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Governance of European Cooperative Banks:

Overview, Issues and Recommendations

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1. Introduction and summary

This article focuses on governance issues of the European cooperative banks, which constitute the largest category within the family of banking cooperatives worldwide. The insights and considerations also apply to other banking cooperatives like credit unions, building societies and cooperative banks set-up by other cooperatives. In recent years, it has been empirically confirmed that European cooperative banking contributes to diversity and stability in the financial system, largely due to its specific member-based governance (Goglio and Alexopoulus, 2014).

To maintain or strengthen the cooperative nature and profile, I have distilled four recommendations related to cooperative governance. These suggestions are based on my own personal interpretation of recent events and regulatory developments. First, the countervailing power of members vis-à-vis banking professionals and/or executives is extremely important at all levels of governance. Within every cooperative enterprise, the external orientation and disciplining of the executives can only come from members (cooperatives do not have shareholders). The preparedness of members to exert countervailing power in the governance largely depends on their commitment, engagement and involvement, which are all related to many different business features and societal contributions of cooperative banks (e.g. performance, distribution concepts, virtualization of banking services, innovativeness, positioning, consolidation, connections with – local – society, etc.) and the perceived meaningfulness of membership. The importance of a vibrant and noticeable countervailing power by members for the viability and specific orientation of cooperative banks is not dealt with in a separate section but is mentioned either implicitly or explicitly in many parts of this article.

The second recommendation is to be cautious regarding the expansion of business outside the cooperative part of the group (i.e. the size of subsidiaries and international activities together). I suggest to limit the latter activities to 30-40 percent of all operations of the cooperative banking group.[2] This rule of thumb is primarily based on the observation that recent sizeable losses and/or write downs at some cooperative banking groups were located at group-level entities and/or subsidiaries in non-retail or non-domestic activities (Birchall,

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[2] This could be defined in terms of total assets, total employment or gross revenues.

2013). These events entailed reputational damage and risks for the affiliated cooperative banks. Furthermore, the latter activities were generally not carried out by group-level entities to serve – large business – customers of local or regional cooperative banks, but were mostly executed by group-level entities with an own (wholesale) banking business or via subsidiaries where group-level entities act as holding company. In this respect, banking activities outside cooperative banks should preferably be closely related to the needs of – customers of – cooperative banks and/or be predominantly linked to the core competences.

The third suggestion is that pros and cons of the introduction, presence or expansion of external investors and/or third-party shareholders must be carefully assessed and clearly explained to member representatives. It is my opinion that the dependency on wholesale funding and equity providers of a cooperative banking group should remain as limited as possible or necessary, even if this would imply lower growth compared to other banks.[3] As will illustrated in section 5, the introduction of external funding or capital providers has led to complications in the functioning of the member-based governance in some cases.

The fourth suggestion is linked to a series of new rules and guidelines that international and national regulators and supervisors have introduced that directly and indirectly affect the governance of banks, both commercial and cooperative (European Banking Authority, 2011; Basel Committee, 2015). These regulatory developments urge cooperative banks to explain their specific governance features in a convincing, credible and transparent way to the regulators and supervisors. It would hurt cooperative banks as well as the entire financial sector if these characteristics would – deliberately or unconsciously – be ignored or misunderstood. Cooperative banks should not ask for favours, but policy makers should take their features into account when designing and implementing policy measures. Cooperative banks exhibit positive effects for diversity, competition and stability in the European financial sector as will be explained in the section devoted to the external manifestations of their cooperative governance.

[3] It is difficult to define a precise threshold for this requirement. Basically, this requirement is closely linked to the desirable loan-to-deposit ratio as well as the appropriate level of the leverage ratio featuring in current supervisory policy discussions.

2. Stakeholder and Shareholder Value Banks

The banking sector incorporates a rich array of banks with diverse business models and ownership structures. Public, state, savings, cooperative, mutual and private banks co-exist in a diversified market. In policy reports and research publications, a particular distinction is made between Stakeholder Value (STV) banks (of which cooperative banks are a major component) and Shareholder Value (SHV) banks (of which listed banks are a major component). The distinction is ultimately about the banks' bottom line objectives and the extent to which profit maximisation is the central focus of their business models. SHV banks can be categorised as 'dual-bottom line' institutions, i.e. they aim at both financial/economic goals and social objectives.

SHV banks have shareholders which are the owners of the bank and the ultimate risk-takers. In this model, the bank management is supposed to act primarily in the interests of the shareholders through maximising the value of the business as reflected in the rate of return on equity and the market capitalization value. The products and services SHV banks provide are a means to generate income for their investors, within the limits of the law and accepted social, financial and sustainable standards. SHV banks are governed by shareholders on a 'one share, one vote' principle, which is equivalent to economic decision-making power in proportion to wealth (Nadeau, 2012). SHV banks also tend to have a single, centralised Board that operates top-down through an appointed CEO with wide latitude to define the company's operating strategy, policies and structures from the centre (Oliver Wyman, 2014).

In contrast, in STV banks there are many stakeholders, and most especially the members (as owners and customers) in cooperative banks. In the STV approach, while profitability is one of the objectives of the bank, it is not exclusive or even the primary objective. It is more an issue of balancing different interests of the various stakeholders in the company via local or central governance bodies. In practice, this means that a STV bank will not pursue profit maximization to the same degree, or with the same intensity, as SHV banks. For STV banks, profitability is a means to safeguard continuity and growth on the one hand and to be able to meet social or societal goals on the other. STV banks are not subject to the pressure from investors for immediate returns, and can consequently apply a longer-term perspective.

Disciplining STV and SHV banks

Dissatisfied members have a powerful option to discipline management or executive Board members of local cooperative banks and/or their central institutions in the form of withdrawing funds and business (Groeneveld and Llewellyn, 2012). Exit or voting with their feet by members diminishes the volume of deposits available to the business, and can consequently be a more powerful discipline on management than the sale of shares in a SHV bank. Although customers of SHV banks have similar options at their disposal to signal their discontent by, for instance, withdrawing deposits, the crucial distinction is that they are not owners of the bank. The exit route by members (who are also customers) is a particularly powerful disciplinary tool in the case of cooperative banks, as it removes resources from the bank, whereas the sale of shares in an SHV bank does not.

Withdrawing deposits thus exerts a powerful discipline on cooperative banks and constitutes, in some sense, a more direct threat to managers. This is because when a depositor withdraws funds, the funding capacity of the cooperative bank is immediately reduced. By contrast, the sale of an equity stake in a SHV bank does not in itself influence the capacity of the bank, though the share price might fall, which would have the effect of raising the cost of capital and might also create a confidence problem for the bank. Thus, if equity stakeholders in SHV banks sell their ownership stake on the stock market, this does not remove assets from the control of the management of the banks, whereas the withdrawal of members' deposits at cooperative banks does.

3. Types of banking cooperatives

Taking a global view, four categories of banking cooperatives can be distinguished (Groeneveld 2015a). They share a number of common characteristics and values, among which: social commitment, local community focus and democratic governance according to the 'one member, one vote' principle. In terms of total assets, European cooperative banks are the largest category, followed by the global credit union movement. The main differences between the two are that in the credit unions customers have to be members, whereas the cooperative banks are also able to serve non-members.

European cooperative banks have long been an integral and well-established part of the European financial system. Cooperative banks operate with a full banking license and serve many non-members nowadays. In the early days, membership was compulsory in order to be eligible to obtain a loan from a local cooperative bank. Many cooperative banks abolished this requirement a long time ago. This was mainly due to fundamental changes in the economic structures of countries, i.e. from an agricultural to an industrial focus, increasing individualism and large innovations in payments services as well as the upcoming demand for mortgages due to increasing popularity of home ownership. Since IT investments require large amounts of money, cooperative banks had to start serving the emerging mass retail markets to reach a certain scale for their operations. The average member to customer ratio now stands at 30%, which implies that a large majority of customers are not members of a cooperative bank (anymore) and that customers are not automatically members. It is true though that the value of membership has eroded over time, as the original motive to become a member of cooperative bank, i.e. obtaining access to affordable financial services, has lost its validity in Western Europe.[4]

Besides, the homogeneity of the member – and customer – base has weakened as a result of social, economic and competitive developments in the course of time. Initially, members of cooperative banks were mainly farmers or craftsmen in cities, which simplified the risk control and management of the early local credit cooperatives. This diverse member base has surely thwarted the functioning of the governance over time. Nowadays, it is much more challenging to reconcile the potentially divergent interests of members with more diverse backgrounds and needs. Be that as it may, only – representatives of – members still play a formal role in local and central governance. Theoretically, they are in the position to ensure that local cooperative banks stay close to their original mission and traditional business orientation. Regardless, cooperative banks are an important part of the diversity and plurality in European banking. In 2013, the total number of members amounted to approximately 78 million, i.e. 18 percent of the entire population in the respective European countries are members of a cooperative

[4] This aspect touches upon the issue of the motives for customers to become a member. According to my knowledge, this topic is a rather unexplored territory in European cooperative banking (EACB, 2007). The most important reason to become a member seems to be trust in the cooperative and customers' satisfaction with the quality and pricing of products and services.

bank. The average domestic market share in retail loans as well as in retail savings is more than 20 percent.

The vast majority of credit unions has to restrict membership to people who come within a ‘common bond’, whereas cooperative banks have no restrictions. The World Council of Credit Unions (WOCCU) estimates that credit unions serve around 208 million people and possess USD$1.7 trillion in assets. This comes down to a penetration rate of about 8%, i.e. the total number of reported credit union members divided by the economically active population age 15-64 years old. Collectively, the credit union movement is smaller than the (European) cooperative banks. If we add up the totals for credit unions and cooperative banks, credit unions have around 18 percent of total assets (Birchall, 2013).

The third category of banking cooperatives is the building society sector, which mainly exists in the United Kingdom and Australia. Building societies are owned by their saving and borrowing members. The business model of building societies is generally fairly simple. Members save at the society and these funds are used to grant loans to members wishing to acquire property, which is the collateral to the loans (Butzbach, 2014).

The fourth – and rather small – category of banking cooperatives comprises banks which are set up by other cooperatives. The Cooperative Bank in the United Kingdom was an example of the latter. This bank was established by the Cooperative Group, but had to be rescued by hedge funds due to a malfunctioning governance which led to ill-considered and costly expansionary decisions (Kelly, 2014).

4. Commonalities and differences in governance

Table 1 summarizes the main similarities and differences among cooperative banks. In the last column, the corresponding governance features of SHV banks are included for the sake of comparison. Before the most salient aspects of this table are discussed, it must be noted that the governance structure of cooperative banks has constantly evolved in reaction to and/or in anticipation of economic, technological, competitive and regulatory changes over more than one hundred years. Without this adaptability, cooperative banks would probably not exist anymore.

The first column highlights important unifying characteristics of cooperative banks, which date back to the time of their inception. The most fundamental one is that cooperative banks are member-governed institutions, with direct or indirect representation of members at all levels of governance. Every cooperative bank adheres to the democratic principle of 'one member, one vote' and applies an open membership policy. Most local and/or regional cooperative banks are funded predominantly by retail deposits raised locally and do not have external shareholders, i.e. equity/capital providers with voting rights. As a consequence, cooperative banks have a different governance structure and business orientation than SHV banks. By definition, cooperative banks operate in a bottom-up manner (starting point is the member base) which creates a framework of checks and balances between local cooperative banks and the central structure (if any).

Generally speaking, customer-members own the nominal valued shares or certificates in local banks. The Swiss Raiffeisenbank and the Dutch Rabobank are exceptions, since their membership has never entailed the financial obligation to buy member shares (to capitalize local cooperative banks). In Switzerland and the Netherlands, members of the initial credit cooperatives were fully liable for members who wanted a loan, but this requirement has been abolished a few decades ago, i.e. the financial reciprocity between members and their bank initially had a different form. At all other cooperative banks, some financial reciprocity between members and local cooperative banks still exists today, i.e. the cooperative principle of member economic participation still pertains to these banks. For most European cooperative banks, a member share or certificate ranges from € 5 to € 100 (and the total amount of member shares is capped to a maximum). Unlike stock shares, cooperative shares do not give members an ownership claim on the reserves of the local bank. Instead, they give a right to some dividend, and are redeemable at cost should the member leave the cooperative. It is impossible for current cohorts of members to convert a local cooperative bank into a joint-stock bank (Public Limited Company status) and to redistribute the built-up reserves. Therefore, one could say that the reserves of cooperative banks are in '*dead hands*'. All in all, cooperative banks are predominantly funded by retained earnings, member shares and customer deposits, though some of them rely on external funding and equity to varying degrees.

Table 1 Current similarities and differences in governance regimes of cooperative banks

	Similarities	Differences	Comparison with non-cooperative banks
Structure	• Local banks are full banking entities (banking license)	• Size and number of local banks and branches • 1, 2 or 3 tier group structure • Degree of integration within the group	• Local/regional entities do not have a banking license
	• Group-level entity is founded by local banks and/or the members	• Nature of group-level entity (association, cooperative, corporate) • Nature and size of (inter)national activities of group-level entity	• Group-level entity ('parent') establishes and owns the local / regional entities if any
Governance systems	• Option for number of levels in governance	• Actual number of governance levels (1 to 3)	• One main level of governance
	• Representation of members (= customers) at all levels of governance		• Representation of shareholders/ owners in the governance • No involvement of customers in the governance
	• Customers are not automatically members, but membership is open to all customers • Democratic system to elect Board at bank's level ('one member, one vote')	• None or limited financial liability of members (member shares or certificates, ranging from € 5 to €100) • Election of group-level entities' Board either directly by members or by their representatives and appointed management in the local banks	• Board is directly elected by shareholders based on the amount of shares owned
	• Capitalisation takes primarily place via retained earnings • Capital is in 'dead hands': current members have no ownership claim on reserves • Local and regional banks are predominantly funded by retail deposits raised locally	• Degree of dependency on external funding and/or external capital (tier 1, 2 or 3) • Existence of third-party investors and/or shareholders (through listed or unlisted entities)	• Shareholders capitalise bank, hardly via retained profits • Greater dependency on wholesale funding • Shareholders determine the dividend policy and provide directions for – returns on – investments
	• Elected members are Non-Executive Directors in Boards (in a supervisory capacity)[1] or Supervisory Board Members • Diversity of backgrounds of Non-Executive Directors	• Governance bodies at group level • Composition of governance bodies (members, managers, outside Non-Executive Directors) • Eligibility requirements for Non-Executives Directors ▪ Mandatory members or not mandatorily ▪ Weight of fit and proper tests (light or heavy)	• Non-Executive Directors at top level are primarily chosen for their reputation and professional capacity • Rather one-dimensional profile of Non-Executives favouring banking and financial experience / expertise
	• Varying degree of autonomy of local banks regarding the expression of the cooperative identity, key business and prudential decisions (within agreed scope)	• Supervisory and regulatory role of group-level entities regarding local banks ▪ Controlling versus non-controlling vis-à-vis official regulators /supervisors ▪ Split of decisions and responsibilities	• Very limited autonomy of local / regional entities on prudential decisions • Very limited room for local entities to differentiate in pricing and servicing

Source: the table is based on investigations of governance structures of European cooperative banking groups and information from other scarce studies (e.g. Di Salvo, 2011).

Note :[1] The Dutch Rabobank is the exception. At the local level, an elected Non-Executive (Supervisory) Board exists next to an Executive (professional) Board of Directors. Rabobank will however change its governance model fundamentally in 2016. It will move to one banking license and one consolidated balance sheet.

Cooperative banking groups are thus formed of a number of autonomous banks, servicing distinct communities (with respect to geography, economic structure, etc.) with potentially distinct needs. Cooperative banks are governed by their members (clients-owners), with direct or indirect member representation at all layers of governance. Local members or member constituencies elect Non-Executive Board Members, or in some instances called local supervisors, who monitor and control local/regional cooperative banks. Almost every local or regional bank operates with a local Board consisting of Non-Executive Board Members and at least one professional banker (e.g. general manager of the local bank). Due to the large number of members, central governance bodies are not based on a direct democracy, but function with a representative democracy. Representatives of locally elected Board members have a seat in central governance bodies, thus influencing the policy and strategic course of the entire organization. The rights, obligations and responsibilities of – representatives of – members in local and/or central governance bodies are laid down in internal statutes, articles of association, or by-laws. An informal survey reveals that around 5 percent of the members are willing to take part in internal governance bodies. Around 780,000 members (i.e. 1 percent) do actually participate in the governance of European cooperative banks. These members are ambassadors and advocates of cooperative banks in society.

Other similarities are that cooperative banks are made of a network of affiliated banks and that individual local banks have collectively set up a group-level entity, being an association, a cooperative or a corporation. The individual banks own the capital of the group-level entity when it has a corporate or cooperative legal structure (APEX). Such group structures with centralised business functions allow cooperation in ways that create efficiency gains through economies of scale and scope. This has inevitably led to a decline in autonomy and discretion of local member banks in managing their banking business and operations.

But here these similarities end, because the level of integration between local/regional banks and the responsibilities and activities of the group-level entities vary considerably across cooperative banking groups. Four different degrees integration are potentially possible:

A. A basic cooperative group does not have an Institutional Protection or a Cross Guarantee Scheme and has very limited centralised functions;
B. Decentralised cooperative groups have a legal framework in the Capital Regulations Requirements (CRR, art 113(7)). They have an Institutional Protection Scheme, limited centralized functions, independent local banks supervised by national supervisor and the management of central body cannot issue instructions to local banks;
C. Consolidated cooperative banking groups have a legal status (article 10 or article 113(6) CRR). They have a Cross Guarantee System, are supervised directly by the ECB, have many centralized functions. The executives of the group entity can issue instructions to local banks (preventing default) and the group entity decisions are binding;
D. A fully integrated cooperative banking group operates with a single banking license for the entire cooperative banking group. There is consolidated supervision and member

representation at the local and central level. The banking business is totally integrated. This category of cooperative banking groups will comprise one cooperative banking group as from 2016: the Dutch Rabobank.

Table 2 classifies eight cooperative banking groups into these categories. The main characteristics are recorded in the first column. The Spanish and Italian cooperative banks operate with a fairly loose structure. The Austrian and German cooperative banks are more integrated but do not have a central institution with a mandate to issue management instructions to the local cooperative banks. The group-level entities of the four other cooperative banking groups are able to issue these instructions.

The group-level entities in the form of central banks also differ regarding the scope of their roles and tasks that they perform within the group and for the local cooperative banks. Group-level entities with the most extensive responsibilities have the following roles:

1. Supporting local banks (i.e. product development, ICT, marketing HR, etc.);
2. Banker's bank for the group;
3. Mandate for the preparation and/or execution of the overall strategy;
4. Holding company for (inter)national subsidiaries;
5. Supervisory role over local cooperative banks.

All APEX organisations act as central service providers for local cooperative banks. Many centrals serve domestic business clients that are too large for the local cooperative banks from a risk concentration perspective, while retaining local relational banking and institutional foundations in social and political networks. Then, there are centrals that undertake national and/or cross-border activities or act as a holding company for domestic and/or foreign subsidiaries. The size and nature of such operations carried out by centrals vary greatly. Besides, the established common entities by local banks can be listed or non-listed, with or without the presence of third-party shareholders.

Depending on the level of integration within the cooperative banking group[5], the local banks and the regional and central institutions either report consolidated as well as separate figures or report only separately. In addition, some group-level entities are responsible for the execution of internal solvency and liquidity mechanisms, and/or internal protection schemes (IPS; supervisory role) to ensure the overall stability of the network. To perform the latter task adequately, the respective group-level entities have supervisory powers that provide a common set of standards for local banks to adhere to. These monitoring devices usually exert

[5] The level of integration varies from loose associations like the Italian Popular Banks to highly integrated groups like Rabobank and Finnish Financial Cooperative Group.

Table 2 Levels of integration of cooperative banking groups

	A. Basic Co-operative Group		B. Decentralised Cooperative Group (Article 113(7) CRR)		C. Consolidated Cooperative Bank (Article 10 or Article 113(6) CRR)			
Cooperative bank	***Cajas Rurales (Spain)***	***BCC (Italy)***	***Raiffeissen banks (Austria)***	***Volks- and Raiffeisenbanks (Germany)***	***Raiffeisen (Switzerland)***	***Crédit Agricole Group (France)***	***OP (Finland)***	***Rabobank (Netherlands)***
- No Institutional Protection Scheme or Cross Guarantee	**x**	**x**						
- Centralized functions in the group are very limited	**x**	**x**						
- Institutional Protection Scheme			**x**	**x**				
- Centralised functions in the group are limited			**x**	**x**				
- Local banks supervised independently by national supervisor	**x**	**x**	**x**	**x**				
- No management instructions by central body to local banks	**x**	**x**	**x**	**x**				
- Cross Guarantee System					**x**	**x**	**x**	**x**
- Consolidated supervision by European Central Bank					**x**	**x**	**x**	**x**
- Many functions in group are centralized					**x**	**x**	**x**	**x**
- Central body has mandate to issue instructions to local banks					**x**	**x**	**x**	**x**
- Central group binding decisions					**x**	**x**	**x**	**x**

Source: author, based on research and questionnaires among these cooperative banking groups a strong disciplinary influence on member banks (and their management), apart from the intrinsic peer pressure within the network. In this case, a dual governance structure exists. On the one hand, local cooperative banks monitor the central institution that they have established for support or to perform (inter)national activities as holding company, while at the same time the central organisation exercises prudential and behavioural supervision over the member banks.[6]

In summary, there is no single governance model that, in all its detail, is common to every cooperative bank (see column 2 in Table 1). This means that there is no completely homogeneous set of cooperative banks across Europe. There is a rich diversity in precise business models, structure and governance. The European cooperative banking sector can, therefore, be characterised as '*Commonality with Diversity'* in that there is a set of basic governance principles that are common to all cooperative banks while at the same time differences exist in the practical way of operation in many areas. Each governance structure is shaped by circumstantial and/or historical elements. These factors comprise the geography (size of the country), national banking market characteristics, consumer behaviour and preferences, complexity and size of the cooperative banking group and regulation and supervision (legislative burden). However, the essence, roots and design of the governance of all cooperative banks differ significantly with those of non-cooperative banks on many points. Just one exemplary aspect, in SHV banks, the 'parent' owns the subsidiaries (see column 3 in Table 1), whereas local cooperative banks are the parents of the central institution and the owners of the subsidiaries. This leads to large differences in governance dynamics between cooperative and SHV banks.

[6] In Finland and Portugal, the APEX institution is officially responsible for the delegated supervision over the legally independent local banks on behalf of the European Central Bank.

5. Non-cooperative activities and external funding

Most local cooperative banks are primarily funded by retained profits and customer deposits and operate in less integrated networks, e.g. the German Volks- and Raiffeisenbanks (V&R) and the Italian BCC banks. They use local savings to fund local loans to households and SMEs. Their (balance sheet) growth potential is largely determined by the capital formation via retained earnings and by retail deposit growth. This means, for instance, that the central banks of the German V&R banks, DZ and WGZ, do not attract additional financial means for the local cooperative banks. This feature results in fully locally oriented cooperative banks; local savings are used for the development of local communities via local credits. In this situation, local governance can operate relatively independent and is mainly shaped by local developments. The flipside is that smaller cooperative banks – like the German V&R banks – cannot service large customers on their own, due to risk limitations.

There are also cooperative banking groups that have issued various (hybrid) capital instruments via their central institution to acquire additional funding and/or equity for their local banks. Rabobank is a case in point. Since the 1990s, local cooperative Rabobanks are confronted with a deposit gap, i.e. the local deposit growth was too low to accommodate local credit demand. The central institution started to issue hybrid instruments to obtain funding for the local banks. Consequently, local Rabobanks could fully meet the credit demand by households and SMEs. The consequence was that Rabobank became more dependent on wholesale funding and had to comply with the requirements of the financial markets, e.g. to get a credit rating and fulfil stricter reporting requirements. The shared ambitions of local banks and their central institution led to a highly integrated group with mutual risk sharing and necessitated internal supervisory and regulatory rules. 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 has remained predominantly local, though.

Then, there are a very small number of cooperative banks that have become partly listed to acquire additional capital to grow more and faster, e.g. the largest Italian Popular banks and 13 regional banks of the Crédit Agricole Group. The corresponding external shareholders do not have voting rights relative to their shares (but that will change for the Popular banks as will be discussed below). It is more common that the central institutions of larger and more integrated cooperative banking groups attract wholesale market funding for their own national and international growth and activities. These institutions act as holding companies for non-cooperative subsidiaries and/or group entities, which are sometimes (partly) owned by external investors. In a few instances, the central institutions are partly listed themselves, i.e. partially owned by external investors or shareholders. For example, the central institution of Crédit Agricole, Crédit Agricole S.A., is partly listed and the regional cooperative banks hold the majority of the shares. The Austrian Raiffeisen banks own a central bank (Raiffeisen Zentral Bank), which has a minority stake in the listed Raiffeisen Bank International.[7]

Over the years, a number of cooperative banking groups have transformed into hybrid financial cooperatives with relatively large central institutions or central banks. The main advantage is obviously that they could realise their growth ambitions and enter new areas of financial services, like leasing, insurance, investment funds and investment banking. This contributed to diversification of their business and enabled them to offer a wide array of services to their member-customers. The larger European cooperative banking groups have opted for different business models when conducting business outside their home country. The Austrian cooperative banking groups acquired banks in Central and Eastern Europe after the collapse of Communism. By contrast, the Dutch Rabobank is now predominantly focussed on the food and agricultural sector in its international business.

Apart from the positive effects, one cannot neglect the governance risks associated with a large expansion of cooperative banking groups outside the traditional cooperative core. First, it seems inevitable that the introduction of external funding providers or investors reduces the governance autonomy of the original owners of the cooperative banks, i.e. members. Strategy and policy making of cooperative banking groups simply becomes more complicated, even though external capital providers may not have voting rights or just a minority stake in central institutions or subsidiaries. In the end, the reliance on external funding or equity could lead to an erosion of the cooperative profile and an estrangement between local cooperative banks and the central institutions with its group subsidiaries. Most of the times, the profit targets of externally financed subsidiaries are higher than those for the cooperative bank, but the risks involved are also higher. This bears the risk of divergent internal governance models or even conflicts of interest between cooperative banks and other group entities, particularly because the latter have no cooperative organisational form and usually apply another orientation than the local cooperative banks.

Recent cases in European cooperative banking corroborate this point. First, the Finnish Financial Cooperative Group bought back all listed shares of a subsidiary in May 2014 for € 3.4 billion to eliminate these is kind of complication in the working of its governance. On its website, this step was motivated by saying that this cooperative bank '*was born to be owned by customers*'. Second, the French BPCE has also recently removed outsider shareholders, i.e. it has bought back the listed shares. The steps of both banks have implied a return to a more cooperative nature. The third example concerns an opposite development. Around 90

[7] Some academics and policy makers have stated in the past that a major weakness of cooperative banks is that they cannot easily extend the capital base by issuing shares. This is ascribed to the governance framework of cooperative banks which may hamper raising capital, particularly in times of distress (e.g. Gutierrez, 2008). I think that this alleged shortcoming is based on a weak argument, since quite some listed banks faced difficulties in acquiring fresh equity capital from shareholders when they were in trouble amidst the credit crisis.

percent of the sector of Italian Banche Popolari is forced by decree to transform into joint-stock companies by the Italian government in 2016. The main reason is that their governance structure has become rather opaque. Many large Popular Banks have external shareholders with limited voting rights (one shareholder, one vote) and members who do not have an effective role in the governance (one member, one vote). This situation does not lead to effective checks and balances in the governance.[8] The decree leads to a redistribution of voting power based on the amount of invested capital. External shareholders will receive the majority of the votes, which effectively means the destruction of the cooperative identity.

These examples underscore the importance of assessing the pros and cons of the desirable size and form of external funding and capital thoroughly. Another potential impediment for the functioning of the governance in case of listed group subsidiaries is that it may become more difficult to freely discuss the strategy of the group in local and central governance bodies, because of the sensitivity of these discussions on the price of the listed capital instruments or shares. If members are for this reason constrained from freely discussing the policy and strategy of the group, it is obvious that the internal functioning of the democracy and governance is obstructed.

For a variety of reasons, most central institutions have gained in importance and size over the years. As long as they are primarily aligned with supporting local cooperative banks without initiating their own activities, this does not really pose a governance challenge. In this situation, one could argue that they are contributing to cutting down on risks and increasing the stability of the group (Desroches and Fisher, 2005). However, if they grow in size and start to undertake banking activities themselves (via domestic or international subsidiaries), they can represent a risk for the entire group. The banking professionals could start pursuing other objectives and/or enter into more risky activities compared to local retail banking. In practice, most centrals and subsidiaries do undertake less retail banking activities, but more wholesale and treasury activities which tend to be more volatile. To contain the risks of activities outside the cooperative part, it is necessary that the activities of the centrals and subsidiaries are approved and monitored by member representatives in central governance bodies. Executives of the central have to be accountable to these representatives. The story of the Austrian Volksbanken illustrates this point. As a result of the economic downturn in Eastern Europe, the international subsidiary of Austrian Volksbanken (Volksbanken International) under the umbrella of the central institution (ÖVAG) faced serious financial problems and needed state support (EUR 1 billion) as well as a capital injection by the local Volksbanken in 2010. One of the conditions attached to this state aid was that Volksbanken had to expropriate the major part of its international activities. In 2014, ÖVAG failed the stress test by the ECB and the local Volksbanken decided to resolve ÖVAG, i.e. it will turn in its banking license. At the time of

[8] The largest Popular Bank, Ubi Banca, has a balance sheet total of around EUR 120 billion. This bank cannot be qualified as a purely local cooperative bank. Moreover, the entire Italian BP sector has performed poorly over the last four years; the return on equity was negative in 2010-2014.

writing, the Volksbanken are involved in a remarkable consolidation process and are establishing a new ‘central institution’.

For cooperative banking groups, it seems advisable to restrict the size of the activities outside the cooperative core of 30-40 percent of total activities. If the activities outside the cooperative core outweigh those of local banks, there is a risk that the eventual losses or write downs cannot be borne by local banks. Historical evidence demonstrates that major losses or write downs at cooperative banking groups are rarely concentrated at member banks, but mostly occur at their group-level entities.

6. Shaping the views of regulators and supervisors

This section buttresses the fourth recommendation mentioned in the introduction. International and national regulators and supervisors have introduced a series of new rules and guidelines that directly and indirectly affect the governance of banks, both commercial and cooperative (European Banking Authority, 2011; Basel Committee, 2015). Moreover, the European Commission's Capital Requirement Directive IV rightly emphasises the importance of sound governance and lists some requirements for the role of governance bodies inside banks. Non-Executive Board Members play an important role in the governance of – local – cooperative banks. Recently, many cooperative banks have significantly upgraded permanent education programs for Non-Executive Board Members. It is deemed vital that they are well equipped to challenge professional managers on their strategic decisions, matters of compensation, and risk policy. However, regulators should not exaggerate with their requirements for Non-Executive Board Members. The new regulations in question should account for differences between cooperative banks. Indeed, Table 1 reports significant deviations between small stand-alone banks and large consolidated groups. Hence, it is crucial that the principle of proportionality is applied for governance requirements at respectively the local, regional and group level of cooperative banks.

Proportionality principle

The principle of proportionality is a long established principle in European banking regulation. It states that requirements should apply in a manner proportionate to the size, scale and nature of operations of an institution, as well as to the nature, scale and complexity of the risks associated with its business model and activities. In the cooperative context, this includes protection schemes, bottom-up group governance and split of activities between local/regional banks and central structures, as these have prudential consequences.

Since the European Central Bank has taken over the leading role in banking supervision from national banking supervisors in November 2014 in countries participating in the Single Supervisory Mechanism, it is crucial to demonstrate and explain how the cooperative governance works for enhancing transparency towards regulators and building confidence among customers and members. The main message for supervisors is that they should duly take into account the governance characteristics of the cooperative model which have both a prudential and cooperative purpose dimension. For instance, the democratic election of members of supervisory Boards or members of the Board of directors in a supervisory capacity (Non-Executive Directors) with a diversity of backgrounds – and not just banking experience and technical skills – can be viewed as a clear asset of cooperative banks and has proven useful for good governance. Indeed, these Non-Executives are generally reluctant to steer cooperative banks in the direction of riskier banking activities like investment banking and wholesale banking.

It must be acknowledged that Non-Executive Directors fulfil a supervisory role, but that they cannot be a substitute for control by the European Central Bank or national banking supervisors, which have more information and means than Non-Executive Directors. Equally important is that Non-Executives are also elected for their experience and expertise in other key areas like management, law, management of human resources, sales management, marketing, IT, innovation, etc. These competences go far beyond just banking and financial skills and external supervisors have little experience with all these issues.

Apart from its important prudential role, the Boards are in fact the custodians of the cooperative purpose. This contrasts with SHV banks, where Board of directors (supervisory Board members) are primarily selected for their banking and financial experience. The Great Financial Crisis has shown that the latter qualifications are no guarantee for better governance or results. In the recent past, bank defaults or problems have particularly occurred with Boards composed of persons all with very similar backgrounds. They mainly encompassed financial experts or technicians focused on maximising profitability and leverage.

Deville and Lamarque (2015) stress that new – capital and liquidity – regulations will also impact on the general principles of cooperative functioning, including their structures.[9] These seem to push for the centralization and unification of small cooperative structures and standardization of practices such as credit risk scoring. Ferri and Pesce (2011) assert that these developments could lead to disproportional rises in compliance costs of regulation for smaller cooperative banks, resulting in a 'too-small-to-comply' trap. Needless to say, cooperative banking groups with a sustainable business model should neither be forced to opt for a more centralised governance structure and/or amalgamation of smaller cooperative banks nor be brought into financial and organisational problems as a result of regulatory requirements or governance adjustments which are actually meant to prevent banks from getting into difficulties.

Key is that one organisational form should not be favoured by the lead banking supervisor in Europe (ECB) and the European Resolution Authority (which will be installed as from 2016) over another to simplify their task; they should not apply a 'one-size-fits-all' approach. It would be really regrettable if supervision and regulation would 'automatically' lead to more integration and consolidation among principally viable local cooperative banks, perhaps also due to a 'forced' introduction of elements of 'Shareholder Value Banks' in their governance structures. Ssupervisors and regulators should not design rules that would devoid the cooperative model of its content by challenging its founding principles. Hence, it is crucial to adhere to the proportionality principle.

[9] The Annual Report 2014 of the European Association of Cooperative Banks provides an informative overview of the implications of eminent changes in supervisory and regulatory regimes for cooperative banks.

7. External manifestations of the cooperative governance

Although some cooperative banking groups encountered governance related issues in recent years, the entire cooperative banking sector is very sound. On balance, one can conclude that the governance of cooperative banks leads to distinct outcomes which are visible in 'hard' figures. First, they weathered the Great Financial Crisis of 2007-2010 relatively well and did not need large scale government support (EACB, 2010). But also in more recent years, their overall performance has deviated from that of all other banks (Groeneveld, 2015b). Structurally, their assets are dominated by retail loans to households and SMEs. In 2013, their loan to asset ratio was more than 50 percent, while the same ratio for all other banks amounted to 37 percent. Overall, cooperative banking groups are funded to a larger extent by retail deposits and to a lesser extent by wholesale funding in comparison with all other banks; the funding resilience of cooperative banks is relatively high. The business model of cooperative banks tends to be more geared towards retail banking activities instead of more risky wholesale banking activities than many SHV banks. It also seems that their loan and deposit growth is significantly more stable than that of all other banks. In good times, cooperative banks' credit growth is more moderate, whereas their credit expansion is higher in recessionary times. Their behaviour seems thus to be counter-cyclical, which brings benefits to the wider economy. Finally, cooperative banks are generally a more stable and safer part of the entire financial services industry. They usually operate with higher capital levels and their returns on assets and equity are on average less volatile. This is mirrored in relatively high credit ratings for cooperative banking groups compared to most SHV banks.[10]

[10] This remark holds for cooperative banking groups which receive a rating based on consolidated data.

8. Concluding contemplations

An important take away from this paper is that the question of governance in cooperative banks has both a prudential and cooperative purpose dimension. Non-Executive Board Members do have a prudential role, but are also the custodians of the cooperative purpose. These two dimensions interact with each other as the cooperative specificities have prudential implications (Deville and Lamarque, 2015). In essence, the governance structure should remain conducive to a healthy performance both as a bank and a cooperative. This is best assured with competent and credible Non-Executive Board Members (Fonteyne, 2007). In order to stay viable, cooperative banks must of course be financially solid, innovative and efficient as well as able to withstand competition to ensure continuity for their members. Looking at the empirical evidence, the member-based governance of cooperative banks translates into a visible and noticeable focus on retail banking. Retail banking is characterised by relatively stable revenue streams and a moderate risk profile. Internal arrangements and protection schemes are also part of their governance structures and contribute to their structural stability.

I envisage three major governance challenges for European cooperative banks. The first is to balance the benefits and risks of the domestic cooperative activities versus all other (inter)national activities via central institutions. The second is to find alternative funding sources and capitalisation without jeopardising the functioning of the member-based governance. Finally, all cooperative banks together must continuously shape banking authorities' perspective and proactively formulate answers to expected prudential governance questions. If these challenges are mastered, cooperative banks will continue to contribute to diversity among credit institutions in terms of governance, size, business orientation, and risk appetite (Ayadi *et al*., 2010). Consequently, considerable systemic and societal benefits of pluralism in the banking industry will be maintained.

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