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Editorial: Cooperative Banks at a Turning Point?

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Are cooperative banks at a turning point? Many changes in the economic and social framework over recent years make this question quite timely. The great financial crisis, which began in 2007, is clearly at the centre of the picture. The crisis stemmed from numerous financial innovations and reckless behaviours that attempted to create more elasticity in the credit system, to the detriment of transparency, which instead generated higher uncertainty and damaged trust toward and within the banking system. As a consequence the crisis has deeply affected the European banking system and its relationship with the productive system, increasing the cost of capital and depressing the economy (IMF, 2007; Banca d'Italia, 2008).

However, we cannot ignore the fact that this financial crisis followed (and to a great extent was a consequence of) twenty years of radical changes in the financial system's size, operational procedures and organizational structure. Many of these changes resulted in clear symptoms of disease in the financial services industry. In particular, there was poor oversight during these changes, including incapability, and in some cases even unwillingness, to institute new forms of governance better fitted to the new context. Financial innovations, deregulation, the states' decreasing role, as well as growing international openness all led to stronger competition; they also prompted a far-reaching consolidation process of banking institutions and an overall rationalization of the banks' productive structures. On the one hand, the mainstream financial industry's innovations concentrated on making high-margin profits while staying compliant and formally within the rules. The banks' benchmark for success was the quarterly earnings report to shareholders. As Stiglitz (2009) outlined, creating earnings based on market values is easier than creating value in the real economy. As a consequence, the financial system had been trapped in an illusion of making money from money and in a short term profitability approach. On the other hand, a long trend of mergers and acquisitions increased banks' average size and spread the practice of standardized loans procedures based on easily observable, verifiable and transmittable data existing within the more complex and structured forms of group organization. Moreover a myopic focus on short-term profit severely affected their customer-relation policies and methods (ECB, 2000, 2001; Belaisch *et al.*, 2001). The re-engineering processes and cost-rationalization strategies widened the physical distance between the new merged banks and peripheral areas and activities, resulting in making small-scale customers more dependent on personal relations (Leyshon and Thrift, 1993, 1995; Berger *et al.*, 2001). Because of physical or "informational" distance, mainstream banks lost efficiency in generating borrower-specific information, which, in addition, due to its "soft" characteristics, is difficult to transmit through large institutions' communication channels[1]. Many potential borrowers were dismissed because they lacked credit records or sufficient collateral and needed small loans, which the banks did not view as profitable. Moreover, the crisis revealed the detrimental systemic effects of incentives based on greed, as one may describe the applied executive's compensation policies. As Stiglitz maintains, banks commonly apply executive compensation schemes that encouraged and infused bankers' irresponsible behaviours. Paid by stock options, executives have an incentive to increase their market value, which is easier by increasing reported income than by increasing true profits, which are bound to real business.

The crisis has also proved the soundness of many researchers' hypotheses regarding cooperative banks' behaviour in general. The hypotheses included the cooperative banks': i) tendency to adopt less risky strategies and to have much lower volatility of returns, with positive consequences for the financial stability of the territories where they operate (Groeneveld and de Vries, 2009; Fonteyne, 2007; Hesse and Cihak, 2007; Groeneveld and de Vries, 2009; Fonteyne, 2007); ii) solidity of network organization, higher order organs and mutual support mechanisms, that has lessened the negative impacts of small size (Oliver Wyman, 2008); iii) propensity to defend consumer interests and maximize consumer surplus, offering

[1] For elaboration, as well as for cooperative bank development's challenges brought along with opportunities, see discussions in Alexopoulos and Goglio, 2011.

simple and transparent products (that are fairly priced and well-designed to meet local needs) in a manner ensuring that risks are well-understood and communicated (Alexopoulos, 2004); and iv) lower inclination, during a credit crunch, to ration credit to customers and to raise loan interest rates, thanks to better capitalization and more prudent lending (Fonteyne, 2007; Ferri, 2008). These potential effects all stem from cooperative banks' governance, business model and specialization, which heavily rely on relationship-based retail banking (Berger and Udell, 1990; Petersen and Rajan, 1994; Harhoff and Körtring, 1998; Di Salvo *et al.*, 2004). Furthermore, while values such as prudence, responsiveness, empathy and transparency are strongly linked to risk management, coop banks tend to adopt a rather conservative approach toward risk. This is because their banking business model flows from their underlying principles and commitment to investing in the real economy and to creating benefits for members, customers and communities.

Both structural changes and the financial crisis have fostered cooperative banks, at least at the local level (EACB, 2009; Goglio and Alexopoulos, 2013; Oliver Wyman, 2014). Combining community bonds and shared responsibility, the capacity to reduce information asymmetry and mobilize local savings (Ahrendsen *et al.*, 1999; Berger *et al.*, 2001) have allowed them to re-establish and even strengthen trust towards the banking system, in a period when this was strongly endangered by the crisis.

As a first assessment we may therefore conclude that, dissimilar to some arguments in the mainstream literature, the very late developments show that cooperative banks are not disappearing in industrialized countries. Contrarily, they seem to be proving their flexibility by adapting to current conditions through innovation and redefining local conditions and, in fact, are among the fastest growing groups of financial institutions in some advanced nations. However, the crisis has modified the context as well as the relationships network in which cooperative banks operate. On the one hand, retail banking (the core of cooperative banks' business) has shown an increase in competition, both from commercial banks trying to recover through relational finance and also from fellow cooperative banks. On the other hand, local identity (the traditional source of the strength of credit cooperatives) is losing importance in small firms' and families' financial decisions, *vis-à-vis* simple interest reasons. In this context, cooperative banks' pyramidal organizational structure, historic reaction to the small scale weaknesses, and their recent process of "consolidating" or "defensive" mergers, that aim to cut costs and possibly also diversify risks, notwithstanding the synergies that they definitely create, are altering some fundamental characteristics of the grass-root initiative (Bonaccorsi di Patti and Gobbi, 2001; Di Salvo *et al.*, 2002; Alexopoulos and Goglio, 2011; Alexopoulos and Goglio, 2013a).

If we reflect on the above points, it stands to reason to conclude that despite their recent success, cooperative banks are at a turning point. They are being forced to deeply rethink their overall and local strategies, their daily activities with members and customers, as well as their loyalty to constitutive social principles. Re-evaluation must first ask: what are the cooperative banks' main weaknesses and challenges?

The first set of problems is inherent to the scale of business. Cooperative banks' low diversification or territorial concentration in their loan portfolios (Barham *et al.*, 1996) may exacerbate the impact of idiosyncratic shocks on the local financial system. This turns banking localism from an element of stabilization to one that amplifies crises. It also neutralizes the possible advantages that the bank may derive from local system externalities (closer relations with firms, informational advantages, accurate selection of debtors, peer monitoring and extra-economic sanctions on insolvent debtors). Personal knowledge and peer monitoring to be effective should be integrated into a clear vision of the territory's strengths and opportunities: in other words, a development vision and consulting capacity are needed in order to improve the bank's capacity to act as an agent of social change and development (Goglio, 2009; Alexopoulos and Goglio, 2013a). Both of these issues should be addressed and solved within the apex institutions and through modernizing the pyramidal structure. In other words, the pyramidal organization must be able to unify the pros of both dimensions, capitalize on inside information at the central level, and monitor from the decentralized network, all coherently with a shared social philosophy.

The solutions to these problems clearly require modernizing both the government and the governance of the cooperative banks (Alexopoulos and Goglio, 2011). The old pattern of running these banks with relatively simple administrative practices, which straightforward management schemes could easily handle, is no longer adequate. It is inevitable that growth requires sophisticated professional management in order to deal with the new, more complex financial situations (Huppi and Feder, 1989; Poyo *et al*., 1993). On the other hand, the qualitative and quantitative reinforcement of management may lead to the separation of ownership and control, thus intensifying agency problems (Emmons and Schmid, 1999a, 1999b; Leggett and Strand, 2002). The risk is either a misappropriation of cooperative funds on behalf of the management for its own use, or a substantial misalignment between corporate philosophy and members' needs and will. This leads us to consider the cooperative bank's governance mechanisms and representation of membership to the Board of Directors. As cooperative banks grow, why members are motivated to be on the board becomes a more relevant question: it is more likely that directors follow their own interests, turning collective action away from its initial goals and giving rise to less efficient solutions (Goglio, 1999; Alexopoulos *et al*., 2013).

But growth and increasing membership may also add difficulties in adequate internal control as it promotes free riding by members (Ferguson and McKillop, 1997; Ouattara *et al*., 1999) which may feel disempowered as the institution adds new members. This in turn makes it difficult to encourage existing members to exercise their ownership rights and responsibilities to oversee management, with declining participation in board elections (Caswell, 1987; Hariyoga, 2004; Osterberg and Nilsson, 2009). Other reasons of non-participation include insufficient knowledge of the subjects discussed and also the claim that the Board of Directors formulates the cooperative's policies without taking into account member needs. In any case, member absenteeism from general meetings deprives them the possibility of realizing the reasoning behind the cooperative bank's operations. As a result, members judge the bank's performance mainly through their transactions with the cooperative bank, being ignorant of the true reasons that shape how transactions run and the consequences of the policy followed. When membership and assets extend beyond small numbers, common bonds lose their tight influence in maintaining a moral obligation to the cooperative (Alexopoulos, 2004; Goglio and Alexopoulos, 2013). The market can often ravage these bonds, as the latest financial turbulences have demonstrated. Therefore it is necessary to work either to restore or strengthen the bonds among cooperative values, members' participation and business. This policy could also effectively solve the problems originating from reduced capacity of local enforcement and peer monitoring, which are most likely to arise when higher membership means looser links with its financial institution (Alexopoulos *et al*., 2013).

Furthermore, it cannot be ignored that the turbulent banking scene created by the crisis has increased regulatory pressure toward strengthening both equity and profits (Alexopoulos and Goglio, 2011). As a consequence, there is the risk of augmented conflicts between the interests of member-depositors and member-borrowers (Smith *et al*., 1981; Smith, 1984; Patin and McNeil, 1991a, 1991b). Accommodating each group's interests heavily influences how the financial intermediary operates, which in turn leads to policy issues that an experienced management may deal with more adequately. Insufficient development of appropriate participatory and monitoring procedures at the local level could lead to a large cooperative's inability to detect and determine the members-customers' (and the community's) socio-economic needs as well as to provide solutions.

This time however there is an additional risk due to the imposed stricter regulatory framework and the institutional steps taken toward introducing an EU banking union. As the costs of creating a union are expected to peak at a time when the banks will be required to build up their capital resources and finance economic growth, the underlying risk is that regulation will be seen again as a constraint to profit margins. Slowly but surely the financial system's most opportunistic parts will return to lobbying against these legal constraints and argue in favour of further liberalization. Eventually they will find their way out and follow the letter but not the spirit of the law, once again infusing excessive risk into the system. So the real question yet again is: *Cui bono* from this one-size-fits-all regulatory framework?

In conclusion, do cooperatives possess the appropriate characteristics to play a new and efficient role in the local banking market? Can they translate their constitutive features into a modern and competitive banking setting? And if they can, how would they successfully fulfill this role? Two conditions that are certainly necessary require the cooperative banks to have: i) a well-chosen, prepared and competent Board of Directors and management, possessing solid cooperative training and knowledge, and ii) a committed membership, bound by close everyday links, even when is increasing in both numbers and demand. But these conditions are not sufficient for change. In order to add potential to their competitive position within a territory, cooperative banks should also strive to become true "local banks." This means not only in proximity or as a relational bank but as a financial institution truly rooted in the territory, with an intensive relationship with the territory and being able to support local economic activities evaluated inside a development pattern. For this reason, the bank's decisional bodies must be "in the territory" in order to have both a thorough knowledge of the socio-economic reality (strengths, weaknesses and possible paths) as well as privileged relationships with local economic actors (Alexopoulos and Goglio, 2013b).

In times of crisis, it is important to understand the power of alternative approaches to business and in this case, particularly to the financial system. As the papers collected in this issue extensively illustrate, cooperative banks are indeed a different "animal" in the banking "zoo"; however this animal is gradually adopting others' behaviours, quite often through conscious decisions. Nevertheless, as we are in an era in which competition is blurring the lines between a pure commercial and a cooperative enterprise, if cooperative banks want to survive and flourish as an institutional pattern, they must re-establish the - lost in a market logic approach - link between cooperative values, members' active participation and commercial strategy, as well as excellence in practices. Otherwise they will disappear, either physically or institutionally. However, their historical and cultural variety suggests that no simple or linear development path can be prescribed for all cooperative banks; their development varies under the influence of historically specific and contemporary economic and social conditions. Since cooperative credit is a flexible mechanism, not necessarily associated to simple or backward social and economic systems, its organization can and should coherently evolve with the development of the territories in which the bank operates. In the same way the institutional and legal framework should acknowledge their different approach to perform banking activities and help their evolution more than in a strictly business-like way, placing bonds and incentives consequently.

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