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CREDIT COOPERATIVES: CHALLENGES AND OPPORTUNITIES IN THE NEW GLOBAL SCENARIO

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CREDIT COOPERATIVES: CHALLENGES AND OPPORTUNITIES IN THE NEW GLOBAL SCENARIO[1]

Giovanni Ferri[2]

Abstract

The future scenario highlights a Western leadership challenged while the geo-economy seems to be moving back to a pre-Industrial Revolution setup. Against this possible background, we outline various considerations along which that scenario will increase the need for credit cooperatives to shape a more sustainable economy.

Next, we selectively review the literature on credit cooperatives – presenting their strengths and weaknesses – and argue that, even more so before the crisis, the conventional wisdom shaping the approach of regulators and supervisors was one in which credit cooperatives were seen as odd guys, with rare attempts at understanding their intrinsic nature and a more usual neglect. Overall, we find that judgment neither justified by available theories of banking intermediation nor supported by the available evidence. Specifically, we conclude that the coexistence of cooperative banks – and, more generally, stakeholder banks – along with purely profit maximizing commercial banks does not depend only on legal restrictions but it stems also from the different pros and cons of the organizational structure of the two types of banks. Namely, with respect to the shareholder value maximizing model (the typical Plc or joint stocks banks), the (stakeholder oriented) cooperative model may under some conditions be more effective at managing the conflict of interests between depositors and bank owners and, at the same time, offer some additional instruments to screen and monitor borrowers as well. Accordingly, following this relative advantage they have, it is to be expected that cooperative banks specialize in traditional – information intensive – business modalities. Regarding the lessons we can draw from the global instability, the impact of the crisis as to the sustainability of the two types of financial intermediaries seems to favor the stakeholder model. Indeed, the relationship banking business model – typical, though not exclusive, of cooperative banks – seems the true winner in the crisis. In addition, the type of financial innovation reshaping financial intermediaries in the last twenty years hinged on the transformation of the banking model from the traditional "originate to hold" (OTH) to the new "originate to distribute" (OTD) – with originated loans immediately securitized on the financial market. Unfortunately, this kind of financial innovation induced the generalized loss of responsible behavior on the part of the banks, since the banks knew *ex ante* they would sell those loans. Thus, the OTD banking model seems to be unsustainable in the long run. Since the stakeholder value financial intermediaries kept their roots in the traditional intermediation while the shareholder value financial intermediaries were more eager to the transformation, the crisis suggests the former model is more

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sustainable than the latter. This is at odds with the prejudice against credit cooperatives, often described before the crisis as outdated and inefficient.
Finally, we take up three main challenges we identify for the credit cooperatives and discuss them in some detail. Namely, as a first task, credit cooperatives need to find ways – at both their network and individual levels – to secure they don't lose their essence. Those intrinsic values allowed the credit cooperatives to survive and expand in the unfriendly environment of the past. But adequate action has to be taken to preserve those values while rejuvenating them. Second, the credit cooperatives must find appropriate ways to shoulder the transition. In general, the credit cooperatives were asked to step in providing increased support to their clients and communities while the commercial banks were retrenching. That has made the credit cooperatives themselves more exposed to the enlarged credit risks of the ongoing recession. Third, credit cooperatives should manage to raise the awareness of the regulatory bodies and of the legislators on the great perils of three main faults exemplified, e.g., in Basel 3: damaging SMEs; failing to recognize the pro-stability importance of a traditional/retail bank business model; disregarding that the increasing cost of regulatory compliance may interfere with safeguarding biodiversity in banking.

Keywords
cooperative banks, shareholder value banks, financial crisis, sustainability of finance, regulation

1. Introduction

The world's gravity seems to be moving from West to East – where two countries counting approximately 2.5 billions of the world's 7 billions total have come back to play a strong role – and the geo-economic distribution of power in the decades to come might look more similar to the pre-Industrial Revolution setup than to the world characterized by the Western leadership that we have experienced in the past two hundred years. The Western model of economic organization is under discussion. Specifically, doubts are cast on the sustainability of the "market fundamentalist" epoch of the recent decades, a time in which unduly excessive reliance on the free market brought about huge global imbalances and instability. That epoch discredited the role of the State and, within the private sector, that of any ownership structure – like that of the cooperatives – that was not purely profit seeking. Within the financial system, credit cooperatives were looked upon as archaic relics of the past that were surviving only thanks to legal protection. But was that a fair representation of the actual situation? It wasn't, as we will argue.

The likely perspective for the future highlights the return of a more interventionist role of the State as well as higher reliance on not purely profit seeking ownership structures. That includes an enlarged role for the cooperatives, in general, and for the credit cooperatives in particular. We will argue that a better, more sustainable world demands that increasing responsibilities are cast on the credit cooperatives. However, in spite of the favorable aspects, the future scenario raises also major challenges for the credit cooperatives. We will focus specific attention on three groups of these challenges.

First, credit cooperatives need to find ways – at both the organizational and individual levels – to secure they don't lose their essence. Safeguarding their cooperative and mutual underpinnings is vital. Those intrinsic values allowed the credit cooperatives to survive and expand in the unfriendly environment of the last two decades. But there is no guarantee that those values will be still available in the future unless adequate action is taken to preserve them. Often that will require finding new ways, even reinventing credit cooperatives to keep them steadfast to their mission and intrinsic spirit.

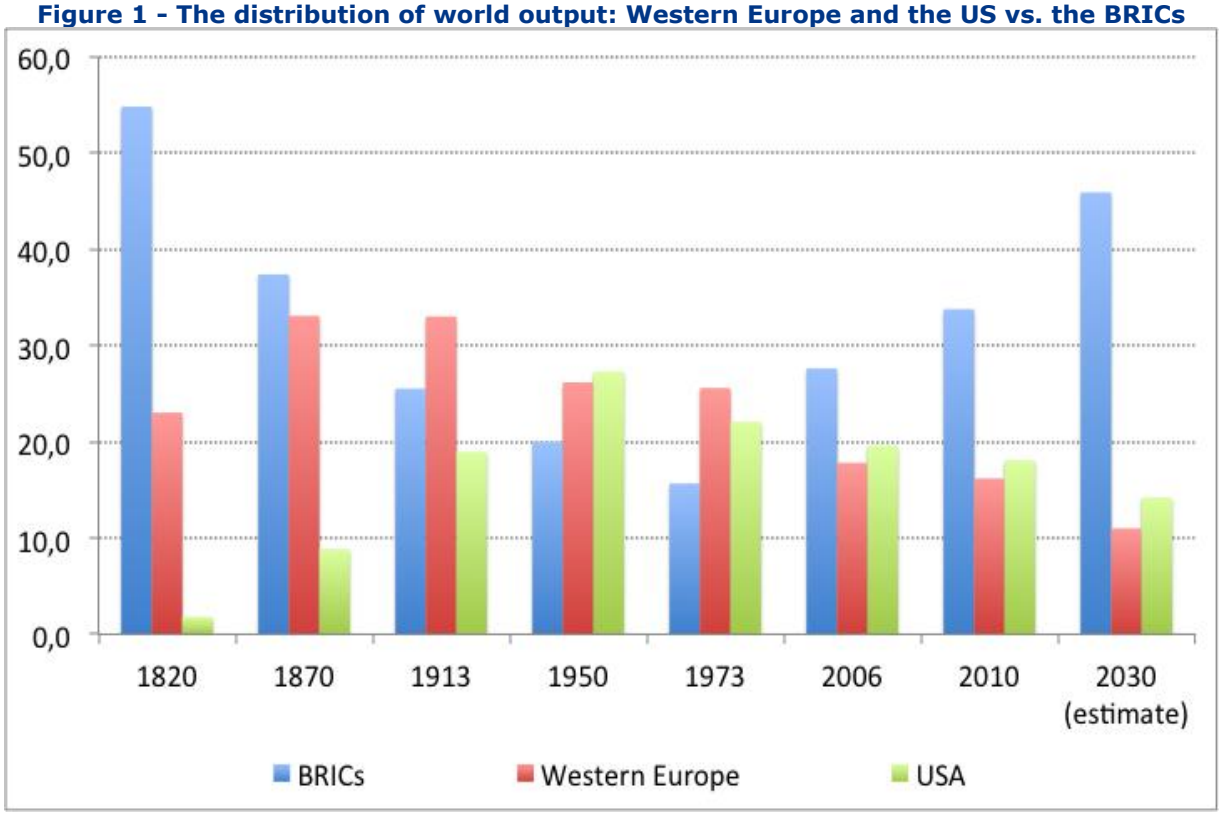
Second, particularly in the countries that have been or are being hit by the crisis, the credit cooperatives must find appropriate ways to shoulder the transition. Specifically, the crisis led to a situation in which the credit cooperatives had to tackle a difficult situation in which the commercial banks were typically retrenching their credit supply. In general, the credit cooperatives were asked to step in providing increased support to their clients and communities. That meant the cooperative banks have contributed to limit the evaporation of liquidity in the economies they serve. But that has happened at the cost of making the credit cooperatives themselves more exposed to the enlarged credit risks of the ongoing recession.

Third, credit cooperatives should manage to raise the awareness of the regulatory bodies and of the legislators on the great perils of three main faults exemplified, e.g., in Basel 3: damaging SMEs; failing to recognize the pro-stability importance of a traditional/retail bank business model; disregarding that the increasing cost of regulatory compliance may interfere with safeguarding biodiversity in banking. The one-size-fits-all principle should be abandoned to give way to a proportionality-based and fine-tuned approach to regulation. This is not an easy task as the credit cooperatives lack the attention of the academic community and their ability to

communicate and influence the public debate is certainly much inferior to that of the top ranking financial institutions. However, it is vital that any attempt is made to change the frame of mind with which legislators and regulators have been approaching the issue of the credit cooperatives.

The rest of the paper is organized as follows. Section 2 is devoted to depict the scenario in which the Western leadership is challenged and the geo-economy seems to be moving back to a pre-Industrial Revolution setup. This section also outlines various considerations along which that scenario will increase the need for credit cooperatives to shape a more sustainable economy. In section 3, we review the literature on credit cooperatives – presenting their strengths and weaknesses – and argue that, more so before the crisis, the conventional wisdom shaping the approach of regulators and supervisors was one in which credit cooperatives were seen as odd guys, with rare attempts at understanding their intrinsic nature and a more usual neglect. Section 4 takes up the three main challenges we identified and discusses them in some detail. Finally, section 5 draws the paper to a close.

Figure 1 - The distribution of world output: Western Europe and the US vs. the BRICs



Source: author's calculations on data from Maddison (2007), updates by the IMF and forecasts by Mold (2010)

2. A structural break towards sustainability and the role of credit cooperatives[3]

Nowadays, what was once the debate on the decline of Europe has transmuted into one in which, due to the difficulties encountered by the US, the danger of decline refers to the entire Western model. Various considerations ignite this debate but, perhaps, the most striking of all descends from observing that the ongoing global crisis distressing the world economy and society originated from excessive

[3] This section draws partly on Borzaga et al. (2011), the first Editorial of JEOD (Journal of Entrepreneurial and Organizational Diversity), the new online journal launched recently by Euricse (www.jeodonline.com).

indebtedness in the US (the 2007-09 bout of the crisis) and later on found a second epicenter in the imbalances of Europe (since 2010 and still ongoing at the beginning of 2012, the time of writing). Though against that possible sunset of the Western leadership no practical alternative is yet in sight, undoubtedly the world's gravity seems to be moving from West to East, where two countries counting approximately 2.5 billions of the world's 7 billions total have come back to play a strong role. Indeed, if we look at the distribution of the world output across the two major components of the Western block – Western Europe and the US – and the new dynamics of the emerging economies – as represented by the four largest ones, the BRICs (Brazil, Russia, India, and China) – we notice that the crisis has greatly accelerated the rebound of the BRICs *vis-à-vis* the economic might of Western Europe and the US (Figure 1). At the time the oil shock structural break began (1973), 47.6% of the total world output was produced by Western Europe (25.6%) and the US (22.1%), while the BRICs accounted for a mere 15.7%. By 2006, before the incipit of the global crisis, the two Western blocks had dropped to 37.4% (17.8% for Western Europe and 19.6% for the USA) while the BRICs had rebounded to 27.6%. The crisis propelled the shift: by 2010 the West accounted for 34.2% just above the BRICs (33.8%). In two decades from now the world could find itself to be in a geo-economic situation more similar to that characterizing the pre-Industrial Revolution era – when the BRICs represented 54.8% of the total and the sum of the, still juvenile, USA and Western Europe reached to 24.8% – than to anything we have seen thereafter. If we take at face value the forecasts produced by Mold (2010), the economic mass of China will be twice as large as that of the USA; that of India will match the one of Western Europe; overall the BRICs would command 45.9% of world output with the two Western blocks producing a mere 25.2% (11% for Western Europe and 14.2% for the USA). Needless to say, should this scenario materialize, the world the future generations we would be living in would look quite different from that prevailing in the life spans of a few previous generations.

The seeds of the current instability were probably planted in the early 1970s when there was a drastic switch also from the perspective of economic theory, policies and institutions. Since then, and even more after the collapse of the Socialist regimes – which gave the impression that a single model had prevailed (the "end of history" evoked by Fukuyama, 1992) – an increasingly strong wind of market fundamentalism kept blowing from New York and Washington, deeply influencing the approach to economic policy worldwide.

2.1. The focus on a single model

The vision blowing in that wind maintained that the best way to trigger human progress was through the allocation mechanism of mostly self-regulated markets, provided property rights and few other institutions were enforced. The main implication of this approach was the need to shrink state intervention and to leave more room for private initiatives. This resulted in a massive wave of privatizations, also involving particularly sensitive public interest services.

Furthermore, a non trivial lemma identified the shareholder-owned enterprise as the ideal company model while prescribing that firm efficiency be measured exclusively by the ability to create value for its shareholders – i.e. maximizing profits. The space for not purely profit-maximizing entrepreneurial and organizational forms was marginalized and restrained. Cooperative firms of all sizes and family-owned businesses were looked upon as a relic of the past. It was believed that these archaic

or eccentric entrepreneurial forms were surviving only due to outdated traditions, special legal protection and/or state intervention. Even new phenomena like social enterprises and shareholder companies subscribing to corporate social responsibility were regarded as hopelessly idealistic. This brand of market fundamentalism pervaded other spheres as well, influencing political thought and promoting the notion that the economic logic of the free market should apply to all social dynamics.

2.2. The failure of the profit maximization model and resilience of other forms of enterprise

The results produced by the implementation of this economic model did not fully meet expectations, even before 2007. Globalization and liberalization ignited intense growth in several emerging countries but many other nations were left behind. Deep inequality in income and wealth distribution grew almost everywhere. In the rich countries, the middle and low classes were able to temporarily preserve their living standards only by resorting to a remarkable accumulation of private debt. In most countries public debt was not curbed at all. Privatizations resulted neither in more efficiency nor in improved customer satisfaction.

At the same time, not purely profit-seeking enterprises were not disappearing as predicted, and instead continued to thrive. Cooperatives kept growing in the traditional sectors (e.g. agriculture, finance, etc.) and even expanded to new segments of the economy such as the newly privatized social and health services. Social enterprises emerged as a new effective solution to the provision of several public interest services. Family-owned businesses kept populating many sectors. Corporate social responsibility made its way into many mid- and large-sized companies.

The effects of the Great Financial Crisis that started in 2007 further testify to the limits of a model based entirely on free markets, which has proven to be unsustainable. At the peak of financial instability, all of the champions of the free market (including Goldman Sachs) had to beg for state support to avoid bankruptcy, and in the process dealt an irreparable blow to the intrinsic logic of the free market model. The crisis also induced a major slowdown of global economic growth. The hit was most intense where the degree of reliance on unfettered markets was largest: in the rich countries. The GDP of these countries dropped significantly, and the costs of the stabilizing interventions caused huge deficits, escalating public debt to dangerous levels. Thus, the private sector debt crisis was transformed into a public sector debt crisis. In order to contrast speculative attacks on sovereign debts several countries had no choice but to cut public expenditures, largely shedding welfare policies.

Meanwhile, at the firm level, the supposedly obsolete enterprises based on a not purely profit maximizing model proved generally more resilient to the crisis. Important examples may be found in the banking sector (where, by and large, cooperative and community banks did not have to ask for public funding and continued lending even as the large banks triggered a credit crunch) as well as in production cooperatives (where, in general, reduced sales did not translate into job cuts or increased reliance on public income support measures).

2.3. Towards sustainability and the role of credit cooperatives

The key problem faced by humanity is recovering sustainability. It is virtually impossible not to see how mankind has turned into a dead alley seriously risking disaster. We can see that from several different angles. We can notice that the world is close to financial disaster; that it often nears nuclear meltdown; that global warming is causes devastation, death and impoverishment; that increasing inequality renders societies arid and rebellious … and we could continue. We need to ask what has taken mankind there. There are many answers. But all of them hinge on the disrespect, the arrogance and the sense of self-sufficiency – with a Greek word we could say the Ὕβρις – of rationality through which man has shielded himself in the presumption of being able to exert his own uncontrolled dominion. The brink of disaster awakes us from the sleep guided by that presumption, revealing it was fallacious. Rationality is helpless without ethical roots and if it is exerted within an organization of our societies based on individualism that is irresponsible to the communities we belong to, to the other human beings. Along with the thought of Hans Jonas (1984), to escape from the brink of disaster we need acts of responsibility, able to change usual behaviors. We need to move beyond the lack of responsibility driven by the erroneous perception of self-sufficiency of the individual. That is the necessary passage to recover sustainability.

Cooperatives offer a way to go beyond the selfish individualism at the roots of the current instability. Cooperatives are instrumental to cater for the future generations. Within them, the credit cooperatives are particularly important at this juncture. Indeed, credit is one of the most significant actions linking the present and the future. Together with the ethical financial institutions, the credit cooperatives are naturally inclined to take those values on themselves. They will play an essential role in molding a better (more sustainable) world.

As Nobel laureate Joseph Stiglitz put it: "[…] We need to encourage a variety of alternative forms of economic organization. We […] have focused too long on one particular model, the profit-maximizing firm, and in particular a variant of that model, the unfettered market. We have seen that that model does not work, and it is clear that we need alternative models. We need also to do more to identify the contribution that these alternative forms of organization are making to our society, and when I say that, the contribution is not just a contribution to GDP, but a contribution to satisfaction" (Stiglitz, 2009, p. 359).

3. Up to now: how credit cooperatives were (wrongly) disregarded or judged "odd guys"[4]

The banking business model based on "relationship banking" – typical, though not exclusive, of cooperative banks – is the true winner after the deep financial instability of 2007-09. Indeed, the Anglo-American transformation of financial intermediaries in the last twenty years had at its center the advent of the new banking model "originate to distribute" (OTD) – whereby banks originated loans to be immediately securitized on the financial market – as opposed to the traditional "originate to hold" (OTH) – in which banks held on their books the loans (and thus the risks) they originated. With the benefit of hindsight, we now know that the widespread recourse to OTD was one of the fundamental causes behind the generalized loss of responsible behavior on the part of the banks. Specifically, as we elaborate below, it is easy to understand that

[4] This section draws partly on Coco and Ferri (2010).

when the bank knows *ex ante* that – through securitization – it will sell at once those loans it is granting, the bank loses the appropriate incentives to duly perform its "screening" and "monitoring" on borrowers. Thus, a generalized deterioration in lending standards is in the cards. And this is particularly worrisome in those contexts where the risk of borrowers' default is systematically high, such as in the subprime mortgage segment. This banking model does appear to be unsustainable in the long run.

3.1. From OTH to OTD finance in banking: theoretical and regulatory mistakes

The shift in the dominating model of banking has generated also a prejudice against the credit cooperatives, often described as outdated and inefficient. We discuss below the relative advantages and disadvantages of cooperative banks *vis-à-vis* their for-profit competitors in a broader perspective, taking into account the proper role of banks in lending activity and the whole chain of agency relationship that each model of banking entails. As could be expected, the cooperative model presents some advantages besides some disadvantages. The Cooperative model may under some conditions be more effective at managing the conflict of interests between depositors and bank owners and, at the same time, offer some additional instruments to screen and monitor borrowers as well.

In the past few years Cooperative banks, also due to their statutory limits, engaged in OTD finance less than for-profit commercial banks. However, in retrospect this was an advantage rather than a weakness. The spectacular collapse in some credit markets has demonstrated that OTD finance does not work. Only the OTH model of banking is coherent with the true advantage of banks relative to financial markets in lending and therefore is sustainable in the long run. If this hypothesis is true, Cooperative banks are therefore better placed now to recover from the financial crisis and at the same time are less likely to cut lending to businesses, particularly to the small and medium-sized enterprises (SMEs). In the near future much of the actual fallout of the crisis will depend on the amount of credit that the banking system will generate. Some evidence demonstrates that while credit from commercial banks dried up quickly, the Cooperative banks did not undercut their clients. This is a clear indication that their banking model is solid through the crisis and sustainable in the longer run.

By and large, the crisis was compounded by deep theoretical mistakes. The progress made by the theory of intermediation based on the asymmetric information approach (e.g. Stiglitz and Weiss, 1981; Diamond, 1984) was rather neglected. The ICT evolution had rooted the wrong perception that risk could be segmented and traded, a view which stood at the basis of securitization but affected also other segments of the credit market. This approach neglected the problem that if one unbundles complex financial relationships into segmented contracts this will, most likely, weaken the intermediaries' ability to asses and govern the overall dimension of that risk, thus amplifying systemic risk. When a borrower entrusts all his financial dealings on a single banking counterpart, in fact, that bank will have access to private (soft) information (Scott, 2006), which will instead be lost when that customer fragments his business among various counterparts, let alone if his debt is securitized on the financial market. At the same time, within a single banking relationship, the bank has the appropriate incentives to screen and monitor its borrowers, thereby acquiring private information on them. It is true that, as a consequence of the "hold up" problem, the relationship bank might try to extract rents from its borrowers. Nevertheless, this might be a price worth paying to avoid falling into irresponsibility.

Theory and regulation contributed to spread the fallacious view that individual risks could be separated.

On its part, regulation contributed to shape a less secure banking system, for example through the international accounting standards (IAS), inspired to the principle of marking-to-market[5], and Basel 2, which introduced a regulatory incentive to rely exclusively on the rating/scoring technologies. It may suffice to consider the pro-cyclical trends potentially induced by the diffusion of credit scoring and disseminated to the banks' minimum capital requirements through banks' internal rating models. This may be labeled the "dark side" of credit scoring (Ferri, 2001). Credit scoring is a substantially mechanic method to come up with the decision to grant credit on the basis of the collection of standardized information on applicants. This method relies on statistical models to assign the applicants to various ex ante risk classes and choose the threshold values to accept or reject the loan applications. As such, credit scoring is a potent instrument able to lower noticeably the administrative/management cost of the loans, to the point that, according to some authors, it could reduce asymmetric information and financial constraints (Petersen and Rajan, 2002). In our view, however, adopting credit scoring has shortcomings as well. It is a well recognized fact that, in reality, the main role of the banks stems from their ability to develop relationship banking with their borrowers, a special situation facilitating a Pareto improving exchange of information between the borrower and the bank. And relationship banking hinges in a critical way on the extraction by the bank of proprietary information on the borrowers, thanks to multiple interactions between the two parts (Boot, 2000). In that, credit scoring lowers banks' ability to gather and process soft information on borrowers, that are often crucial to overcome the asymmetries of information between the borrower and the lender. In truth, credit scoring implies totally trusting standardized data and automatic mechanisms, an approach, which is the opposite of using soft information, which are by nature information that one cannot circumscribe in standard formats and that require relationships rather than mechanical instruments. From this perspective, credit scoring – as it reflects the borrower's current situation rather than his future prospects – may induce pro-cyclical fluctuations in the cost and the availability of credit, something that could amplify the endogenous fluctuations in the loan supply (Rajan, 1994) and, thus, in economic activity. Analogous considerations apply to ratings and, so, also to Basel 2 and Basel 3.

The approach postulating the need for banks to evolve from the OTH to the OTD model (Bryan, 1988) implied a subordination of the banks to the financial markets, where their loans would now be priced as securities on the basis of statistical models rather than the bankers' *intuitus personae*. This subordination derived from the evolutionist view whereby multilateral financial markets would do a better job at allocating risks (Goldsmith, 1966; 1969). Alas this vision was based on a transactional view of the bank, which had been amply falsified by theory and evidence (Allen and Gale, 2000).

3.2. On the merits of different governance structures in banking finance

In addition, the evolutionist theorem had a lemma regarding the bank's company model. The credence became widespread that the most appropriate company model

[5] Also Masera (2012) raises worries about the possible short circuit marking-to-market could introduce in traditional banking.

to support financial development was for the bank to be established as PLC, bearing the objective of maximizing shareholder value. It was believed that, by aiming to maximize short-term profit, this type of bank would be better able to capture the opportunities unfolded by the transformation of the banking model from OTH to OTD. The model of the cooperative bank – the prototype of stakeholder value banks – was then depicted as archaic since, assigning value (also) to objectives different from maximizing short-term profit and putting on the same par (at least in their statutes) – especially via the principle "one head one vote", irrespectively of the amount of shares actually held – the weight of each shareholder in the bank's choices, allows representing a larger set of the bank's stakeholders.

The corporate governance of the cooperative banks is under discussion. Some observers hold that it contributes to generate untouchable directors who will rarely be replaced and, thus, may act in a self-referential way. Though there is some truth in this claim, this reasoning neglects the possibility that the long tenure of cooperative banks' directors is the inevitable price to pay to allow a wider representation of stakeholders. On this, it is worth observing that, just thanks to their higher stability of directors, cooperative banks are better able to pursue long-term objectives. In particular, some authors remark that these intermediaries abide by a long-term business model, intensely oriented to serve the SMEs and the local communities (De Bruyn and Ferri, 2005). Furthermore, it has been shown that the cooperative banks' lower profit volatility – a fact in line also with the results of various studies at the IMF (Fonteyne, 2007; Hesse and Čihák, 2007) – is correlated with the higher stability of directors and not so much with the lower income diversification (i.e. a smaller share of non-interest income on total operating income) that is also observed at the cooperative banks. Thus, it's the governance model of the cooperative banks that seems at the basis of their lower profit volatility and that likely allows these banks to pursue longer-term objectives. It is also their governance that makes it more sustainable for the cooperative banks to do business on the basis of a banking model which is not only OTH but features the deep rooting of relationship banking.

We may derive from the above that, being more devoted to relationship banking and, thus, better able to reduce the information asymmetries on borrowers, the stakeholder value banks are the ones better able to overcome the market failure at the origin of the establishment of the bank. However, irrespective of this, for many years we have seen a substantial dislike of cooperative banks by lawmakers. Therefore, this determined a double subordination for the stakeholder value banks: as their shareholder value homologues they were increasingly subordinated to financial markets in terms of their business model and, on top of that, they were also subordinated to the shareholder value banks in terms of their company model.

In addition, we should not downplay that the assumption of credit cooperatives underperforming with respect to for-profit commercial banks may be unwarranted. For example, Ferri et al. (2011), using two large panels of European banks for 11 years in the pre-crisis period, thoroughly examine the impact of ownership structure on performance across profitability, loan quality and cost efficiency. In their results, both shareholder and stakeholder banks have distinct advantages, while no ownership type overperforms any other in all three measures.

The crisis marks the need to think over also about the (in the past) negative prejudice against stakeholder value banks. In light of the above, it is not by chance that stakeholder value banks were less penalized than shareholder value banks during the crisis. In particular it is to be stressed that stakeholder value banks are better inclined

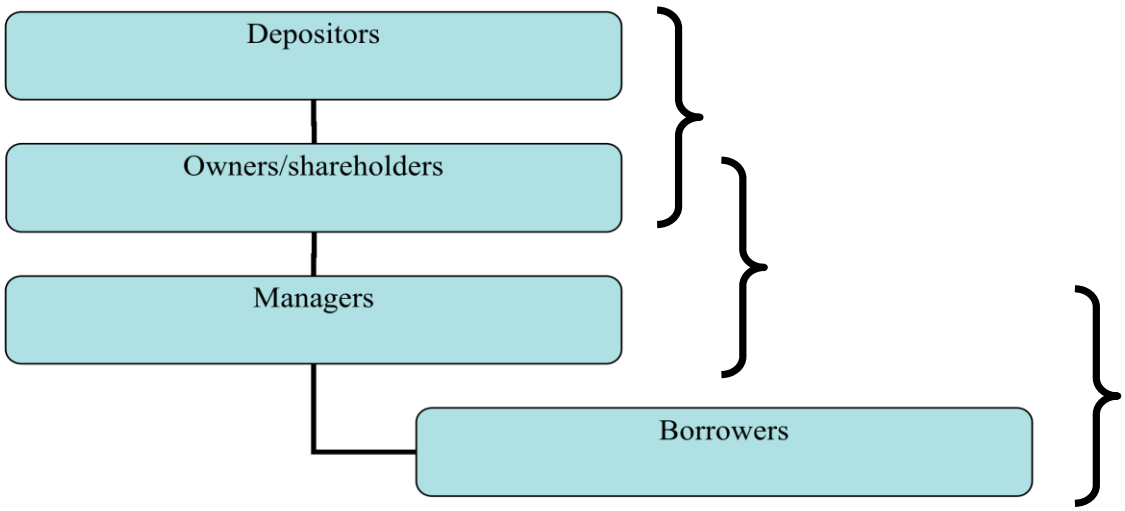
to follow a business model having longer-term objectives and, as such, better suited to strengthen relationship banking and thus to favor responsible behavior, in lieu of that irresponsible behavior at the origin of the crisis.

The arguments against the governance model of cooperative financial institutions, and more generally against not-for-profit entities, could be phrased in terms of the asymmetric information theory. Complex organizations systematically suffer from a moral hazard problem between owners and managers. An organization is set up with a set of formal ends whose beneficiaries are the formal owners of the organization, but the necessity to manage it concretely implies that control over decisions is normally allocated to individuals whose interest is seldom aligned with the owners'. An organization with a clear and unambiguous, measurable, objective has some advantages over another. Profit lends itself nicely to the definition of targets for the managers and therefore diminishes rooms for discretionary behavior and rent extracting on the part of the managers.

However, in the case of banks, this sort of analysis is too a simplistic approach to a high degree. As we discussed above, the very existence of bank finance and banks as organizations can be traced back to another sort of asymmetric information, the one between lenders and borrowers and to scale economies in monitoring and screening activities. On the other side, the fact that banks operate mainly with capitals borrowed from depositors makes them agents rather than principals in another relationship, the one between owners and depositors. Of course, the moral hazard between owners and managers is still relevant, but it would be absurd to judge the governance structure of the cooperative financial institutions on the basis of this criterion only. A more general analysis is necessary to appropriately evaluate the ability of different models to overcome difficulties in the various types of imperfections that the banking institutions face. Not surprisingly, a more in depth analysis reveals that different types of institutions are better suited to overcome different information problems.

Our first task here, in order to compare financial institutions, is to isolate conceptually their differences. Here we will build on the approaches taken in two separate studies by Fonteyne (2007), for the IMF, and Cuevas and Fisher (2006), for the World Bank. It is not difficult to define the asymmetric information problems concerning a commercial profit-oriented bank. The following scheme summarizes them in a necessarily simplified way (Figure 2).

Figure 2 - The three agency relationships in for-profit banks



At each stage the relationship between the upper and the lower level is characterized at least by an agency relationship with a moral hazard content. Starting from the lower level, is the most studied agency relationship so far, the one between borrowers and lenders. In this relationship both pre-contractual and post-contractual asymmetric information, leading respectively to adverse selection and moral hazard problems are relevant. The very existence of banks can be attributed indeed to the inability of markets to overcome the issue of the intermediation of funds in the presence of those problems among a multitude of agents on both sides of the market. *Ex ante* screening and *ex post* monitoring of investment projects are certainly activities outside the reach of individual savers/depositors, because of economies of scale. Even when those activities would be in principle possible, still a possible free rider problem would exist when many savers, as is the case, finance one borrower. A cost-sharing arrangement for screening and monitoring would need to be devised and the bank is the most logical "sharing" arrangement. This highlights the fact that the Banks' Owners and Managers are, in practice, there to mitigate the basic agency conflict that exists between Depositors and Borrowers. Still their existence brings forth some additional agency conflicts and correlated transaction costs. In particular, the bank introduces an agency conflict between depositors and owners of the bank. Since the owners operate mainly with funds they do not own (deposits), they do not bear most of the downside risk and have a perverse incentive to increase the risk of their *portfolio*. On the other side, operative decisions, in particular those related to loan policies are usually attributed to managers of the bank. In a traditional bank the Owners are only interested in profit maximization, while the Managers may be driven by other objectives, notably size and perks. Note that the Management may in principle, thought it's difficult to say in practice, be more interested than the Owners in the stability of the Bank and, therefore, its presence may mitigate the conflict with the depositors. However, the type of activities in which the management engages is wasteful and, therefore, adds to the overall costs of intermediation. As all the Owners are only interested in profits, however, this conflict is manageable with relatively effective tools and this constitutes an advantage for for-profit Banks.

To sum up a for-profit bank, as an organization that substitutes for markets, is useful and welfare-enhancing in so far as the costs from the additional conflicts that it causes is lower than the costs of the original unmediated agency relationship. On the whole, therefore, the organizational structure should be evaluated on the total agency costs it delivers, rather than those pertaining to a single stage of the chain. Analyzing banks as other firms in competitive markets not plagued by asymmetric information markets is therefore highly misleading. This highlights the fact that the cultural model that has been used to dismiss the governance model of the cooperative financial institutions is simplistic at best, not based on the development of economic theory and simply reflects a prejudice.

Let's now analyze along the same lines the agency costs that are more likely to be relevant in the cooperative model. The main difference with the for-profit model is the fact that the distinction among borrowers, shareholders and depositors is not as clear cut as it becomes more blurred than in the traditional model and, therefore, the conflicts are more complex. Depositors and shareholders are, up to some points, the same subjects[6]. Also, typically, the cooperative institutions face some limits in their lending activity. Often, a substantial part of their lending has to be realized with

[6] Of course in general a cooperative bank can raise deposits also from non-members and this raises the issue of to what extent it is wise to allow cooperative banks to raise deposits and whether it is useful to place a limit on this possibility.

members. The fact that the same person plays different roles within and with the cooperative financial institution suggests some conflicts of interests may be dampened. Of course, one needs to consider that one of the roles is usually prevalent. A member who is a net borrower (who borrows more than its deposits) is certainly more interested in his loan than in his deposit. But his membership makes him more sensitive to the interests of the borrowers' community than a standard borrower. Opportunistic behavior is less likely because membership in a cooperative bank usually entails the development of a network of relationships that go beyond a pure lending relationship. Members may be linked by commercial and professional (not to mention family or friendship) relationship that have two positive effects:

a. they make opportunistic behavior more unlikely because the stigma associated with a default is possibly larger than the one developing in a standard lending relationship;
b. they facilitate both screening and cross monitoring among members/borrowers.

Both these advantages may facilitate the channeling of credit towards worthy entrepreneurs or at least change the conditions at which credit is awarded. Collateral, which in the case of SMEs is practically necessary to obtain credit, may be less important in this type of relationship. Existing evidence supports the view that collateral is a discipline device in credit contract to avoid opportunistic behavior (Berger and Udell, 1995). A cooperative institution may be better placed to use soft information for monitoring purposes and other disciplining devices stemming form the sort of relationships common among members.

An additional benefit of the typical governance structure stems from the fact that, often by Statute, cooperative Financial Institution must provide credit to the members on better terms than to other borrowers. In Italy, for example, according to an estimate of the Association of Cooperative Credit Banks (BCC) 19% of the global value added generated is distributed in the form of lower interest payment for members[7]. Lower interest payments per se reduce the incentive for opportunistic behavior of entrepreneurs (Stiglitz and Weiss, 1981).

A final note on potential advantages of Cooperative Credit Institutions is that most of them are related to the various relationships among players with multiple roles (stakeholders) relative to the Institution. It is likely, however, that the importance of such relationships is inversely correlated with the dimension of the institutions. Relative advantages are therefore concentrated in the low end of the dimensional scale for intermediaries.

The disadvantages of the Cooperative governance structure on the other side are concentrated in the relationship between members (owners and depositors at once) and the Management. The objectives of cooperative credit include the promotion of growth of the Institution, as well as objectives of development of local and national communities, of cooperation and sometimes the promotion and financing of culture and charities. Of course, it is much more difficult to hold the Management accountable on such a large and diverse (and sometimes not easily quantifiable) set of objectives. There remain large avenues for discretionary behaviour and rent extracting for managers. This suggests that the governance of cooperative Financial Institutions should pay much more attention to this specific conflict and to control of the management than to other conflicts (Cuevas and Fisher, 2006).

[7] The advantage for members is calculated on the basis of the difference in interest payments required to members and non-members on comparable loans.

On the whole, however, there seem to be reasons to expect that the Cooperative governance structure may be appropriate at least in some cases. Given the discussion above, the most sensible policy approach is not to choose a determinate governance structure as the one preferable in every context. Just as firms in competitive markets, different organizations and governance structures compete and demonstrate their relative advantages in the markets. An appropriate choice would be to recognize and, up to some point, to encourage diversity in governance structures in order to ensure that the most appropriate ones emerge naturally as the winners. Of course, levelling the playing field in this case would not necessarily entail enforcing the same regulation on every type of intermediary. As we saw earlier, the perils for financial stability of intermediaries come mainly from the perverse incentives of banks' owners and, therefore, from the agency problem between them and the depositors. This problem is exacerbated by the insurance on deposits offered by the lender of last resort. But this problem is less important (though not irrelevant) in Cooperative Banks as the Owners-Members are, for an important part, also Depositors. The fact that profits are not the objective of Cooperative Banks moreover considerably dampens the incentive to increase risk taking opportunistically in lending (or any other financial activity). Prudential regulation is thus less necessary for this type of intermediaries. Limits to the discretion of Managers on the contrary may be more useful than in traditional for-profit banks (Cuevas and Fisher, 2006).

3.3. Sustainability of cooperative banking

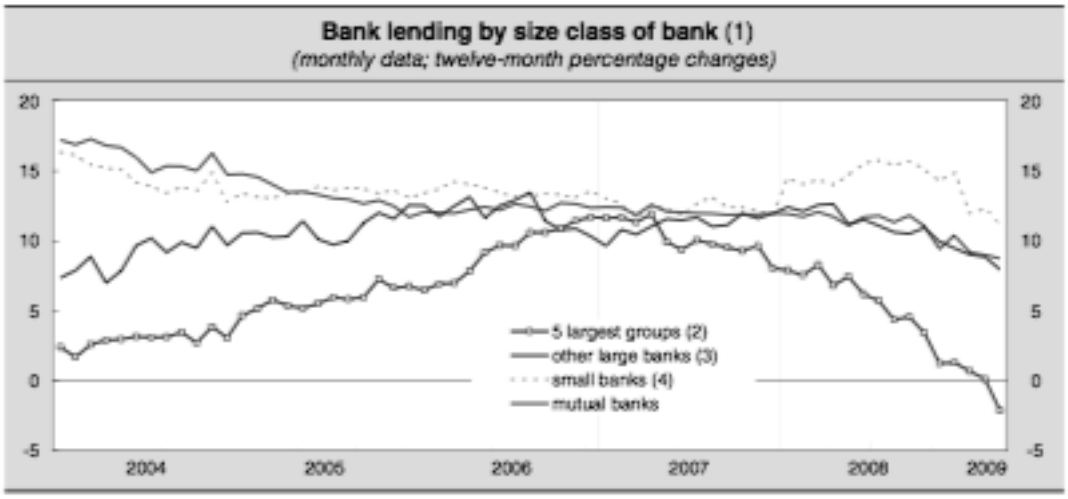
In capitalist economies financial de-regulation and liberalization often lead to financial bubbles that, possibly originated by the formation of over-optimistic expectations on new discoveries or the enlargement of the extent of the markets, are inflated by excessive lending (Morris, 2008). The experience of the latest decades with international financial crises increasing in frequency and in severity seems to support this view (D'Apice and Ferri, 2009). Indeed, according to this argument, the latest financial crisis triggered by the subprime problems could mark the end of a prolonged phase of ever freer financial markets. The ongoing debate on how to re-regulate finance is a case in point.

While financial markets tend to be more cyclical than financial intermediaries, even within the financial intermediaries some types may be less pro-cyclical than others. To be sure, in the previous discussion we dwelled extensively on the possibility that financial intermediaries that have the objective of maximizing stakeholder value (often, though not exclusively, cooperative institutions) may be better able than their shareholder value maximizing homologues to overcome the asymmetric information problems between depositors and borrowers, while reducing also the overall conflicts of interests affecting the entire intermediation chain. Thus, stakeholder value intermediaries should be more stable than shareholder value intermediaries, given that risk tends to be pro-cyclical. Furthermore, when the economy's price system is distorted by a financial bubble the risk-seeking incentive for the shareholder value banks is amplified also because it becomes particularly difficult for regulator/supervisors to spot it and to curb it.

Our deductions find supporting evidence in various papers published at the IMF as well by independent academics. These studies, in fact, reach the conclusion that cooperative banks tend to be more stable and this seems to depend on their lower return volatility. While stakeholder value banks' larger focus on the traditional bank intermediation function – and limiting their financial market related activities –

explains part of this, the literature also finds that some of their lower volatility is germane to the corporate governance model of these intermediaries.

Figure 3 - Bank lending by size class of bank



In line with the above, we may thus conclude that stakeholder value financial intermediaries offer a key support a sustainable model of lending. In this perspective, it is not by chance that we observe cooperative banks contracting their supply of loans significantly less than shareholder value banks have done in the aftermath of the fall 2008 intensification of the financial crisis. For instance, in the case of Italy, the loan growth rate at the end of 2008 was 4.6% for PLC banks as against 8.7% for the total of the two components of the cooperative banks – 6.3% for the *Banche popolari* and 11.3% for the *Banche di Credito Cooperativo*[8]. Still for Italy, Banca d'Italia (2009) shows that the drop in the dynamics of loans was particularly noticeable for the large (PLC) banks while it was much less for the mutual banks (the *Banche di Credito Cooperativo*) and for the small banks (where this group is dominated by the *Banche popolari*; Figure 3).

4. The future: key challenges for the credit cooperatives

To take the opportunities that will likely unfold for them in the new scenario, credit cooperatives need to face those challenges. Overall, responding to the challenges we identified calls for action on different levels.

4.1. Preserving the mutual and cooperative essence

Preserving their own essence is a task the credit cooperatives must tackle mostly within themselves. Within each of them, a credit cooperative evolves over time and its success – driving it to expand – may plant the seeds for possible future problems. Provided the endowment of social capital is enough, the good working of a credit cooperative demands the adequate support of its members' participation. However, the expansion of the credit cooperative's operational scale may provide a formidable shock in that securing participation becomes increasingly complex. Democratic processes are costly and often cumbersome, but they must be kept vivid particularly in the credit cooperatives. It is probably necessary to find new ways to shape

[8] Our calculations based on data taken from Banca d'Italia (2009).

participation along the channels offered by the communication technology. It should be considered whether the social network approach is the right one. The balance between physical and virtual interaction is probably the new frontier to redesign the members' participation. In addition, the credit cooperatives typically belong to a network and the network itself is part of their identity. Ensuring good governance also along and across the network is a task that should not be undermined by free riding. Participation is important at this level too. The network dimension is key to provide several services the individual credit cooperatives would not be able to supply otherwise, but that dimension can offer as well best practices and useful instruments to improve the governance and the general functioning of each credit cooperative.

4.2. Shouldering the transition: "at the mercy of a rude stream"

Shouldering the negative impact of the crisis is a very demanding task. Typically, the credit cooperatives were less exposed to the initial financial shock coming with the US-originated wave of 2007-08. Nevertheless, their fragility to macroeconomic shocks was no less than at the other commercial banks to start with and that fragility seems to have heightened for the credit cooperatives. In fact, while the commercial banks undertook a major restriction of their credit supply, since 2008, the credit cooperatives did not retrieve as well from supporting their local customers and communities. For the credit cooperatives, that translated into increasing loan market shares and also into rising loan/deposit ratios. So, it looks like the credit cooperatives, particularly in Europe, are now more fragile to the new wave of the crisis originating from the European sovereign debt crisis.

4.3. Tackling the downside of a "stepmother" bank regulation

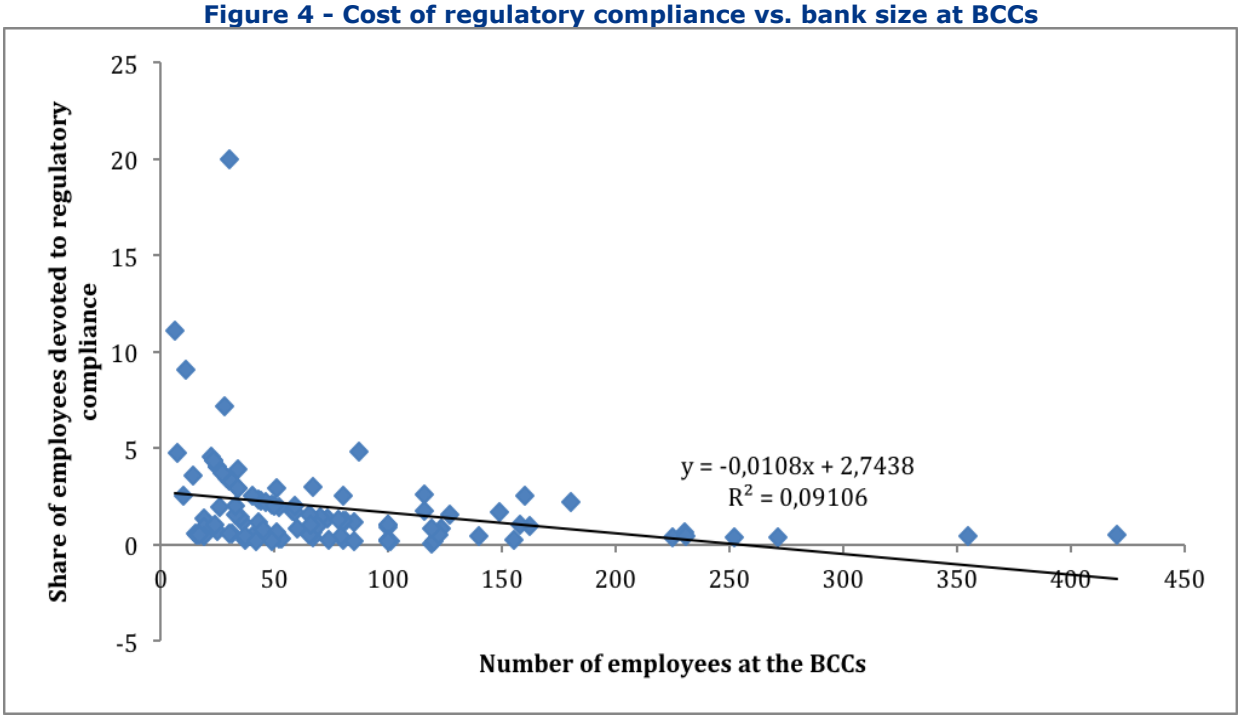
Last, and not least, the credit cooperatives are facing the downside of a bank regulation that – certainly unintentionally – is "stepmother" to them by burdening the credit cooperatives with ever more demanding requirements of rules that don't seem appropriate for them. In spite of the lessons of the crisis, regulation seems to be still teetering and unable to take the needed steps to recover financial stability, primarily by reestablishing the separation between commercial and investment banking, as advocated by the de Larosière (2009) and Vickers (2011) reports and by the influential proposal put forward by Paul Volcker (2010). Indeed, sidestepping those recommendations, regulation appears to be playing the old adage of the nth version of a Basel Accord on bank minimum capital requirements and imposing the banking system heavier and heavier regulatory requirements. By and large, the current regulatory framework is unfriendly to credit cooperatives for three main reasons.

First, various assessments anticipate a significant negative impact of Basel 3 on lending to the small and medium-sized enterprises (SMEs). For instance, based on data for Spain, Carbò Valverde (2011) finds that: 1) the negative effects of the increased solvency requirements are significantly more dramatic on credit available to SMEs. The reduced amount of credit available to SMEs due to increasingly stringent solvency requirements could climb to twice the reduction of other types of loans; 2) the negative effect on credit increases notably if the increasing solvency demands take place within the context of increasing costs of credit; 3) the reduction in the number of loans granted to SMEs in a country such as Spain, in which there is a high dependence on bank financing, could very well have considerable negative effects on investment in production. Negative impacts of Basel 3 for lending to SMEs across

Europe are found also in an independent study by ACCA (2011). This penalization for the SMEs is particularly at odds with the perception that the SMEs not only provide more diversified risks, but they were involved the least with the process of transformation of manufacturing and service companies into finance holdings. Since the said transformation of larger-sized companies was certainly part of the build up of systemic risk then exploded with the ongoing crisis, one would expect that SMEs should be recognized as lower risks rather than being penalized with higher capital requirements for the banks that lend to them. In any event, should Basel 3 neglect adjusting this, as the SMEs constitute the bulk of their business, the credit cooperatives will be undoubtedly put at a disadvantage.

Second, the regulation fails to recognize that the relationship-based business model, typical – though not exclusive – of the credit cooperatives, generates less risk exposure in traditional lending activities while making these banks less likely to venture into difficult to assess financial market-related new types of risk. Masera (2009, 2011) has been particularly clear on the danger of relying exclusively on minimum capital requirements along an automatic – hands off – type of regulation. More recently, Masera (2012) has been even more explicit regarding the importance of the banks' business model: "The very nature of the business model of the banks should provide a fundamental reference for evaluating risk. The intrinsic stability of a well managed traditional type bank is not recognized […] the banking model that better than others can lead to financial stability, growth and employment creation the economies characterized by the dominating role of SMEs might be the memorable casualty of the Basel system" (p. 35). Similar considerations may be found in de Larosière (2010, 2011).

Figure 4 - Cost of regulatory compliance vs. bank size at BCCs



Third, the increasing regulatory requirements unintentionally raise the compliance costs of regulation. This trend harms credit cooperatives along the following line. As there are some fixed cost components of compliance, regulation is introducing a sort of "artificial" economies of scale. For instance, Ferri and Pesce (2011) find a strong negative correlation between the relative cost of regulatory compliance (as measured by the share of employees allocated full time to that task) and the size (in terms of

the number of employees) of the BCCs (*Banche di Credito Cooperativo*, Italy's mutual cooperative banks). That negative correlation is represented descriptively in Figure 4.

In turn, these "artificial" economies of scale can be a real issue for the many tiny-sized credit cooperatives. The higher regulatory compliance costs could lead them into artificially-motivated growth. In turn, becoming larger-sized, credit cooperatives could face more severe governance problems and risk losing their ethical business roots. These problems may worsen if supervisors act on the basis of performance measures (e.g. profitability) appropriate for shareholder value banks but not for credit cooperatives (that are stakeholder value), pushing the latter to behave as the former.

5. Conclusions

We argued that, while the Western leadership may be dwindling and the geo-economy seems to be moving back to a pre-Industrial Revolution setup, the need for credit cooperatives to shape a more sustainable economy.

Selectively reviewing the literature on credit cooperatives, we argued that the conventional wisdom shaping the approach of regulators and supervisors has been one in which credit cooperatives are seen as odd guys, with rare attempts at understanding their intrinsic nature and a more usual neglect. Overall, we found that judgment neither justified by available theories of banking intermediation nor supported by the available evidence. Specifically, we concluded that the coexistence of cooperative banks – and, more generally, stakeholder banks – along with purely profit maximizing commercial banks does not depend only on legal restrictions but it stems also from the different pros and cons of the organizational structure of the two types of banks. Namely, with respect to the shareholder value maximizing model of banking, the (stakeholder oriented) cooperative model of banking may under some conditions be more effective at managing the conflict of interests between depositors and bank owners and, at the same time, offer some additional instruments to screen and monitor borrowers as well. Accordingly, following this relative advantage they have, it is to be expected that cooperative banks specialize in traditional – information intensive – business modalities, such as in SME lending. Regarding the lessons we can draw from the global instability, the impact of the crisis as to the sustainability of the two types of financial intermediaries seems to favor the stakeholder model. Indeed, the relationship banking business model – typical, though not exclusive, of cooperative banks – seems the true winner in the crisis. In addition, the type of financial innovation reshaping financial intermediaries in the last twenty years hinged on the transformation of the banking model from the traditional "originate to hold" (OTH) to the new "originate to distribute" (OTD) – with originated loans immediately securitized on the financial market. Unfortunately, this kind of financial innovation induced the generalized loss of responsible behavior on the part of the banks, since the banks knew *ex ante* they would sell those loans. Thus, the OTD banking model seems to be unsustainable in the long run. Since the stakeholder value financial intermediaries kept their roots in the traditional intermediation while the shareholder value financial intermediaries were more eager to the transformation, the crisis suggests the former model is more sustainable than the latter. This is at odds with the prejudice against credit cooperatives, often described before the crisis as outdated and inefficient.

Finally, we tackled three main challenges identified for the credit cooperatives and discussed them in some detail. Namely, as a first task, credit cooperatives need to

find ways – at both their network and individual levels – to secure they don't lose their essence. Those intrinsic values allowed the credit cooperatives to survive and expand in the unfriendly environment of the past few decades. But adequate action has to be taken to preserve those values while rejuvenating them. Second, the credit cooperatives must find appropriate ways to shoulder the transition. In general, they were asked to step in providing increased support to their clients and communities while the commercial banks were retrenching. That has made the credit cooperatives themselves more exposed to the enlarged credit risks of the ongoing recession. Third, credit cooperatives should manage to raise the awareness of the regulatory bodies and of the legislators on the great perils of three main faults exemplified, e.g., in Basel 3: damaging lending to SMEs; failing to recognize the pro-stability importance of a traditional/retail bank business model; disregarding that the increasing cost of regulatory compliance may interfere with safeguarding biodiversity in banking, which should by now be recognized as a paramount asset to preserve.

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