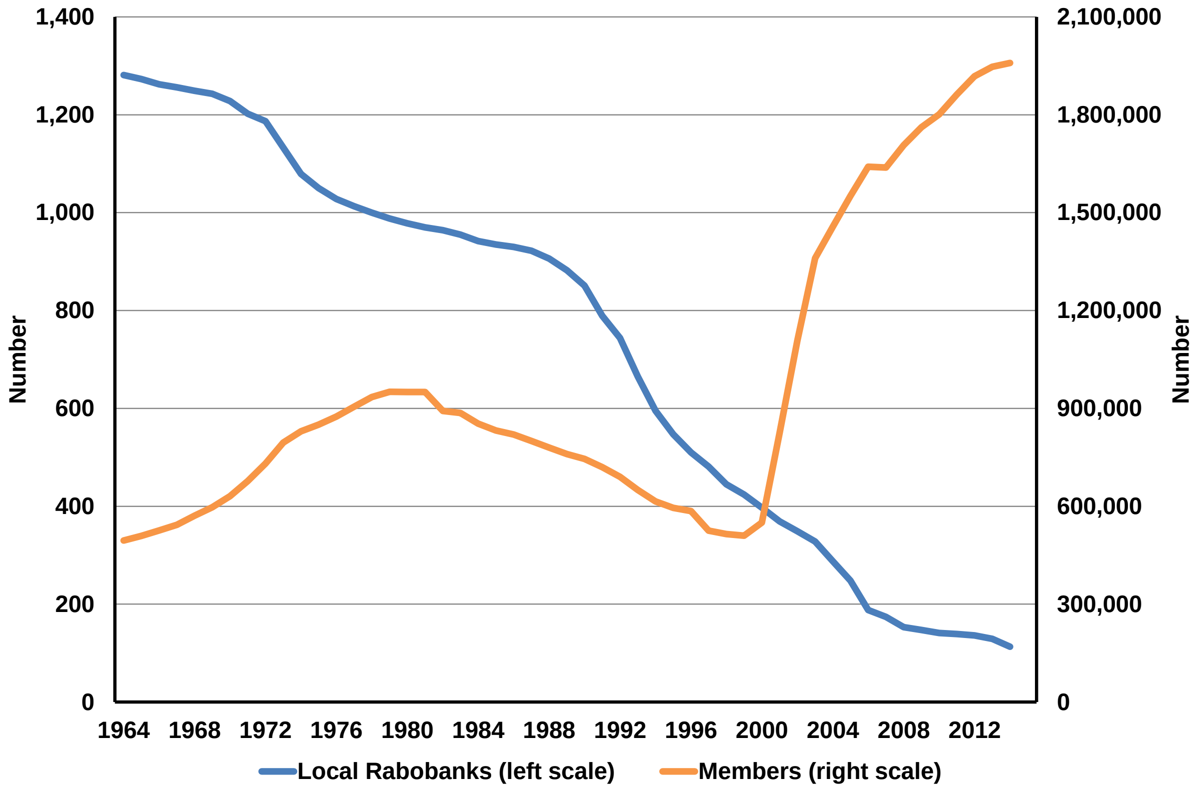
It must be emphasised that the performance of any cooperative bank cannot only be assessed by looking at financial indicators or hard data. Due to its 'dual bottom line' approach, it is also inappropriate to use only financial variables to compare cooperative banks with other banks. Indeed, financial data mask the realisation of societal goals. Apart from these qualifications, the concept of 'performance' has many dimensions: the degree of customer satisfaction, customers' perception that the bank acts in their interests, the access offered to networks and knowledge of the bank, the stability/duration of relationships, the perceived attention/concern for the environment and local communities, et cetera. Having said all this, the development of a number of key performance indicators will be discussed in the following subsections. Given the wide range of potential indicators, we had to make a selection. This section starts with an important cooperative indicator: the number of members. Then, developments in domestic market shares will be presented. Subsequently, profitability, capitalisation, efficiency and the share of international activities in total activities will be reviewed.

4.1 Members

After the Great Cooperative Debate, the revitalisation of the cooperative ideal reaffirmed that member influence is the core element of the organisation. Members keep the bank on track by exercising influence and having a say in policy on behalf of customers. Having a large membership is essentially the best legitimacy for the continued existence of the cooperative and for local autonomy. The bank subsequently developed and implemented a new membership policy, including member recruitment campaigns. These programmes were very successful. Over the past fifteen years, the total number of members grew from 510,000 in 1999 to around 2 million in 2014 (Chart 1). The member to population ratio increased from slightly more than 3 percent in 1999 to more than 11 percent in 2014. Apart from the renewed focus on acquiring and binding members and the issuance of Member Certificates in 2000, this surge was the result of a combination of factors. For instance, customers would not be inclined to become members if they are dissatisfied with the – pricing of – products and services or attitude of employees. Hence, the rise in member to population ratio can be viewed as a rough indication of clients' appreciation of the cooperative banking model. It should be stressed that members do not receive individual financial benefits.

The continuous decline in the number of banks deserves some elaboration. After a peak of 1,324 LCBs in 1955, the number of LCBs is expected to drop to 100 in 2016. One may wonder whether this is a positive or negative development from a banking and cooperative perspective. For a long time, mergers were considered to have predominantly positive effects. The resulting larger LCBs were able to serve ever growing firms in their working areas themselves, because risk concentration became less of an issue. Initially, these mergers could also be largely justified by an increasing social-economic homogeneity of adjacent working areas of neighbouring individual LCBs.

Chart 1 Number of members and local banks



Source: Rabobank

On the other hand, consolidation has undoubtedly complicated member participation and engagement. Hence, mergers have clear trade-offs in terms of – proclaimed – efficiency gains on the one hand and a potential loss of member commitment/stewardship due to larger working areas on the other. Rabobank needs to look for ways to continue operating in proximity to and as relational organisation for customers and members, thus enhancing social-economic relationships with their territories and a sustainable development of these areas. Aiming at social goals simply asks for physical presence and close relationships with local authorities and economic actors. In this respect, it seems important that the territories of LCBs largely coincide with the local areas with which members feel connected. With less LCBs, more efforts are needed to stimulate member involvement and to remain informed about important local issues for members. New ways of communicating and making connections with the member base are required. For instance, members can be tremendously valuable to prioritise local activities which deliver mutual benefits for a large group of members and the LCB in question. It must pointed out that risk management and/or efficiency motives for further consolidation between LCBs have lost their relevance in the new governance structure.

4.2 Domestic market shares

With a market share of 85 percent, the originally strong position in the Food and Agri sector has been retained.[14] In almost all other areas of retail banking, market positions ameliorated up to 2011 (Chart 2). In 2008 and 2009, the market share for deposits peaked at an all-time high (42), mirroring the perceived strong position of Rabobank amidst great turbulences in Dutch banking.

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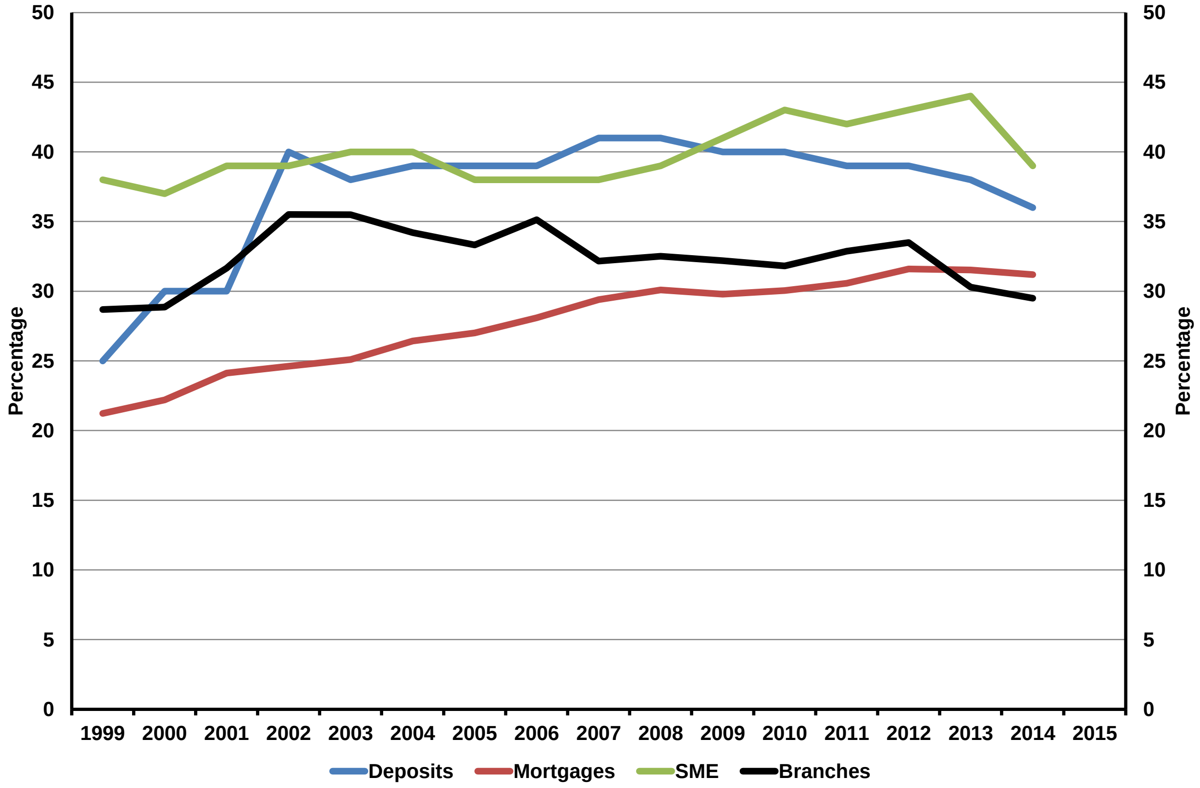
[14] The size of this sector in the Dutch economy has shrunk over time and currently accounts for roughly 20 percent of Rabobank's total loan portfolio.

Chart 2 Domestic market shares of Rabobank



Source: *Rabobank*

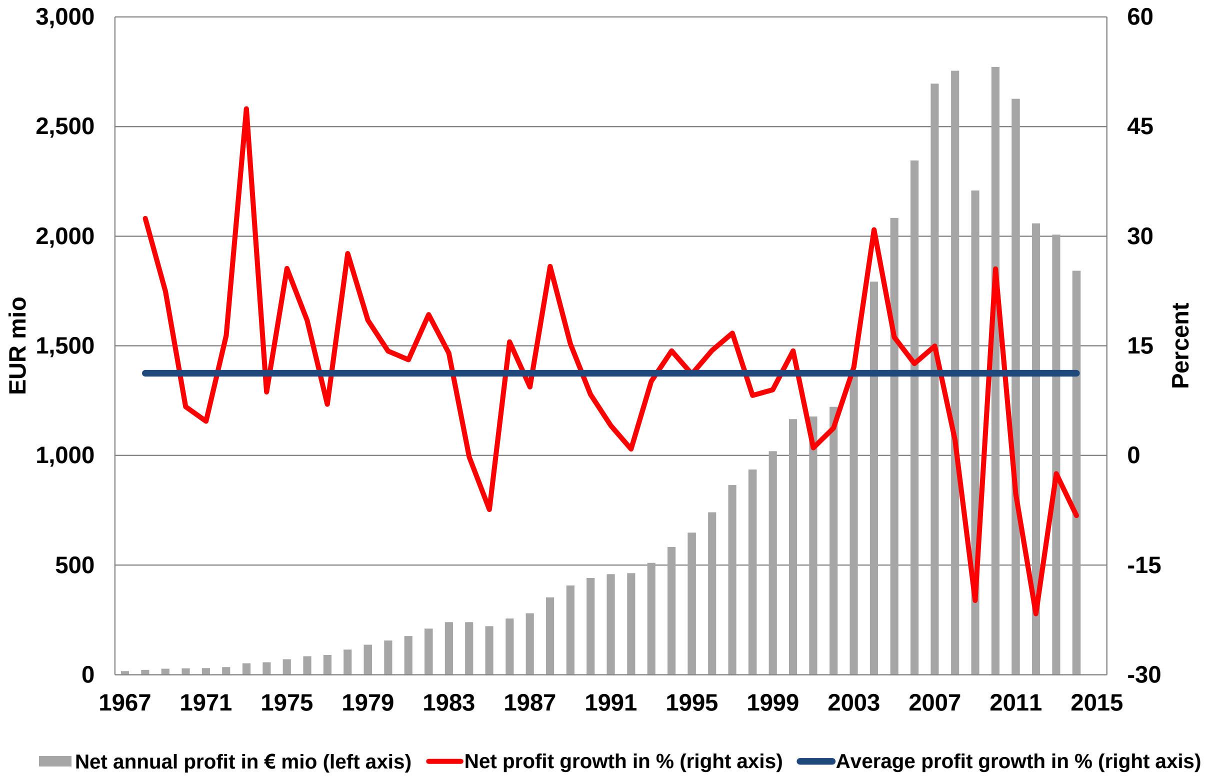
Note: the market shares for deposits and mortgages denote the outstanding volume of deposits and mortgages of Rabobank as a percentage of total banking deposits and all outstanding mortgages (i.e. granted by banks, insurers, and all other parties) in the Netherlands, respectively. The SME market share reflects the percentage of Dutch SMEs which indicate that Rabobank is their primary bank.

The market share for branches declined from a peak of 35 in 2006 to around 30 in 2014. Rabobank still has the most dense branch network in The Netherlands, which reflects the specific business and distribution model of Rabobank. For the banking business, branch networks provide an important, albeit declining, comparative advantage in the Dutch retail markets. They facilitate mobilising and retaining a stable funding source, though it should be noted that savings became a relatively expensive funding source as a result of the low interest rate policy of the ECB in recent years. From a cooperative perspective, the importance of spatial 'proximity' to members and customers should not be underestimated. Visibility and presence in local communities bolster physical participation of employees in local networks and are conducive for a well-directed sustainable development of local regions in kind and with money via the local cooperative funds. Nonetheless, Rabobank has scaled down the number of branches as a result of changing customer preferences for virtual distribution channels and to lower costs.

4.3 Profitability

The business model of all cooperative banks is predominantly geared at retail banking. This type of banking generally generates more stable revenues and profits than wholesale or investment banking (see Groeneveld, 2015). It appears that the return on equity or assets of European cooperative banking groups is much less volatile than that of shareholder value banks. This statement is also true for Rabobank, though the variability of its net profits has increased in recent years (Chart 3).

Chart 3 Size and growth of annual net profits of Rabobank Group



Source: Rabobank

Since 1967, net profits have always been positive and increased at an average growth rate of more than 11 percent per year. Rabobank had a tradition of achieving virtually each year a net profit higher than the year before. In 2009, this tradition was broken; not because of write-offs due to the credit crisis, but as a result of the poor economic conditions during the ensuing recession in the Netherlands. This economic downturn caused a rise in bad debt costs to 48 basis points of the loan portfolio, whereas the long term average is about 25 basis points. Moreover, the bank was faced with very low margins on savings, caused by strong competition in this field.

Just after the climax of the crisis, net profits surprisingly bounced back to an all-time high in 2010. Underlying figures indicate that this was caused by – at that time still – low credit losses, international interest rate developments, which turned out positively for Rabobank, and high revenues from activities on global financial markets. However, this profit level could not be maintained in the following years. Net profits have decreased every year since then, which reflects (i) structural changes in banking, (ii) the effects of subsequent financial and economic crises (e.g. low credit demand) and, (iii) specific losses and write downs in Rabobank's own operations. It is expected that banking profitability will remain subdued in the years to come. The situation in banking has changed radically, with more banks returning to retail banking in a low interest rate environment. Regulatory and compliance costs have surged as well, apart from rising Dutch banking taxes.[15] As a result of changed consumer preferences and the need to maintain an economically sustainable business model with a healthy reservation capacity, Rabobank has embarked on a large virtualisation program of services and products, which entails many job losses in the next years.

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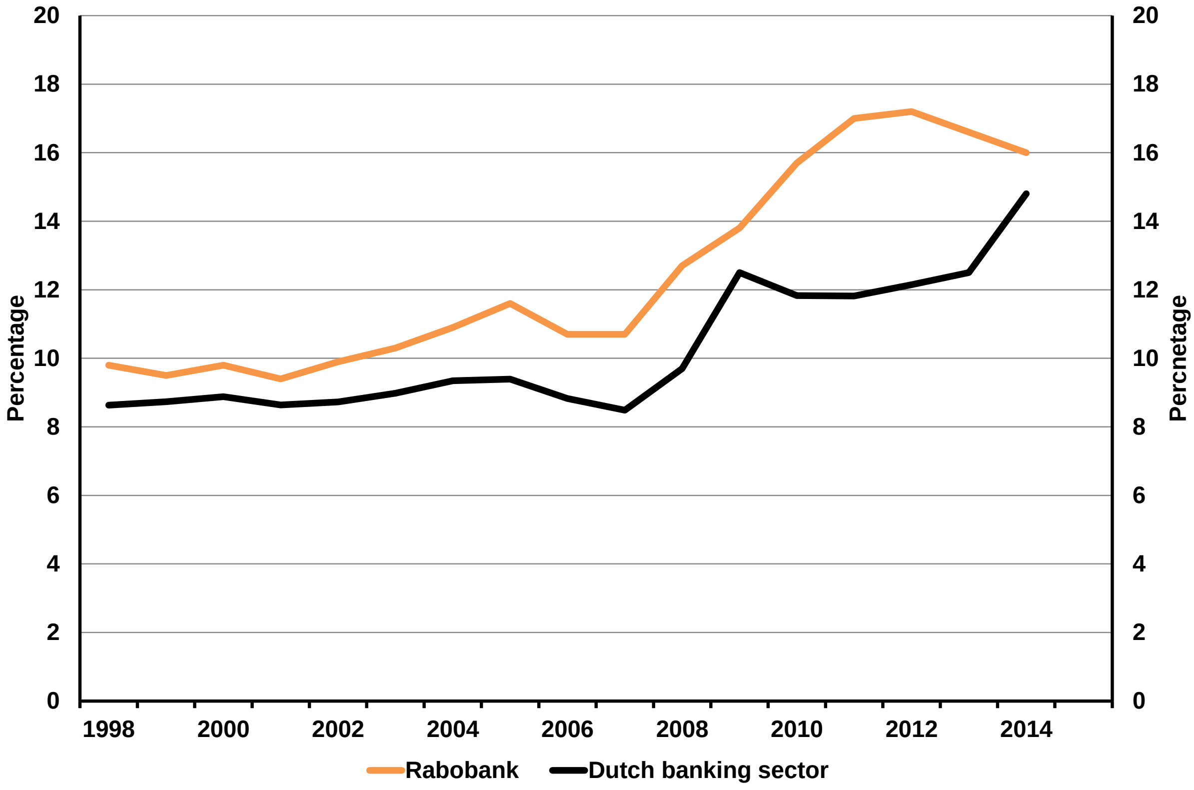
[15] The Banking Tax equalled EUR 500 million in 2014 for Rabobank.

4.4 Capitalisation and ratings

The cooperative banking model generally results in solid capital buffers, because profits are not distributed but for the greater part added to their reserves. There is no one calling for profit to be maximised from the equity 'in the dead hand' of Rabobank Group. The equity 'belongs to no one' and has to a significant extent been accrued by adding profit to reserves year in, year out, for more than a century. According to Fonteyne (2007), the knowledge that this carefully built-up capital cannot be easily replaced by external capital sources after considerable losses, stimulates executive managers of cooperative banks to apply a relatively low risk appetite. This disciplining factor partly explained the relatively good performance of all cooperative banks during and right after the initial credit crisis (Birchall, 2013). Up to the crisis, commercial or listed banks had distributed around half of their net profit to their shareholders.

Chart 4 Tier 1 ratio of Rabobank Group and entire Dutch banking sector



Source: *Rabobank and European Central Bank.*

Since the 1990s, Rabobank has always deliberately operated with a higher Tier 1 ratio (the ratio of equity versus risk-weighted lending) than the entire Dutch banking sector. Based on the risk profile, capital buffer, stability of income flows, market shares, strategy and diversification of activities, Rabobank was awarded with the highest rating among private banks from rating agencies Standard & Poor's and Moody's for many years. In 2012, Rabobank has lost its Triple A-rating from Standard & Poor's owing to the application of a new method of calculation or the ratings. However, its creditworthiness has remained unequalled. In 2015, Rabobank still belonged to the best-rated privately owned banks in the world according to all rating agencies.

It can be said that the high capitalisation and the associated high credit ratings have proven extremely important in the recent turbulent times. Due to this status, continued access to the financial markets was assured even during the crisis and hence, the independent position could be preserved. In 2008, the Tier 1 ratio stood at 12.7 percent and even went up towards 17 percent in 2011. Since then, this ratio has decreased to some extent, but stayed above the average ratio of all Dutch banks.

As stated before, Rabobank Group has found ways to finance its expansion throughout 1990-2010 via the issuance of hybrid capital instruments and Member Certificates without compromising its solvency position. A disadvantage of this kind of capital strengthening is that annual compensations to investors logically have to be paid, which in turn squeezes the reservation capacity. For this reason, Rabobank aims at a gradual reduction of the relative share of hybrid capital instruments and Rabobank Certificates in its capital base. Simultaneously, Rabobank has formulated a growth path that rests on both improving the reservation capacity and a moderate asset growth. Against this background, Rabobank has sold its subsidiaries Sarasin (Swiss private bank) in 2012 and Robeco (asset manager) in 2013.

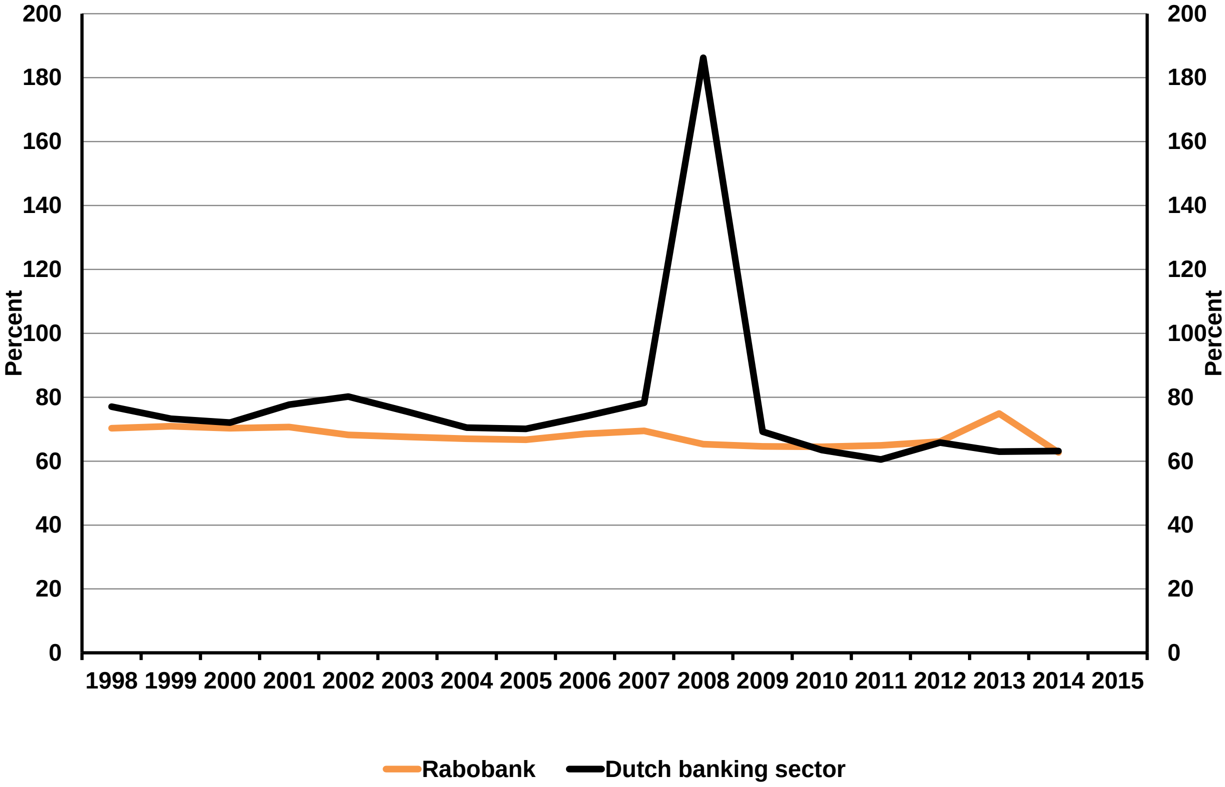
4.5 Cost to income ratio

An often used measure for the efficiency of banks is the cost to income ratio (i.e. operational expenses divided by operational revenues). Up to 2009, Rabobank has operated with a somewhat lower cost to income ratio than the entire Dutch banking sector. The relatively high costs of the dense branch network were thus compensated by higher returns in other areas. The large hike in this ratio for all other banks in 2008 catches the eye. This was obviously related to well-known large shocks in Dutch banking, i.e. the nationalisation of the Dutch part of Fortis/ABN Amro, and government support for ING and SNS (which was nationalised in 2013 as well). All in all, sixty percent of the Dutch banking sector needed some form of government support. This massive government intervention has long lasting consequences for the competitive environment and trends in the Dutch banking sector.

Since then, ING and ABN Amro took major steps to slim down their organisations and to improve efficiency and profitability. Rabobank seemed to have been somewhat paralysed by its good performance before and just after the credit crisis. In 2012, newspapers wrote that the bank was acting with a slight arrogance, though it had always been characterised by a degree of modesty. With hindsight, it seems as if the media had a premonition of the issues Rabobank would encounter a few years later. As described above, Rabobank was confronted with internal issues and economic headwinds since 2010. With some delay, it responded to structural changes in external circumstances and internal problems with major adjustments in its governance and operations.

Whereas the efficiency in Dutch banking improved considerably after 2009, the cost to income ratio of Rabobank peaked at 78 in 2013 as a result of increasing loan losses and one-off effects like the Libor settlement, reorganisation costs, and high write offs on real estate and ground positions. The coming years will be dominated by an ongoing virtualisation and simplification of products and services and employment reductions. These programmes are assumed to generate cost savings and a structural improvement in the efficiency ratio in due time.

Chart 5 Cost income ratio of Rabobank Group and entire Dutch banking sector

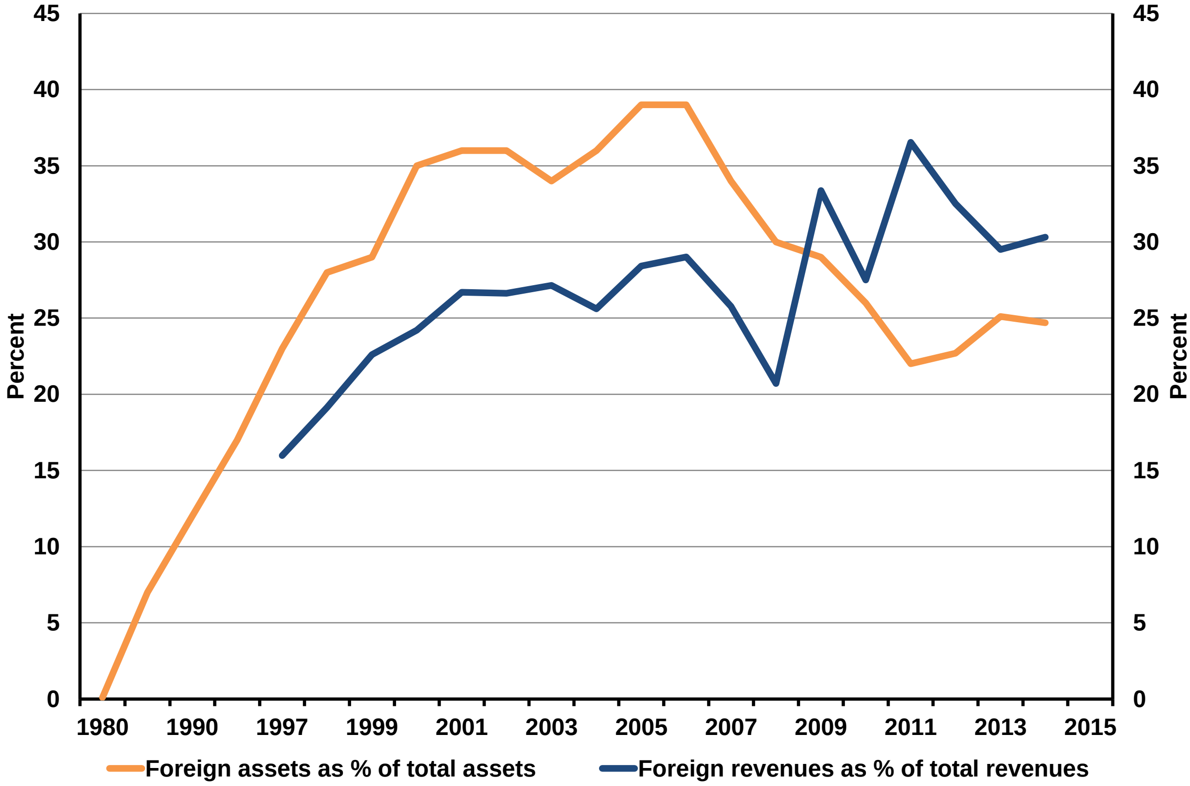


Source: *Rabobank and European Central Bank.*

4.6 International activities

Chart 6 illustrates that the share of Rabobank's international activities has grown continuously since 1980 until the break-out of the credit crisis. In 1980, international activities were still virtually absent, but increased considerably in the subsequent ten years as measured by international assets and foreign revenues as a percentage of total assets and revenues respectively. After a while, it became apparent that international investment, wholesale and corporate banking activities can be riskier and more volatile than the activities of LCBs in The Netherlands, with the latter focusing primarily on retail banking. The higher revenues that can be expected from the international wholesale business are sometimes counterbalanced by a greater volatility in returns caused by the deterioration of particular international markets or a rise in the level of credit or country risks. In the remote and recent past, substantial net losses and write-downs of Rabobank Group were mostly concentrated in the international activities (and/or at group subsidiaries). For instance, the share of foreign revenues in total revenues displayed a large drop in 2008. The reason is that in the period of 2007 to 2009 around 2.5 billion after tax has been written off through the profit and loss account on positions in the banking operations that had been impacted by the financial crisis (Vogelaar, 2012, p. 207). However, these losses were more than offset by strong results of LCBs in particular.

Chart 6 Development of international business as percentage of total business



Source: *Rabobank*

The chart shows the drop in the share of all international assets from around 40 percent in 2006 to 25 percent in 2014. This is the consequence of a deliberate policy to cut back foreign credits to free capital for domestic retail activities. The international wholesale business was refocused towards customer-oriented activities. For its international business, Rabobank has the ambition to be a globally recognised food and agri bank.

5 Concluding remarks

Like other European cooperative banks, Rabobank survived the credit crisis 2007-2010 relatively well (Goglio and Alexopoulos, 2014). Rabobank incurred losses and write-downs of around six percent of its total equity, but it did not need any form of state aid. Though it is difficult to pinpoint one specific cause for this achievement, it is safe to say that its solid and balanced corporate governance structure with member influence, a low risk profile and long-standing business model are important explanations. The former feature fosters a predominant focus on retail banking, i.e. financing the real economy. The conscious choice to remain a cooperative made in 1998 has surely paid off very well ten years later. Furthermore, the resulting high capitalisation and credit ratings have proven to be powerful assets in the recent financial turmoil; Rabobank entered the crisis with solid liquidity and capital buffers, which largely explains why it retained good access to professional funding.

After 2010, Rabobank was obviously affected by the weak economic situation given its focus on the real economy. In addition, Rabobank was negatively impacted by the low interest rate environment and the general loss of confidence in the Dutch banking sector, which was exacerbated by its own role in the Libor fixing scandal. Regarding the reputational damage, the sector has taken various initiatives to restore its image, but that will not happen overnight. Recommendations and requirements for good governance and solid risk management were formulated, since banks can only adequately perform crucial public functions – which are vital for a well-functioning economic system – if trust and confidence in and among banks exist. In 2014, a banking oath was introduced in Dutch banking. This oath is not something without obligation, since this oath is backed by a newly designated disciplinary law.

Though Rabobank has faced difficulties after the credit crisis, its financial solidity has never been put into question. In 2014, Rabobank comfortably passed the stress test carried out by the European Central Bank in order to be admitted to the Single Supervisory Mechanism, i.e. the Asset Quality Review. For the future, Rabobank has identified the following major challenges in banking:

- Tougher competition due to remarkable shifts in the business models and strategic focus of existing and new competitors;
- Great urge for cost reductions and efficiency improvements to increase the reservation capacity for the necessary capital expansion;
- Fundamental regulatory and supervisory changes.

Therefore, the key objectives for Rabobank are to strengthen its distinctive cooperative nature and to secure its solid financial profile simultaneously. The envisaged new governance structure is aimed at maintaining trust and confidence of internal and external stakeholders in Rabobank. Indeed, whether Rabobank succeeds to tackle all challenges is largely determined by the set-up and functioning of the representative democracy, i.e. how and to what extent members participate in policy and strategy making. Sound profitability is required for solid capital ratios, continuity and growth and for the realisation of social objectives like contributing to a sustainable development of society and boosting the vitality of communities. All these ambitions can only be realised with innovativeness, good products at fair prices, operational excellence and last but not least well-motivated and highly qualified employees, who participate actively in society.

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