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IN ITALIAN COOPERATIVE CREDIT BANKS**

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# COOPERATIVE CREDIT NETWORK: ADVANTAGES AND CHALLENGES IN ITALIAN COOPERATIVE CREDIT BANKS

Mitja Stefancic \*

*"Cooperation can get started by even a small cluster of individuals who are prepared to reciprocate cooperation, even in a world where no one else will cooperate"*  
(R. Axelrod)

## Abstract

This paper provides an outline of both the competitive advantages and challenges currently faced by Italian cooperative credit banks. These banks play an important role for the stability of the financial system at the level of regions. They provide credit to individuals and households, as well as capital to SMEs. Italian cooperative credit banks are integrated into a distinct sui generis network, which grants them an adequate level of competitiveness in the; and Visiting PhD student market. By effectively implementing democratic principles of governance and by focusing on retail banking, these banks foster responsible behaviour, which is crucial in times of crisis. This paper suggests that a better understanding of their specifics highlights their contribution to sound cooperation in economics. Finally, the paper provides policy recommendations for a qualitative supervision of cooperative credit banks to further increase the stability of the cooperative credit network and, thus, of the Italian financial system.

Keywords: Italian cooperative credit network; competitive advantages; governance; challenges

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## 1. Introduction

The aim of this paper is to shed light on mutual cooperation in banking by focusing on “cooperative banks” in Italy. One needs to pay particular attention to the classification of such banks. As an attempt to evaluate an idiosyncratic segment of the Italian financial system, I apply a narrow definition of cooperative banks by focusing on their regulation. I exclude financial intermediaries with similar voting mechanisms, for instance the so-called *banche popolari* which, on average, tend to be large. Instead, I focus specifically on the *banche di credito cooperativo*. In Italy, these banks play a vital role for local entrepreneurial growth and economic development. In the last decades, they achieved economic success and are thus considered an important segment of the national financial system. Furthermore, new ones have been established recently: as noted by Saccomanni (2007), in the period from 2000 to 2007, 30 new banks have emerged.

Since cooperative credit banks are among those institutions that have shown better resilience to the 2007-2008 financial crisis, it is not surprising that they have gained increasing attention from the scholarly community. With the implementation of democratic principles of governance, and by relying on traditional yet fully competitive intermediation models, they seem to provide the best alternative to standard commercial banks. They can be viewed as complementary to commercial banks. Cooperative credit banks are particularly important to highly industrialized and well-performing regions such as Trentino Alto Adige, Lombardia, Veneto, Tuscany and Emilia Romagna, as well as to other regions in the North, the Centre, and the South of Italy.

Italian cooperative credit banks relate into a well-developed commercial “network”, which maintains important historical roots both at a local and a regional level (Andruccioli and Messina, 2007, 66-67; Finocchiaro, 2007). I refer to such a network as the *Italian cooperative credit system*. The concept of a “system” is useful for addressing the relationships among players that form a business unity – in our case, Italian cooperative credit banks<sup>1</sup>. The aim of this paper is to discuss both the competitive advantages and shortcomings resulting from such a network, particularly with respect to corporate governance and different intermediation models in banking. I argue that an improvement in their governance would further increase their economical and social benefits. I thereby wish to stimulate scholarly debate on this topic. What distinguishes cooperative credit banks from commercial banks? Are scholars aware of such differences and of their implications for analysis? Do regulators and policy-makers adequately account for their specifics? These are some of the questions that inspire my research. I believe that they need to be answered carefully in order to shed light on the cooperative credit network and, thus, provide insights on

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<sup>1</sup>In any field of science, this concept is used to understand the pattern or structure between any parts or sets. Usually, it is assumed that a system has an environment and, consequently, there is a requirement for boundary maintenance. One shall not overlook the problem of stability of networks, to be treated as an empirical question in scholarly research.

an important segment of the Italian banking system.

In this paper, I first take a broader look at the European cooperative credit banks and their performance during the crisis. Such an introduction helps one to obtain a better grasp on the Italian cooperative credit system as it enables a comparison with other kinds of banking systems in Europe. Subsequently, I account for the competitive advantages that cooperative credit banks developed during the past decades. From the outset, I should point out that major advantages over competitors result from better financial services, proximity to clients, economic benefits equally enjoyed by cooperative members, effective governance mechanisms and lower risks of failure. On the other hand, by reference to scholarly research, I provide a list of their shortcomings and competitive disadvantages. Although straightforward examples of mismanagement appear to be rare in Italian cooperative banking, they nonetheless call for an effective supervision from financial authorities and regulators. Such problem needs to be addressed from a *qualitative* point of view. I conclude by suggesting some improvements in the regulation and supervision of these banks for promoting a “stable” financial system<sup>2</sup>.

## 2. Specifics of Italian cooperative credit banks and their governance

As on average most other European counterparts, Italian cooperative credit banks showed a remarkable ability to overcome the 2007-2008 crisis and its resulting side-effects (Groeneveld and de Vries, 2009). Additionally, interesting insights are obtained by reviewing their performance in the period prior to the crisis, and by comparison to the performance of standard commercial banks. Gutierrez (2008) for instance focuses on a number of performance indicators for the 2004-2006 period. Her findings suggest that the Italian cooperative banks have a higher solvency ratio (16.3) compared to standard commercial banks (11.0) as well as a higher Tier 1 ratio (15.5 versus 8.1)<sup>3</sup>. Results from other scholarly research confirm the soundness and the solidity which are characteristic of most cooperative banks operating in Europe (Gurtner *et al.*, 2002). On the other hand, such banks on average tend to be less profitable than standard banks, with a ROE ratio of 7.4 compared to an average of 10.2 of the Italian banking system.

### 2.1 Governance: the cooperative credit network

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<sup>2</sup> The concepts of “financial stability” and “financial instability” are well-discussed by the economic literature. One of the best accounts can be found in Alessandro Vercelli’s essay *Minsky, Keynes, and the Structural Instability of a Sophisticated Monetary Economy*, published as a working paper by the Department of Political Economy at the University of Siena in March 1999. Vercelli distinguishes the everyday language use of the word “instability” (meaning liable to change) from the more specialised language of economics. In the domain of economics, one may distinguish between “dynamic” instability and “structural” instability: the latter focuses on structural properties of the object or phenomenon to which it refers. In defining financial (in)stability, Vercelli refers to the school of Andronov in mathematics (see Andronov, Vitt and Khaikins’ *Theory of Oscillations*, published in 1937).

<sup>3</sup> The Tier 1 ratio is a core measure of a bank’s financial strength. It is defined as the ratio of the bank’s core equity capital to its risk-weighted assets.

Even though cooperative banks may suffer from specific sources of financial instability (Hesse and Cihak, 2007), an appraisal of their specifics enables scholars and policy-makers to obtain valuable insights for the design of a financially stable system – currently a major goal in financial policy at both international and national levels (FSF, 2008; Nier, 2009). Policies accounting for the specifics of financial intermediaries in turn help securing social order and social cohesion. Such policies apply to the Italian context particularly well. A focus on organisational issues helps one to design a strategy accounting for the differences between cooperative credit banks on the one hand, and standard commercial banks on the other. It is therefore important to define the concept of “governance” at the outset.

Broadly defined, it refers to the system by which enterprises or segments of their businesses are managed and controlled. While there are several definitions for governance, Cadbury provides a definition that suites cooperative credit banks well: governance is “concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society” (Cadbury, 2000).

It is precisely within such a framework that cooperative credit banks are successful in developing most of their advantages over competitors and define their *raison d’être*.

Table 1 - Governance Framework in cooperative credit banks

|                       |                         |
|-----------------------|-------------------------|
| <b>ECONOMIC GOALS</b> | <b>SOCIAL GOALS</b>     |
| <b>COMMUNAL GOALS</b> | <b>INDIVIDUAL GOALS</b> |

Source: author, based on Cadbury (2000)

Cadbury’s definition of governance is particularly insightful. It refers to the multifaceted economic and social goals, which are crucial to the establishment of cooperative enterprises and, specifically, to cooperative banks. Despite lower levels of profitability due to a less pronounced development policy and a more conservative business model, Italian cooperative credit banks provide vital credit and financial services to small enterprises and the local community (Finocchiaro, 2002; Finocchiaro, 2007; Tarantola, 2008; Goglio and Leonardi, 2010). They are well-integrated into local productive networks and industrial clusters, which are widespread in Italy (Antoldi, 2006). According to the data provided by Federkasse – the Italian federation of cooperative credit banks –, as of September 30<sup>th</sup> 2009, more than 420 cooperative

credit banks operated in different Italian regions, and 993 thousand members have been registered with Italian cooperative credit banks. As of the same date, 4,192 cooperative banking branches provided services to 5.7 million customers in Italy. Furthermore, on September 30<sup>th</sup> 2009, roughly 31,000 employees were working in Italian cooperative credit banks<sup>4</sup>.

Cooperative credit banks in Italy do not operate individually – that is, independently from each other; conversely, they operate within a regulatory framework and a branch network, which allows them the pursuit of economies of scale and scope. Banking and credit networks can be organised either as relatively flat organisations, or as multi-level structures with in-between levels of regional groups or associations. Similarly to Spanish cooperative banks, Italian cooperative credit banks are organised in networks which resemble decentralised systems with voluntary integration (Di Salvo, 2002; Finocchiaro, 2007; Fonteyne, 2007). For such networks to exist, banks that relate to them must be able to share information about each other. Stated otherwise, they need to be able to sustain each other financially in times of crisis. The benefits from belonging to such a network are numerous. For example, they help achieve a decrease in transaction costs, reduce uncertainty, and effectively redistribute risks. Next, I will discuss the legal framework that regulates Italian cooperative credit banks as suggested by a number of studies, namely by Capriglione (1995, 92-115), Tilli (1996) and Caleffi (2006).

## *2.2 Regulatory framework: the 1993 Italian Banking Act*

To develop an in-depth understanding of the Italian cooperative credit system, one needs to obtain a full grasp of the regulatory framework under which these banks operate. The 1993 Italian Banking Act ("*Testo unico delle leggi in materia bancaria e creditizia*" – *T.U.B.*) accounts for the specifics of cooperative credit banks. In order to operate on the market, cooperative credit banks have to have at least 200 registered members (Art. 34); each bank needs to recover in a years' time if the number of members falls under such a threshold. Cooperative credit banks are heavily dependent on their members: in fact, they need to apply a number of "solidaristic principles" to their main business by providing credit primarily to members (Art. 35). Finally, cooperative credit banks need to register 70% of the annual net profits as reserves (Art. 37). Such a regulatory framework – summarised in Table 3 – has a number of economic implications. They are discussed below.

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<sup>4</sup> [www.creditocooperativo.it](http://www.creditocooperativo.it). Last accessed: 18 August 2010.

Table 2 - Regulation of cooperative credit banks

| ITALIAN BANKING LAW | SUBJECT                             | DESCRIPTION  |
|---------------------|-------------------------------------|--|
| <b>ART. 33</b>      | Limits to Shareholder Participation | EUR 50,000 per member.   |
| <b>ART. 34</b>      | Voting Rules                        | One man, one vote  |
| <b>ART. 35</b>      | Mutualistic Features                | Credit is granted primarily to members.  |
|                     | Regional Limits                     | Cooperative credit banks can expand to a neighbouring region if – and only if – they have at least 200 members in that region.   |
| <b>ART. 36</b>      | Conversion to Joint Stock Company   | The bank needs to be liquidated in order to change status. What is left from liquidation is to be paid into the mutual aid fund “Fondo Sviluppo”.  |
| <b>ART. 37</b>      | Profit Allocation Policy            | <ul style="list-style-type: none"> <li>- 70 percent of the annual net profits is to be allocated to reserves.</li> <li>- 3 percent of the annual net profits is to be allocated in the mutual aid fund “Fondo Sviluppo” for the promotion and development of cooperation.</li> </ul> |

Source: Gutierrez (2008) and 1993 Italian Banking Act/T.U.B.

By reference to Hesse and Cihak (2007, 18) one could argue that their ability to retain profits or distribute them in the form of consumer surplus provides them with greater stability: “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 mechanism that many cooperative banks have created”. Furthermore, the presence of cooperative banks appears to weaken commercial banks, in particular those commercial banks that already show some sources of weakness. Stated otherwise, cooperative banks tend to increase the stability of the banking system in the long-run.

One of the major competitive advantages of the Italian cooperative credit system results from a mutual aid fund to which cooperative credit banks subscribe. What is the specific function of such a mutual support mechanism? To put it simply, if an

individual bank experiences distress or a sudden decrease in its capital, the funds collected by other banks provide the means to avoid a crisis. The underperforming bank *de facto* receives funding and is eventually saved by means of the financial aid from affiliated banks: this stands as a good example of what can be defined as a “cooperative behaviour” in banking. Cooperation enforces trust among banks and other financial intermediaries. The latter is essential, for instance, in lending activities among banks themselves and in all operations within the interbanking market. If coordinated and properly fostered, cooperation does *not* impair competition: conversely, it helps to ensure a high level of fairness among different players in financial markets.

### 2.3 Focus on retail banking

A distinctive feature of Italian cooperative credit banks results from a well-developed retail business, which enables them to adequately address the financial needs of their cooperative members and customers. It comes as no surprise that they show an ability to meet the needs of innovative, small-sized and family-owned enterprises, which are typical of the Italian economy (Bianchi *et al.*, 2005; Antoldi, 2006; Colli, 2007; Caruso and Palmucci, 2008; Dessì and Floris, 2008). For example, one of the banks that initially funded the entrepreneurial efforts of the Benetton family – whose main business started in the 1960s and then expanded in a global fashion brand, thereby achieving commercial success particularly in the 1980s and 1990s – was the *Cassa Rurale di Ponzano*, namely a cooperative credit bank based in the Veneto region (Malvestio, 2006, 16). This role is particularly important due to the problems faced by new, initially small firms in obtaining necessary capital for growth. In fact, even the most advanced economies often lack financial institutions willing to either finance or support new entrants in the market.

A comparison with the US market helps to substantiate this argument<sup>5</sup>. In the 1980s and the 1990s, the U.S. saw a decline in the number of “independent financing outlets for business” and a shift in favour of larger banks. As a result of such change, several small enterprises have been excluded from financing and have been denied access to credit. To tackle this problem, a group of post-Keynesian economists argued for the establishment of the so-called “community development banks” (CDBs) with a set of well-defined goals: “one aim of the CDBs should be seek out projects that promise to be profitable but are not being financed because of their small size, their perceived riskiness, or the ‘inexperience’ of the prospective management. Theory and evidence suggest that commercial banks are reluctant to make loans to firms that have not already established close relations with a loan officer. Thus, firms that have been denied access to credit due to perceived inexperience find it difficult to establish the required ties. This problem is aggravated when the firms are small and, hence, lack market power” (Minsky *et al.*, 1993, 11)<sup>6</sup>. One should note that within the Italian

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<sup>5</sup>The comparison is developed for illustrative purposes.

<sup>6</sup>At the beginning of the 1990s, a proposal has been introduced for the creation of a network of community development banks, known as the “Clinton/Gore proposal”. Institutional reform of the financial structure of the U.S. economy was initially one of the priorities on President Clinton’s agenda.



economy, cooperative credit banks perform this important function. Thereby, they provide a valuable contribution to the national economy.

In the next sections, I first develop a discussion on the competitive advantages of Italian cooperative credit banks. Subsequently, I attempt to provide an exhaustive list of the challenges faced by these banks.

### **3. Competitive advantages**

In the past, it is argued, cooperative banks flourished because they managed to effectively overcome important market imperfections. In the 19th century, two types of institutions emerged as a response to market inefficiencies: "savings banks" were established from the 1810-1815 onwards, to overcome opportunistic behaviour, rather typical of commercial banks at that time; on the other hand, "cooperative banks" were established from the mid-19th century onwards to overcome problems of opportunistic behaviour by borrowers. As noted by Fontayne, "within small communities, relatively intimate knowledge of each other's credit- and trustworthiness ensured that loans were only provided to borrowers who could be expected to repay them... Beyond financial incentives, social relations among members were also a contributing factor to the success of cooperatives" (Fontayne, 2007, 9). The importance attributed to social relations remains a distinctive feature for many cooperative credit banks in Italy.

#### *3.1 Counter-cyclical behavior*

During the 2007-2008 financial crisis, a number of important commercial and investment banks as well as public banks (such as the "Landesbanken" in Germany) experienced financial distress. Furthermore, a number of former co-operative groups that chose to demutualise, for instance the Northern Rock bank and Bradford & Bingley in the UK, faced severe losses and have been exposed to a risk of failure. By reference to data provided by Bloomberg (October 2009), the top 25 financial players including groups such as Wachovia, Citi, Merrill Lynch, Bank of America, UBS, HSBC, and the Royal Bank of Scotland accounted for almost 80% of the global costs of the crisis. By contrast, cooperative banks accounted for less than 3% of the total costs, and are therefore "hardly responsible for the direct costs of the crisis" (EACB, 2010, 8-10). Costs suffered from the real economy are hard to quantify due to persistent problems such as relatively high levels of unemployment and declining growth in a number of industrial sectors.

I argue that the cooperative model in banking is prudential and safer than the business models generally applied by commercial and investment banks. If anything, problems can arise as a consequence of a demutualization process with the subsequent adoption of riskier business models. As an aim to stimulate scholarly debate, it is useful to recall the fact that a number of differences persist between cooperative and commercial banks. In principle, commercial banks tend to have a more aggressive business strategy, as shown for instance by higher levels of risk-

taking and a strong emphasis on profitability, measured by ratios such as ROA, ROE, total operative costs, cost-to-income ratio, recurring earning power. By contrast, cooperative banks tend to have rather conservative business policies: they often “pride themselves in the fact that they are *not* profit maximisers. Instead, their purpose is to maximise their members’ consumer surplus, and this may be complemented by additional objectives that seek to contribute to the well-being of stakeholders other than member-consumers (e.g., employees)” (Fontayne, 2007, 19). In times of financial instability resulting from – among others – an increasing financialisation of the economy, they often act counter-cyclically.

### *3.2 OTH model of intermediation: primacy to stakeholders*

Despite some significant developments in financial markets that took place in the last decades as a result of the financial deregulation, the liberalisation of the Italian banking market, and a rise in competition prompted by technological innovation, the cooperative model in banking has preserved its fundamental idiosyncrasies and can be best described as an “originate-to-hold” (OTH) model. Banks and financial institutions applying such intermediation model to their business take in deposits, and provide credit and financial services primarily to cooperative members (as stated in their statute and in the 1993 Banking Act). They rely primarily on their members and are dependent on the loyalty of retail customers<sup>7</sup>. In the example of the Italian cooperative credit banks, such customers are mainly individuals, households, and SMEs, particularly from the agricultural sector as well as non-profit organisations. To provide an example, in the third quartile of 2008, the market share in credit-provision and financial investments was directed primarily to craft enterprises (21.6%), households for productive purposes (16.3%), households for consumption (9%), small enterprises from different sectors (16.1%), non-profit organisations (10.6%), and to non-financial enterprises (6.3%)<sup>8</sup>.

According to Angelini and Cetorelli (2003), Italian cooperative credit banks operate in “market niches”. They do *not* specialise in large, risky financial investments and transactions, and do not operate in the interbanking markets as much as commercial banks. Cooperative credit banks are well-equipped to overcome market failures due to their deep rooting in relationship banking, which enables them to develop tailor-made services and reduce asymmetries on borrowers. Their OTH intermediation model has long-term objectives and, as such, is “better suited to strengthen relationship banking and thus to favour responsible behaviour, *in lieu* of that irresponsible behaviour at the

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<sup>7</sup> The same intermediation model is sometimes referred to as the “buy-and-hold” model. The alternative model is the so-called “originate-to-distribute” (OTD) model, which is rather frequent in banking: a fundamental difference consists in selling loans to third parties. In practice, it is argued, such model created several agency problems in which the “agents” (the originators of the loans) did not have proper incentives to fully act in the interest of the “principles” (final holders of loans). It has been applied extensively by banks for leveraging their comparative advantages in loan origination and “better” risk sharing with the rest of the economy. See: a) Allen F. and Carletti E. (2006), Credit Risk Transfer and Contagion, *Journal of Monetary Economics*, 53, 89-111; and b) Masera R. (ed.) (2009), *The Great Financial Crisis*, particularly pp. 84-85.

<sup>8</sup> Data are available on [www.creditcooperativo.it](http://www.creditcooperativo.it), in the “Statistics” section. Most recent data refer to 30 September 2008. The original data are drawn from the Bank of Italy.

origin of the crisis" (EACB, 2010, 17). Such model is consistent with the cooperative goal to maximise stakeholders' value rather than profits. This characteristic has several implications for economic theory and for the design of policies aimed at economic development: a policy aimed at promoting cooperation is sensible at any time when the gain from mutual cooperation is higher than the losses faced by the single players that are willing to cooperate. In principle, the goal of maximising "stakeholders' value" is common to all cooperative enterprises. Arguably, such endeavour makes it possible to (often) fill the gap between the "social" and "economic" efficiency (Zamagni and Zamagni, 2008)<sup>9</sup>.

Although fundamental differences can be observed within the cooperative credit systems across different European countries (Di Salvo, 2002), a standard governance and business model applies to European cooperative banks, including the Italian cooperative credit banks. The model is conceived in such a way to compete on a regional and a national level; it could hardly compete in international markets. By reference to Groeneveld and Sjauw-Koen-Fa (2009), one may argue that the model currently shows features such as: (a) a corporate governance with cooperative ownership; (b) a policy aimed at increasing the wealth of local communities (which encourages a cooperative attitude); (c) high levels of capitalisation; (d) stable levels of profit; (e) a rather conservative business strategy based on retail banking; (f) proximity to customers effectively managed through branch networking.

### *3.3 Cooperative business philosophy*

A business philosophy that stresses the crucial contribution from social relations and trust for decreasing uncertainty and for channelling capital and financial surplus, remains a distinctive feature of several cooperative credit banks. By promoting a fair economy and sustainability in local economic growth, it translates into a successful market strategy: ideally, success shall be matched by social progress and social justice. These features add substance to the concept of "corporate social responsibility", which gained prominence and is being viewed increasingly as a measure of reliability in cooperative credit banks and social enterprises alike (Luciani and Tanno, 2009; Becchetti and Borzaga, 2010). Arguably, such a powerful concept could have been better exploited for marketing purposes by the Italian cooperative credit banks during the 2007-2008 financial crisis, to further increase competitiveness and increase their market share. Evidence from empirical analysis suggests that cooperatives gain prominence when markets and institutions fail to meet social and economic needs. This occurs with frequency in times of financial distress and economic crisis (Brazda and Schediwy, 2001).

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<sup>9</sup>The concept of "stakeholder value" – despite being subject to different interpretations – suffices to challenge the argument asserting that within modern enterprises, equity and efficiency tend to somewhat exclude each other. Such argument, advanced by the American economist Arthur M. Okun in his 1975 book *Equality and Efficiency, the Big Trade-Off*, suggests that there is a trade-off between them. Such a point of view is challenged by the fact that the dynamic efficiency of the economy increases with an equitable distribution of wealth; similarly, the dynamic efficiency of enterprises is a prerequisite for achieving better chances for economic mobility and equitable distribution of wealth.

Cooperative credit banks, which to scholars may look like less attractive in times of financial stability, turn into interesting case-studies in times of financial distress. The “too big to fail” regulatory principle does not apply to these banks. Indeed, they are provided with internal safety nets that make them less exposed to the fragility of the financial system. Commercial banks often lack such safety nets, and – by contrast to cooperative credit banks – their losses are to be often covered by public funds. Furthermore, research on data for the period from 2000 to 2006 shows that, from an operational point of view, small financial intermediaries as the Italian cooperative credit banks have a better quality of the loan granting process, and are able to implement more efficient recovery processes (Mattarocci and Gibilaro, 2008).

Nonetheless, cooperative credit banks – like other financial institutions and financial intermediaries – may occasionally experience distress and are not immune from failure. As a result of the fact that the cooperative capital is variable, any cooperative bank can theoretically face a run on capital, for example in case that at a given time a large number of customers or cooperative members decided to withdraw from their membership. Italian cooperative credit banks are no exception to such problems, even though they rarely occur in practice. It is therefore crucial to list their weak points and suggest some essential improvements including better control mechanisms, a major degree of independence from local political parties, and improvements in the Human Resource (HR) management policy.

#### **4. Challenges in the governance of cooperative credit banks**

##### *4.1 Dispersed ownership*

Dispersed ownership is typical for cooperative banks, particularly for cooperative credit banks. This suggests the fact that they face relatively high monitoring costs. Dispersed ownership lowers the probability of single members to monitor banking activities. Even though cooperative managers have lower incentives to undertake risky activities, dispersed ownership may *not* adequately support the establishment of control mechanisms for preventing managerial opportunism, which can be pursued even at the level of branch managers. By reference to Hansmann’s (1996) insightful essay on the ownership of firms, it can be argued that managers could be tempted to use resources to engage in personal empire-building and to pursue interests different from those of members and customers, which tend to be risk-averse. Opportunism limits trust-sharing and reciprocity among economic agents. It thus tends to impair cooperative behaviour.

One should acknowledge that in recent decades, cooperative credit banks have lost some of their original competitive advantages. It is argued that much of the advantage in overcoming opportunistic behaviour by borrowers has been significantly eroded. The competitive disadvantages that commercial banks faced in the past have been mostly neutralised due to the improvement in legal and judicial frameworks, which nowadays offer better enforceability of contracts. As a result of the liberalisation process in banking, the gap in the number of branches has gradually decreased, and

the market share measured in terms of cooperative branch networks, is declining; furthermore, with the introduction of information technology and new technological devices in banking, branches themselves no longer provide the same advantage as they once did. Many of the proposals to improve the governance of cooperative banks have been impractical or ineffective (Cornforth, 2004; Finocchiaro, 2007; Fonteyne, 2007).

#### *4.2 Reliance on cooperative members and local markets*

When evaluating competitive advantages of cooperative credit banks, one needs to take the opposite side of the coin into account. The fact that these banks have loyal customers suggests that they are heavily reliant on them. This does not always translate into new opportunities for business. What if they were unable to attract new customers, for instance those from emerging industrial settings? What if traditional customers faced losses and decreasing competitiveness on the market and their businesses? The fact that a large amount of scholarly research recently focused on Italy's stagnation and on lower growth rates compared to most other industrialised countries in Europe shows that these questions are indeed relevant (Gallino, 2003; Daveri and Jona-Lasinio, 2005; Rossi, 2006; Ramazzotti, 2010; Vaciago, 2010, 46-47). Furthermore, cooperative credit banks are themselves exposed to change, and need to develop their business so to meet new requirements and stay competitive on the market. According to Saccomanni (2007), the rationale for such change needs to be properly understood and adequately managed. Improvements are required in terms of productivity, as well as with regards to risk management through – for example – the introduction of new banking technologies and new procedures in internal auditing. Compliance to new regulation is essential, as it is the enforcement of the existing safety net.

Italian cooperative credit banks differ in terms of assets, number of employees, location, historical background etc. As such, they need to build solid mutual relations to increase their competitiveness with an attempt to provide local solutions to problems that are increasingly global. One of the potential drawbacks from belonging to an "alliance" results from the fact that some counterparts may behave opportunistically by applying risky strategies and by appropriating part of the rent generated within the alliance. In fact, in the economic tradition "cooperation" is defined primarily as mutual cooperation between "self-oriented" actors (Moulin, 1995; Dardi, 2010). To paraphrase the French sociologist Émile Durkheim (1982, 98), it is rather "normal" that a given amount of speculation exists in banking. Further research is needed in order to shed light on the above-mentioned drawbacks and to provide guidelines on how to implement control mechanisms to detect similar problems and timely prevent them from occurring. An opportunistic behaviour of only a few such banks could have negative spillovers on the entire cooperative credit system.

From a theoretical point of view, the problem of network (in)stability is frequently overlooked. As observed by Aldrich and Whetten (1984) it shall be addressed as an *empirical* question in scholarly research. Finally, close ties with local firms and local

communities can be twofold as they include both advantages and disadvantages. By comparison to other financial intermediaries, cooperative credit banks may suffer more from declining industries in the regions where they operate, and from the economic depression of local economies, particularly those facing increasing global competition that may not be able to withstand such a competition in the long-run. As small banks that offer financial support to local communities, cooperative credit banks are strongly related to the “territory” and settings in which they operate, and depend on their socio-economic characteristics. This is particularly relevant for Italian banks due to the remarkable social, economic, and cultural differences that are characteristic of all Italian regions<sup>10</sup>.

#### 4.3 (*Too much*) influence from politics?

In Italy, a peculiar influence from politics on business and economic dynamics seems to imply that the governance of these banks may sometimes relate to political interests. In part, this problem has been addressed in an insightful paper by Sapienza (2004): results from her analysis show that the lending behaviour of Italian banks (particularly state-owned banks) is affected by electoral results of the party affiliated with the banks. Specifically, the stronger the political party in the area where the firm is borrowing, the lower the interest rate charged. In principle, small banks are not immune from such dynamics, and may equally suffer from them. Perhaps this problem is not limited to Italy. In Italy, however, it appears to be somewhat more pronounced than elsewhere.

Influence and external pressure from politics can be ambiguous. They do *not* secure efficiency in financial markets nor at the level of individual financial intermediaries. Instead, they can lead to a misallocation of funds, and may thus impair the effective functioning of the markets. The importance of standard cooperative values such as “reciprocity” and “mutualism” may decrease in terms of importance (Verrucoli, 1962; Bassi, 1976; Venditti, 1995). Arguably, Italian cooperative credit banks are not immune from such drawbacks and, as a result, some of them may take on higher risks and a higher financial exposure than normally required. The “Credito Cooperativo Fiorentino”, a cooperative credit bank based in Campi Bisenzio, Tuscany, which has recently undergone inquiry by the Bank of Italy, makes a good case-study. The bank has been investigated due to risky development policies and a significant lack of transparency in some major operations. As a result, its President, who is a member of an influential Italian political party, resigned. Subsequently, the CEO board resigned in July 2010. The bank adopted special administration procedures, as of the Italian banking law (Muchetti, 2010; Corriere della Sera, 15 August 2010).

My aim here is not to comment on political issues: they go beyond the scope of the present paper. Instead, my aim is to stress the multifaceted “economic” implications resulting from the relation between Italian politics and the banking industry, and list

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<sup>10</sup> It is useful to conceive territories in terms of abstract spaces of characteristics. A theoretical discussion on the relevance of the concept of territoriality for an analysis of cooperation can be found in: Axelrod R. (2006), *The Evolution of Cooperation*, particularly Chapter 8, “The Social Structure of Cooperation”, and on pp. 158-168.

some of its potential side-effects on local banks. Although the investigation on the Credito Cooperativo Fiorentino is still in place and no conclusion has been reached so far, the example is telling of such a relation. Such example challenges the argument that economic organisations and financial institutions in advanced Western economies do not have to serve political interests (Rosenberg and Birdzell, 1986; North *et al.*, 2009); or, at least, it forces its reappraisal. It shows that local financial markets – even when it comes to cooperative banking – *may* be more-or-less influenced by local political parties. Party interests and political pressure could have a positive outcome only in case of a perfect and transparent political competition. These issues need to be addressed and analysed *cum grano salis*, possibly within an interdisciplinary research framework.

The above discussion suggests that political and private economic matters should remain separate from banking activities so to prevent politics from exerting influence on the market equilibrium. On the other hand, effective regulation and supervision should prevent financial institutions from ineffectively exploiting the role that normally belongs to social policy (indeed, it is useful to recall the detrimental effects of private financing to low-income communities via the subprime loans, which can be viewed as a major cause of the 2007-2008 financial crisis, particularly in the US market). Such an argument is particularly relevant for cooperative credit banks since, by its very nature, their business model is based on a responsible (social and economic) behaviour.

#### *4.4 Human resource management and executive turnover*

A responsible, well-educated management with planning and organising skills and leading capabilities is essential for preserving the “intergenerational endowment without owners”, which is characteristic to cooperative credit banks. By reference to the governance framework introduced earlier (Table 2 on page 4), it is clear that chief executives need to possess a sociological perspective to complement their expertise in finance and accounting. Moreover, executives in these banks need to commit themselves to fundamental cooperative values. To quote from Fonteyne, “the way cooperatives were designed is such that this net economic value is in essence an owner-less intergenerational endowment that is available for use by current members, under the implicit or explicit understanding that they will grow it further and pass it on to the next generation of members. The managers of a cooperative have direct control over this endowment and can therefore be seen as its custodians” (Fonteyne, 2007, 27).

A final problem faced by Italian cooperative credit banks refers to relatively poor capabilities for HR management. This problem has been discussed in the past by an influential economist such as Alfred Marshall (1961). On the one hand, such problem can be addressed from a perspective focusing on “human capital” and “knowledge management” (Giuli, 2001). On the other hand, it can be appraised by evaluating the effectiveness of the executive turnover as well as of related organisational procedures (Battistin *et al.*, 2006; Tarantola, 2009, 10). Indeed, particularly in cooperative banks

top executives' turnover appears to be influenced by local connections rather than by the bank's performance itself. As argued by a number of scholars, local connections have a particularly strong effect in mutual, rural and cooperative banks: despite recognising that disciplining mechanisms are at work in most banks, connected top executives appear to have a lower turnover in such clusters of banks (Battistin *et al.*, 2006).

Despite being in principle as flexible as commercial banks or more, small-sized banks can hardly afford a separate HR department, its own manager, and personnel qualified in HRM. Whether the cooperative credit network is provided with the adequate tools to select and recruit successful managers remains a question open to scholarly debate.

## 5. Conclusions

This paper has been developed with an aim to stimulate discussion on Italian cooperative credit banks and, specifically, to point to the fact that cooperation is an important pillar for a stable economy. Italian cooperative credit banks are community banks that operate locally. They provide financial services to a variety of members and are particularly efficient in addressing customers' needs. Their activity is complementary to that of commercial banks: their behaviour is counter-cyclical and often beneficial in terms of financial stability. It can be argued that such stability is essential for promoting economic development, securing social order and social cohesion; and to prevent social conflicts resulting from high unemployment, rising poverty, and an unequal distribution of wealth (North *et al.*, 2009). At a local level, cooperative credit banks relate to entrepreneurial clusters and industrial districts. They provide capital and funding to newly-established enterprises, which is essential for them to grow. By integrating into a well-functioning cooperative network, they effectively compete with larger competitors, namely banks that operate nationally or internationally.

Since the 19<sup>th</sup> century, Italian cooperative credit banks maintain a set of well-defined characteristics. Some of them have developed into a number of competitive advantages, ranging from relationship banking and high customer loyalty to a sound policy for promoting corporate social responsibility. Despite increasing competition in the market, several advantages are retained at present. As it has been shown earlier, benefits result from: *a)* a governance based on cooperative ownership; *b)* a focus on retail banking; *c)* a traditional OTH intermediation model with inbuilt safety-nets; *d)* high solvency ratios; *e)* finally, a high level of capitalisation. In addition, new ones have emerged. Whether cooperative credit banks in Italy will be able to preserve their specifics in the long-term, is an open question. Will they succeed in increasing their market share? Will they tend to adopt more commercial strategies? Or, perhaps, will cooperation in banking gain prominence in the aftermath of the financial crisis?

When stimulated and properly supervised, such a banking typology contributes to economic development. On the other hand, however, I acknowledged that the governance in cooperative credit banks is somewhat impaired by a number of



shortcomings that need to be adequately addressed and essentially improved in the coming years. As reported by Gutierrez (2008), there have been at least 20 cases of Italian cooperative banks with special administration procedures since year 2000. In the past, many of the proposals to improve the governance of cooperative banks have been impractical or ineffective. An effective mechanism for management control is still somewhat missing. Major challenges currently faced by the Italian cooperative credit banks include: *a)* side-effects resulting from a heavy reliance on cooperative members; *b)* side-effects resulting from a rather strong dependence on local economies and – to a minor extent – from parties' interests; *c)* organisational issues such as a HR management and recruitment policies that require major improvements.

To conclude, a thorough investigation of cooperative banks and of their specifics can contribute to a better understanding of the concept of “cooperation” in banking. Despite increasing attention from social economists as well as from institutions such as the Bank of Italy and the IMF<sup>11</sup>, their implications for improving financial policies remain in part unaccounted for. New insights could possibly translate into improvements in regulatory frameworks which are much needed in the aftermath of the financial crisis. A better recognition of the specifics listed above and their business philosophy would be particularly beneficial. Whereas in the past the international regulatory framework has been designed with mainly commercial banks in mind – as is shown for instance by the third pillar of the Basel II Agreement –, recent developments in financial markets force regulators and policy-makers to take specifics from different banking typologies into equal account.

Banks are normally heavily regulated. Cooperative credit banks are among *the* most regulated financial intermediaries. Ineffective government regulations and insufficient supervision from financial authorities can “adversely distort the behaviour of bankers and inhibit standard corporate governance processes” (Levine, 2004, 3). An in-depth understanding of cooperative credit banks (as well as popular banks, credit unions and local community banks), can contribute to improving the current regulatory framework from a *qualitative* point of view. As shown by some examples of failures in the past, despite applying to rather conservative policies and despite integrating into a sound credit network, these banks are not immune from mismanagement, potential runs on capital and subsequent failures. By properly addressing these shortcomings, both executives in Italian cooperative banks and financial regulators will be able to increase the reliability of cooperative credit banks and further increase their positive contribution to sustainable economic development.

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<sup>11</sup>Consider for instance the below-referenced papers, in the References section.

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