Financial Cooperatives: Problems and Challenges in the Post-Crisis Era[1]

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Abstract

The last years have witnessed a wide reshaping of the banking scene, the aftermath of which includes an increased risk of operative downsizing of the banking system towards certain customer segmentations, marginal areas and activities. Recently the banking scene has deteriorated, especially at the local level, as the financial crisis increased the scarcity of readily available, sufficient and reliable services. The present paper argues that this new reality creates new opportunities for financial cooperatives to increase their importance among the market and areas that they historically serve. Further, it argues that these changes can be exploited only if the financial cooperatives would be able to transform without losing their basic values and it outlines the critical path that the financial cooperatives should follow in order to provide efficient, and crucial for local development, services and products. This route goes through the development of new strategies and in certain cases of the modernization of their services. The authors also stress and define the risk of failing that might hinder the cooperative movement, as the huge potential of cooperative endeavors is rarely "translated" automatically to gains.

Keywords: financial cooperatives, local development, economic crisis, banking and development, credit unions

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A new context for cooperative banking

The banking sector has undergone radical changes in size, manner of operation and organizational structure in the last two decades. Financial innovations, deregulation and the decreasing role of the States along with growing international openness led to a stronger competition and prompted a far-reaching process of concentration among banking institutions and a rationalization of their productive structures. The long trend of mergers and acquisitions (M&A) increased the average size of banks, the application of standardized loan policies based on easily observed, verifiable and transmittable data within the more complex and structured forms of group organization and a myopic focus on short term profit severely affected the customer relation policies and methods (Belaisch et al., 2001; ECB, 2000, 2001). The reengineering processes and cost-rationalization strategies widened the physical distance of the new merged banks from peripheral areas and activities and small customers more dependent on personal relations (Berger et al., 2001; Leyshon and Thrift, 1993, 1995). Because of physical or “informational” distance, mainstream banks lost efficiency in generating borrower specific information, which, in addition, due to its “soft” characteristics, is difficult to transmit through the communicating channels of large institutions. Many potential borrowers were dismissed because they did not have credit records, enough collateral and needed small, not profitable, loans.

The recent financial crisis can not be separated from the afore said structural change, since it is also a consequence of the bad governance of the change, or of the inability, and in some cases even unwillingness, to institute new forms of governance, fitted to the new context. The crisis is articulated around a number of financial innovations and reckless behaviors aimed to give the credit system more elasticity, to the detriment of transparency, which generated growing uncertainty that damaged trust for and within the banking system, increased the cost of capital and depressed economy (GFSR, 2007; BoI, 2008).

This new banking environment offered new opportunities to cooperative banks, confirming their ability to adapt to highly diverse economic and institutional environments that made them a substantial part of the banking industry in many European countries, with more than 4,000 local and regional banks, 62,000 branches and 49 million members in the European Union, and market shares in terms of number of branches at about 60% in France, 50% in Austria, 40% in Germany and the Netherlands, 39% in Italy and 10% in Spain and Portugal (EACB, 2008). Concentration in retail banks leads to an increase in cooperative credit, as historically financial cooperatives expand in banking markets that are socially and/or spatially segmented. The mix of community bonds, shared responsibility and the capacity to mobilize local savings allow not only to reduce information asymmetry and solve scale diseconomies due to small loans, but to re-establish and strengthen trust towards banking system. (Berger et al., 2001; Ahrendsen et al., 1999). There is evidence, however, that the financial cooperative sector has, also, undergone radical changes during the last decade. According to the relevant data of the European Association of Cooperative Banks (Table 1), although the number of local banks decreased from 4,567 to 4,162 (i.e., almost 9%) this evolution did not deteriorate their local presence nor their penetration to the market. More specifically, during the same period, the number of banking outlets has increased by 7.5%, which is consistent to the cooperative banks orientation to retain strong links and strengthen their proximity advantages within local areas. This seems to be appreciated by local societies as membership has increased by 11% and total clients by more than 25%. This development strengthened cooperative bank assets by more than 37%, added some 38% more deposits which led to a 45% more financing to local economies.

Table 1: Main figures of European cooperative banks - EU-25 (2004, 2007) (financial data in million €)

	2004	2007	% of change
Local Banks	4,567	4,162	-8.9
Banking outlets	58,437	62,829	7.5
Members	44,500,827	49,347,932	10.9
Clients	125,700,769	158,750,433	26.3
Assets	3,742,789	5,150,218	37.6
Deposits	1,943,795	2,689,309	38.4
Loans	1,888,905	2,741,158	45.1

EACB, annual reports, own calculations

That development has recently attracted researchers' interest to assess where does the cooperative bank business model sustainability and resilience to structural changes and financial shocks stem from. A strand of research highlighted the importance of cooperative banks for financial stability in the regions they serve, suggesting that cooperative banks have generally lower incentives to take on risks and, thus, tend to adopt less risky strategies (Groeneveld and de Vries, 2009; Hesse and Cihak, 2007; Fonteyne, 2007). Cooperative banks seem to be more stable, due to the much lower volatility of returns, which more than offsets their relatively lower profitability. The reason behind the observed lower variability of returns lies in the fact that cooperative banks in normal times pass on most of their returns to customers, but are able to recoup that surplus in weaker periods. To some extent, this result can also reflect the mutual support mechanisms that many cooperative banks have created. This last remark is focusing on the special features of the cooperative organization model. Historically, the small size of cooperative banks has been balanced by their network organization and the formation of higher order organs. Their structure as networks of banks and not as bank networks made possible the expression of the advantages deriving from small size. In addition, mutual help and solidarity among the autonomous cooperative banks has lessened the negative impacts of small size (Wyman, 2008).

The crisis, however, shed also light on issues that are strongly attached to the philosophy of the financial cooperatives, in terms of everyday business. They tend to defend consumer interests and their presence and mode of operation maximize consumer surplus, to offer simple and transparent products, fair priced, better designed to meet local needs, in a manner that ensures that risks are well understood and communicated. Moreover, at a time of credit crunch, compared to commercial banks credit cooperatives may be less inclined to ration credit to customers and be less prone to raise the loan rate during a time of financial stress; thanks to better capitalization and more prudent lending, they may be less likely to be distressed themselves and, therefore, may be more able to continue assisting their customers in a time of financial stress (Fonteyne, 2007; Ferri, 2008). These potential effects stem all from their governance, business model, and specialization, which heavily rely on relationship-based retail banking (Berger and Udell, 1995; Di Salvo et al., 2004; Harhoff and Körtring, 1998; Petersen and Rajan, 1994). If one considers that in most cases the economics of the small business is indistinct from the domestic economy of the entrepreneur, then the fruits of the mutually beneficial cooperation (between the member and his/her cooperative bank) diffuse towards the household and affect its prosperity. Hence, the positive effect of the operation of the cooperative institution is not merely restrained at the entrepreneurial sphere. It reaches and concerns almost spontaneously more dimensions of a communitarian and/or holistic approach of the relevant context of analysis (Alexopoulos, 2004).

Problems and challenges

Both structural changes and the financial crisis have created a context where, at least at the local level, the model of financial intermediation that credit cooperatives follow is encouraged to flourish, plugging the gap between local needs and the mainstream services. Nevertheless, the post-crisis banking environment will also definitely test their ability to provide plausible solutions to the inefficiencies the model presents in its development, which have three related roots:

1. Increase in competition at the level of retail banking, that traditionally financial cooperatives serve: not only from Commercial Banks trying to recover on the field of relational finance, but also among Cooperative Banks themselves;
2. Local identity, the traditional source of the strength of credit cooperatives, but also in certain cases source of danger;
3. Small scale weaknesses, to which credit cooperatives have reacted historically with the pyramidal form of the organizational structure and during the last decade more radically with "consolidating" or "defensive" mergers, aiming at cutting costs and possibly also at diversifying risks. Notwithstanding the synergies that these mergers definitely create, they also alter some fundamental characteristics of the grass-root initiative (Bonaccorsi di Patti and Gobbi, 2001; Di Salvo et al., 2002).

From these three general sources of problems stem the following intertwined challenges.

Difficulties in diversifying loan portfolios especially in a time of crisis

Credit cooperatives have problems in diversifying their loan *portfolio* when local productive activities are relatively homogeneous or sector dependent (Barham et al., 1996): negative shocks, as a decline in output prices, can lead to widespread loan defaults, deposit-runs and the loss of financial viability unless external insurance of some form is available. The territorial concentration of the loans *portfolio* in a strongly specialized area may exacerbate the impact on the local financial system of idiosyncratic shocks, turning banking localism from an element of stabilization into a factor amplifying crises, and neutralizing the possible advantages that the bank may derive from local system externalities (closer relations with firms, informational advantages, accurate selection of debtors, peer monitoring and extra-economic sanctions on insolvent debtors). Moreover, the more a banking system is closed, the more it may transmit and amplify the economic effects of a geographically localized shock (regional credit channel).

Along the same lines entrepreneurs operating in areas hit by the crisis need special advices by the banks. In most cases personal knowledge and peer monitoring is not sufficient: a clear vision of strengths and opportunities of the territory, i.e., a development vision and consulting capacity, is needed in order to improve the bank capacity to act as an agent of social change and development

(Goglio, 2009). The dialectic procedure inherent in such a social process, which is evidently present in the long history of financial cooperatives, has proved that the scale problems arising in the implementation of this territorial approach should be addressed and solved within the apex institutions. The modernization of the pyramidal structure should also refer to the development of appropriate services that could result to a meaningful and effective intervention at the local level. The apex institutions may supply first level banks with low risk channels of investment for the surplus of savings, additional funds, insurance, supervision and regulation, counseling and training, endorsement and sponsorship. In order to perform these functions efficiently, the lower levels must be able to give the right territorial information and definition of problems, and implement the solutions proposed from above. In other words, the pyramidal organization must be able to conjugate the pros of both dimensions, capitalize at the central level on the inside information and monitor from the decentralized network, coherently with a shared social philosophy. Evidently, this requires the modernization of the cooperative banks and their government and governance.

Need of more sophisticated management and resulting agency problems

While in the past financial cooperatives, following an old pattern, were run under relatively simple administrative practices that simple management schemes could easily handle, with growth the need to employ sophisticated professional management in order to deal with the more complex financial situations becomes inevitable (Huppi and Feder, 1989; Poyo et al., 1993). On the other hand the qualitative and quantitative reinforcing of management may lead to the separation of ownership and control and intensify agency problems (Emmons and Schmid, 1999a, 1999b; Leggett and Strand, 2002). The risk is either a misappropriation of cooperative funds on behalf of the management for its own use, or a corporate philosophy substantially different from members' needs and will. Statistical evidence suggests that as financial cooperatives increase membership, benefits are transferred from members to management, able to channel residual earnings from members – i.e., higher net interest margins – toward itself – i.e., higher salaries and operating expenses. This leads to a well known debate among cooperative theorists and practitioners, about the governance mechanisms and representation of membership to the Board of Directors (BoD).

Board of directors: political aspirations, personal improvement, collusion

As cooperative banks grow in dimension, the issue of the motivation of the members of the boards of directors becomes more relevant. What induces a person to embark on this role, given that s/he cannot expect substantial direct economic profit from it? The principal/agent problem forcefully arises. Working to create positive externalities for the community is not necessarily at odds with the pursuit of one's own broader interest: directors may have a particular personal interest in the availability of the public good in question (i.e., an efficient local bank), and may hence be willing to contribute in order to achieve the result. Else they may act purely out of altruism, or seek to acquire specific credits within the community – social status, for example, in order to promote her/his political career or to be appointed to some more lucrative post (perhaps, but not necessarily in the cooperative network). In general, the greater the member of the board direct interest in the availability of the public good (i.e., the greater his/her individual demand), the less likely will be that his/her initiative is instrumental to other ends. As they perform their role in the board, following their own interests, directors may turn collective action away from its initial goals, giving rise to less efficient solutions. The problem is even more serious when the role of director is performed by influential individuals without a direct interest in the availability of the local public good, since it is more likely for such an individual to pursue his/her election to the board and to see it as a means towards ultimate goals not necessarily beneficial to the local society or even illegal. All these chances are related to the dimension and power both of the specific bank and the cooperative network (Goglio, 1999).

On these issues research is really poor and needed. In Greece, the almost complete defamation of the agricultural cooperatives during the 80s, which was mainly due to the intense state intervention and the consequent linkages of the cooperative leaders with political centers and power that led many cooperatives to bankruptcy (Papageorgiou, 2004) led to the foundation of credit cooperatives on a pure entrepreneurial, yet cooperative, financial services perspective (Alexopoulos, 2004). An interesting lesson was drawn from their successful initiative to the benefit of the entire Greek cooperative movement, i.e., that cooperatives should not be considered as the vehicle for exercising state social policy or a means for local or wider political power but as private enterprises aiming at the improvement of the economic and social conditions of their members on the basis of their joint ownership and action.

Governance difficulties

Increasing membership may also add difficulties in adequate internal control as it promotes free riding by members (Ouattara et al., 1999; Ferguson and McKillop, 1997). Older members feel disempowered as the institution adds new ones, which in turn creates difficulties in making existing members exercise their ownership rights and responsibilities in overseeing management. According to recent surveys, participation in board elections decline as credit cooperatives become larger. In any case, the absence of members from the general meeting deprives them the possibility of coming across the reasoning accompanying the operation of the cooperative bank. As a result they judge the performance of the bank mainly through their transactions with the cooperative bank, having no idea about the reasons that shape the character of transactions and the consequences of the policy followed (Alexopoulos, 2004).

Usually low attendance is connected with the large numbers participating that render general meetings ineffective and with the distance from the seat of the credit cooperative, where the general meeting is normally held, that acts as a barrier to participation. The recent M&A process within the sector is definitely strengthening the validity and importance of this last remark. Other reasons of non-participation are the insufficient knowledge of the subjects discussed, or the charge that the board of directors formulates the policy of the cooperative without taking into account the needs of the members. The result is, again, that members choose to exercise control and to influence the cooperative bank's operation through transactions and through the direct local contacts with the directors. Moreover, they measure the credibility of the directors by taking into account their position to local society. However effective these ways of participation in the running of their cooperative may be considered, it is clear that members attempt to influence the results of the policies applied and not the processes that produced these policies and, subsequently, results. Thus, cooperatives should rather adopt rules for effective functioning of their highest organ without falsifying their democratic character, such as distance voting and bylaw clauses on the possibility of holding meetings in separate locations (Osterberg and Nilsson, 2009; Hariyoga, 2004; Caswell, 1987).

Weakened bonds

When membership and assets grow beyond small numbers the importance of local knowledge and enforcement might decrease: common bonds loose their tight influence in maintaining a moral obligation to the cooperative. However, both the past success and the present revival of cooperative credit rest on the commitment to the communitarian principle, on the implementation of a different approach to financial intermediation. Therefore it is necessary to work either to restore or to strengthen the bond among cooperative values, members' participation and business, bond often ravaged by the market, as last financial vicissitudes have shown. In a time in which marketing departments of multinational banking institutions struggle to develop strategies in order to make their customers "feel" that they are part of the bank philosophy, to keep them "involved" and to "listen" to what they have to say of their performance, it is definitely a luxury for financial cooperatives to loose the close links with their membership. This policy could also be an effective answer to the problems deriving from the reduced local enforcement and peer monitoring capacity, most likely to arise when the – increased – membership retains loose links with its financial institution. Although urban settings increase these difficulties, in our point of view, regardless of the spatial setting, a financial cooperative should be aware that growing membership can also lead to situations which threaten its institutional and/or operative equilibrium.

Conflict of interests and operational objectives

Conflicts between the interests of member-depositors and member-borrowers augment in a large-member financial cooperative (Smith et al., 1981; Smith, 1984; Patin and McNiel, 1991a, 1991b). Accommodating each group's interests influences heavily the operational character of the financial intermediary, which in turn leads to policy-problems that might be more adequate to be dealt by an experienced management. Moreover, the insufficient development of adequate participatory and monitoring procedures at the local level could lead to the inability of a large cooperative to detect the socio-economic needs of members-customers (and the community's) and provide solutions. In the turbulent banking scene created by the crisis an increased pressure towards the strengthening of equity and profits should be expected: while for commercial banks these could be regarded as important indicators of sound institutions, their importance is rather reduced under a cooperative point of view. Further, if financial cooperatives fail to pronounce and defend efficiently their different banking philosophy, following conventional banking assessment procedures and, consequently, modes of development and operation, even on behalf of the regulation authorities, this may lead to an imbalance between the firm's profits and the members' surplus, endangering the harmonization of the firm's growth and local interest to the detriment of local potential and capacity.

Sharing membership in a credit cooperative is not only related to the better knowledge of participants' behavior, but to an entirely different approach in financial intermediation through which the demand side of the market configures essential features of the supply side. Although monetary benefits are usually appreciated by members, both members and cooperatives should agree that this is not the distinctive feature for the local economy. It should be clear that they do not need to trade off the qualitatively different banking approach against an aggressive price policy in order to be competitive: in the long run this may hinder their development and deprive members and local society of the essential characteristics of their performance, which places the satisfaction of human and local needs at the centre of their operational objectives.

Discussion and conclusions

Credit cooperatives are social and economic organizations. In their dual capacity they have historically managed to help local societies that saw in the cooperative form the means to serve their needs. Much of the literature on financial cooperatives argued that they can be "appropriate technology" for relatively backward economies, but become less important and should fade away with development as individuals' market opportunities expand. The very late developments show that not only are they not disappearing in industrialized countries but, proving their flexibility, are among the fastest growing groups of financial institutions in some advanced nations, demonstrating that they are in the position to adapt to any conditions, innovate and re-define the local potential. However, their historical and cultural variety suggests that no simple or linear development path can be prescribed for all them; their development varies under the influence of historically specific and contemporary economic and social conditions. Since cooperative credit is a flexible mechanism, not necessarily associated to simple or backward social and economic systems, its organization can and should evolve in coherence with the development of the territories where it operates. In the same way the institutional and legal framework should help the evolution of financial cooperatives in a not strictly business-like way, acknowledging their different approach to perform banking activities, and placing bonds and incentives consequently.

The paper has tried to present and stress the key dimensions of the distinctive characteristics of financial cooperatives which are considered as critical for their development. As states and banking authorities are heading to a re-regulation of the banking system, the future steps of cooperative financial intermediaries need a regulation that will respect and treat with caution their different organizational and operating model. However, local societies do not run a cooperative institution for the shake of it: members seek for quality in services and products and support only sound institutions. The benefits of having strong financial cooperatives with adequate organizational features, such as mutual guarantee funds and monitoring procedures, spread to the society as a whole, since in their absence the taxpayers would have to face higher-risk and potential costs. If financial cooperatives do not want to intensify their moral hazard problems connected with growth, they should urge the formation of adequate and high standard internal auditing procedures: a combination of ownership form, common bond requirements, supervision and monitoring restricts risk-taking for financial cooperatives. Their success lays in the density and quality of the different formal and informal characteristics of the mutual institutions. The most original feature of cooperatives is to provide for the material needs of their members as well as to respond to their fundamental aspiration for greater dignity in their lives, at the level of individuals and of collective action as well. In an era when competition has blurred the lines between a pure commercial and a cooperative enterprise, credit cooperatives face a major challenge: to re-establish the - lost in a market logic approach - link between cooperative values, members' active participation and commercial strategy and practice.

The current banking context places indeed imperative challenges to financial cooperatives, forcing to a deep thinking on their general and local strategies, on their daily activity, both with members and customers, on their loyalty to constitutive social principles. Succeeding in these challenges without loosing financial stability and operational character requires a) a well chosen, prepared and competent BoD and management, with deep and solid cooperative training and knowledge, and b) a committed membership, bound by close everyday links also with increases in numbers and demand. Thus the questions are if cooperatives do possess the characteristics to play a new and efficient role in local banking market, if they can translate their constitutive features in a modern and competitive banking setting, and how. Given the necessary restructuring to adequately answer their local customers' needs, in order to add potential to their competitive position on the territory cooperative banks should also stress to become true "local banks", i.e., not only a proximity and/or a relational bank, but a financial institution rooted in the territory, with intensive relationship with the territory, able to support local economic activities evaluated inside a pattern of development. For this purpose the bank's decisional bodies must be "in the territory", i.e., have both a good knowledge of the socio-economic reality (strengths, weaknesses and possible paths) and privileged relationships with local economic categories. To set an example, a normal relational bank would grant credit to a small entrepreneur on the basis of long time knowledge of trust in repayments, also with few collaterals (on the basis of moral collaterals). A true local bank would also extend credit in more cases if it could be able to understand the potentialities of the investment, in general and specifically for the territory.

Current trends in local development theories and programs call for interventions that seek to mobilize endogenous resources, support active participation and collective action, emphasize on empowerment in order to enhance capabilities of local people. If these are considered the prerequisites that foster the "involvement" of local actors, "unlock" local potential and act toward the implementation of a sustainable development process, then it seems that the cooperative institutions, and even more the cooperative institutions active in the critical sector of credit, could "fit efficiently" in such a multifaceted process. Thus, the real potential of these membership based organizations can be implemented if they manage to turn to proactive agents of social change and development.

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