COOPERATIVE AND SAVINGS BANKS IN EUROPE: NATURE, CHALLENGES AND PERSPECTIVES

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Stakeholder-based financial institutions (cooperative and savings banks) have a long tradition in the financial system of developed countries. The prevalent form of these entities differs across countries as a result of the differentiated legislative reforms between the 1980s and the 1990s, but they still represent an important share in the banking sector in several countries. The transformation and innovation of the financial system have increased the competitive environment that these entities face posing important challenges for the future. Moreover, the financial crisis initiated in 2007 has increased the challenges that stakeholder-based banks face and has highlighted the need for regulatory reform with a particular focus on corporate governance and funding diversification issues. The current debate about these reforms is not new; some European countries have already applied some regulatory reforms presenting different approaches.

1 Introduction

Stakeholder-based financial institutions (cooperative and savings banks) have a long tradition in the financial system of developed countries. Originally, these entities were created to provide financial services to specific sectors or to improve the financial access in selected geographical areas. Their foundation used to be promoted by local authorities, religious organizations or professional associations. Later on, the transformation and innovation of the financial system increased the competitive environment that these entities face. These changes motivated a series of reforms in some European countries during the last two decades of the past century, with some countries opting for its privatization or demutualization. On the contrary, other countries opted for maintaining their traditional organization. More recently, the financial crisis has posed new challenges for these institutions. On one hand, it has highlighted the importance of liquidity and funding risk for banking activity. Thus stakeholder-based banks are faced with the problem of how to improve their access to wholesale funding. On the other hand, the crisis revealed some deficiencies related to their corporate governance, which were somehow reflected by the fact that these institutions received an important share of the public support. In this context, it is not surprising that some countries are debating on a new wave of restructuring, even in those countries were this sector was already reformed some years ago (i.e. Norway or United Kingdom).[1]

Even though the prevalent form of stakeholder-based banks differs across countries as a result of the differentiated legislative reforms between the 1980s and the 1990s, they still represent an important share in the banking sector in several countries (see Table 1). In countries like Germany, Spain, France or Norway, these entities entail more than 40 % of the financial sector assets. In the United Kingdom, a country that has experienced several waves of privatization, building societies maintain an important presence in the financial intermediation (20 % of retail deposits and 15 % of mortgage loans). However, their importance in terms of total assets is relatively small given the size of investment banking activities in this country.

This paper presents and discusses the main characteristics of stakeholder-based banks, the challenges they face nowadays and the reform experiences in some European countries. The paper is organized in six sections additional to this introduction. Next section reviews the main characteristics and classification of stakeholder-based banks, together with an overview of the stakeholder sector in some European countries. Section 3 describes the pros and cons of these entities. Section 4 presents some statistics regarding the performance and the public

1. In the same vein, the public support received by systemic financial institutions has motivated numerous initiatives aimed to reduce these advantages.

MARKET SHARES OF THE MAIN GROUP OF STAKEHOLDER-BASED BANKS BY COUNTRY — TABLE 1

TYPE OF INSTITUTION	FRANCE	GERMANY	SPAIN	NORWAY (a)	UNITED KINGDOM
	COOPERATIVE BANKS %	SAVINGS BANKS & *LANDESBANKEN* %	SAVINGS BANKS %	SAVINGS BANKS %	BUILDING SOCIETIES %
Assets	38.3	34.6	52.2	63.0	4.6
Deposits	55.7	42.9	40.5	70.0	20 (b)
Loans	52.7	38.9	41.9	—	15 (b)

SOURCES: Ayadi et al. (2008), DSGV, Bank of Spain, Sparebankforeningen, Office for National Statistics, and H. M. Treasury (2009).

a. Including DnB Nor.
b. The share of deposits refers only to savings balances. The share of loans refers only to residential mortgages. Data correspond to years 2008-2009.

support received by these institutions during the financial crisis. Section 5 describes the main challenges for the future and goes through the reform experience of some European countries.

2 Stakeholder-based banks: Main characteristics and national peculiarities

2.1 GENERAL CHARACTERISTICS OF STAKEHOLDER-BASED BANKS

Stakeholder-based banks are financial institutions where the ownership is not based on shareholders (as it is the case of commercial banks) but in a social group or organization whose members share a common interest related with the provision of funding or the promotion of saving. These entities, which include a broad range of organizations, have a long tradition and most of them date from the 19th century.

The existence of stakeholder-based banks has been debated for many years. Originally, these entities were created to foster the access to some banking services of those financially excluded groups of population. At that time, commercial banks did not provide these services because of several reasons related with national regulations, households risk characteristics and the underdevelopment of financial markets. Regulation limits were aimed to channel banking resources towards the funding of public debt (investment coefficient in public debt) or the investment in strategic sectors. These limits left a small scope for the banks to devote their funds to other sectors, including households and small and medium enterprises. Funding to these sectors was relatively riskier at this time since households and entrepreneur’s income volatility was elevated in a context where the welfare state and labour regulation had not been fully developed. Moreover, the management of credit risk coming from these sectors was difficult as a result of the lack of proper information [for example, Jappelli and Pagano (1993, 2001)] show the importance of central credit registers to reduce adverse selection problems and to increase the volume of credit) and the difficulties to hedge these risks with the financial instruments available at this time.

Thereafter commercial banks started to expand their activities to these financially excluded areas as a result of the development of the financial sector. This trend was the result of a process of financial innovation, liberalisation and an intense deregulation of the banking activity. Therefore, financial exclusion was pushed to the background as the main and general argument to justify the existence of these entities (although it could still be valid for some specific sectors or regions that are relatively small to be profitable enough for commercial banks).[2] Moreover, the rapid growth of the stakeholder-based sector during the last decades could be better explained by the expansion of the range of services and activities that these entities

2. In Spain, in 14 percent of the municipalities savings banks are the only provider of financial services, and represent 70 % of the total number of branches municipalities with a population of less than 1,000 [WSBI and ESBG (2011)].

could offer (partially as consequence of the deregulation process),[3] than on the grounds of financial inclusion.

Nowadays, the main difference between stakeholder-based and commercial banks relies on the objectives pursued by the managers. Commercial bank managers care about maximizing the value of the ownership participation for shareholders by optimizing the future path of dividends, buybacks and increases in the value of the share. Stakeholder-based banks managers' concerns are not as concentrated in the value of ownership participation as they are also interested in fulfil the different targets included in their mandate. As explained above, these objectives are related with providing banking services to some region or financially excluded individuals (savings banks) or to some group with some specific characteristics (cooperative banks). Moreover, ownership participation cannot be easily transferred and stakeholders do not receive an explicit dividend. The only direct benefits are materialized on social investments in the case of saving banks or through the improvement on the banking conditions (deposit or loans) in the case of cooperative banks. Obviously, this does not imply that stakeholder-based banks do not care about profit generation insofar it is related with the solvency of the firm and the possibility to fulfil the organization's mandate over the long term. This mixture of characteristics creates what is known as a "double-bottom" line for these institutions as they combine social and financial objectives.

An additional important difference from commercial banks is that they cannot issue equity in the markets so they have to rely mostly on retained profits to increase their capital levels and they obtained a lower discipline from financial markets. Their legal nature supposes that mergers and acquisitions usually are limited to voluntary operations that avoid the disciplinary effect of hostile bids.[4] Moreover, these mergers use to be concentrated within similar entities that difficult the possibility to obtain economies of scale or scope that could result from mergers with other kind of financial institutions. For example, in the case of Spain Carbó et al. (2002) find that, during the wave of mergers within the savings bank sector between 1989 and 1993, on average, the new entities did not obtained substantial gains on efficiency.

The classification of these banks comprises a high diversity of categories depending on the nature of the founders (public or private), the legal organization (foundation, private liability society or public entity), the kind of activities (specialized or universal banking) or the area of influence (local, regional or national). For simplicity and clarity of the arguments, this paper focuses on the distinction between cooperative and savings banks that are the most prevalent forms of organization.[5] The main differences between savings and cooperative banks are:

- *The nature:* Cooperatives are private banks while savings banks have a closer affinity with public institutions (i.e. savings banks are in many cases, but not always, in public ownership). Therefore the public sector's role in the corporate governance of saving banks – though admittedly varying among particular institutions – is not negligible. In fact, in some countries, like Germany, savings banks are governed by public laws *(Trägerschaft).*

- *The corporate governance:* Members of a cooperative bank are private citizens or individual entrepreneurs that play an active role in supervising the management of

3. For example, in Spain, after the Fuentes Quintana Reform of 1977, competition became more intense as a result of the convergence between the savings banks regulatory framework to the one for commercial banks. Later on, savings banks started to expand geographically as a result of the liberalization of establishment in 1989, followed by a consolidation process during the 1990s. **4.** See Oliver Wyman (2008). **5.** See Carbó and Méndez (2006) for a detailed classification of these entities depending on their ownership structure.

the company. Their influence is not based on the size of their stakes but on the principle of “one member, one vote”. On the contrary, savings banks’ ownership is formed by depositors, employees, investors and local and regional public authorities or non profit foundations.

– *Restrictions on Assets:* Cooperative banks’ activities usually have some limits on asset allocation, such as the establishment of a minimum percentage of the assets to be devoted to a specific activity. Restrictions on saving banks are less usual and, when they exist, tend to be related with the geographical area in which they operate (territoriality principle).

2.2 NATIONAL CHARACTERISTICS IN SELECTED EUROPEAN COUNTRIES

This section includes a brief description of the stakeholder-based banks in some of the European countries where they still have an important presence: France, Germany, Spain, Norway and United Kingdom. Table 2 summarizes the most notable features of these entities prior to the regulatory reforms adopted as a result of the financial crisis started in 2007. This description tries to facilitate the reader the understanding of the playing field during the years prior to the financial meltdown. The different regulatory reforms applied between the 1980s and 1990s by these countries have resulted in a quite different mapping in each of the national banking systems. As it has been highlighted, there are some countries where cooperative banks are the prevalent legal form in this sector, i.e. France and United Kingdom, while in others, like Germany, Spain and Norway,[6] savings banks have taken the major role. Moreover, these entities also present some other peculiarities between countries different from their legal status.

Regarding to those countries in which savings banks have a prominent role, there are models where their activity is restricted, i.e. Germany, while in others they are allowed to offer any kind of financial services, i.e. Spain and Norway. The case of Germany has some idiosyncratic characteristics since two different types of institutions can be differentiated within the Savings Bank Group: *Sparkassen,* at the local level, and *Landesbanken,* at the regional level. There exists also a national central institution, *DGZ Dekabank Deutsche Girozentrale (DGZ Dekabank),* which acts as a national Landesbank and is owned by the *Landesbanken* (50 %) and by the national association of savings banks *(Deutscher Sparkassen und Giroverband,* DSGV). The organizational and legal structures of both savings banks and *Landesbanken* have largely remained unchanged and, in fact, their existence is protected through the prohibition of mergers or takeovers with institutions outside the Savings Bank Group. Savings banks constitute public law institutions with no private owner that are subject to some restrictions in their activity. For example, they cannot hold equity participations in entities outside the Savings Bank Group, undertake risky operations or operate outside their local area. Moreover, they should serve the public interest of their region, fostering savings and providing credit to the small and medium enterprise sector, and conduct their business according to sound business principles by law. Their capital is raised through retained earnings; indeed, profits are particularly important for them since municipalities, as their owners, are rarely in a position to inject additional equity and since they cannot raise equity by issuing shares in the market [Ayadi et al. (2010)]. They can issue a form of preference shares, known as silent capital, which receive dividend payments and absorb losses, although the investors in these instruments can recover this amount when benefits turn positive. Besides the existence of savings banks, regional banks or *Landesbanken* represent a different kind of mutual financial entities which enjoy freedom of operation. These banks present different legal forms: Some are joint stock companies, while others are still public law institutions. Their ownership lies in hands of local savings banks, their

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6. The analysis will focus on the predominant stakeholder bank in each country, for example, in Spain only savings banks characteristics are presented although cooperative banks also exist in this country.

CHARACTERISTICS OF THE MAIN GROUP OF STAKEHOLDER-BASED BANKS BY COUNTRY PRIOR TO THE RECENT CHANGE IN DE REGULATORY BURDEN (2009)

TABLE 2

TYPE OF INSTITUTION	FRANCE	GERMANY	NORWAY	SPAIN	UNITED KINGDOM
	COOPERATIVE BANKS	SAVINGS BANKS	SAVINGS BANKS	SAVINGS BANKS	BUILDING SOCIETIES
LEGAL STATUS	Local or regional independent banks organized through a federated two- or three-tier structure (local, regional and national insitutions).	Public law institutions with no private owner. There are also regional banks inside the Savings Banks Group (Landesbank) which present different legal forms; some are joint stock companies while others are public law institutions.	Independent foundations. Limited liability banks in which almost 10 % of the capital is owned by a foundation.	Foundations of private nature combining financial activity with social vocation.	Mutual institution owned by its members.
GOVERNING BODIES	Local cooperatives are member-centric with the principle of "one member, one vote". Local institutions delegate a great variety of functions (mutual support, debt issuance, representation...) to the Central Network institution.	The Executive board, which reports to a Supervisory board, is composed by 2/3 appointed by the municipality/ies where it is located and 1/3 elected by the employees (thus depositors are not represented in the governing bodies).	Committee of representatives, the highest body, is comprised of employees, depositors and public appointees. 1/4 of the committe is elected by the owners of the primary capital certificates, independently of their share of total capital.	The General Assembly formed by different stakeholders (including employees, representatives of depositors, local and regional government bodies, founding entities and community interest groups). The representation of public institutions in the General Assembly should not exceed 50 % of the voting rights.	Member-centric under the principle of "one member, one vote".
REGULATION	Subject to general banking regulation.	Subject to general banking regulation and to savings bank law of the respective German state in which they are located.		Bank of Spain has power over financial stability aspects (solvency and liquidity). Autonomous Communities set other legal considerations relative to the governance structure and consumer protection issues.	Subject to their own legislation (the Building Societies Act 1986 as amended by the Building Societies Act 1997)
SUPERVISION	Bank of France	Federal Financial Services Authority (BAFin) in cooperation with the Bundesbank.	Financial Supervisory Authority	Bank of Spain	Financial Services Authority (FSA)
RESTRICTIONS TO ACTIVITY	Freedom of operation. They manage different activities (market finance, investment, insurance, etc.) through specialized subsidiaries	They cannot hold equity participations in enterprises outside the Savings Bank Group, undertake risky operations or operate outside of their local area. Landesbanks enjoy freedom of operation.	Freedom of operation	Freedom of operation	Mortgage loans should represent 75 % of total assets.
PROFIT SHARING	They have the legal obligation to allocate part of their profit as reserves. The listed non-voting shares receive an annual dividend determined by the banks' statutes and legal ceilings.	A substantial part is destined to fund social, cultural and other purposes. Dividends are distributed among silent equity units' holders.	Distributed among charitable gifts and cash dividends to primary capital certificates holders.	At least ½ to reserves, the rest was devoted to Obra Social (community toward projects) and to dividends to equity units (cuotas participativas) and preference shares.	Destined to accumulate reserves and to improve conditions of the financial services supplied to depositors or borrowers (higher savings rates and lower mortgage rates).
CAPITAL	Non-marketable shares hold by natural persons (customers). "Principle of solidarity" among entities within networks, which provides access to capital when needed. The national body can issue debt instruments (including subordinated notes and investment certificates).	Accumulated reserves. They can issue a form of preference shares, known as silent equity, which do not have rights over total assets and which absorb losses, although they can recover this amount in subsequent periods in case of positive profits.	Accumulated reserves (ownerless capital) and capital from the market (primary capital certificates).	Accumulated reserves. They could issue capital in form of equity units (cuotas participativas), which could not exceed 50 % of total equity. No one could hold more than 5 % of all equity units in circulation. They could issue preference shares with non voting rights.	85 % of their capital comes from retained earnings. They can issue capital through Permanent Interest Bearing Shares (PIBS) - non-core Tier 1.
OTHER CHARACTERISTICS	The group (national body) is listed on the stock exchange. Local or regional banks have a majority ownership of the national body and provide financing for the local banks.	By law, they should serve the public interest of their region (principle of regionality) and conduct their business according to sound business principles. They should open a transaction account for every applicant. Mergers or takeovers with institutions outside the Savings Bank Group are prohibited.	Gift fund destined to serve social and cultural purposes.	Strong local roots. Inter-regional mergers needed the authorization of the autonomous communities concerned.	50 % of their funding should come from retail deposits (the remaining 50% can be obtained through wholesale funding).

SOURCES: Ayadi et al. (2010, 2009), Ori et al. (2004), Bank of England, Bank of Spain, Financial Supervisory Authority (Norway), Sparebankforeningen, and Pérez et al. (2007).

respective regional public bodies and, in some cases, in some other *Landesbanken.* In particular, *Landesbanken* are the second tier of the Savings Bank Group and have two prominent functions: they serve as house banks of their respective state and act as the clearing houses or central banks for the local savings banks in their region.

In the case of Norway, *Sparebanks* or savings banks have been traditionally organized as independent private foundations that enjoy freedom of operation. In 2002, these institutions were given the option of converting to limited liability savings banks. The new institutions are regulated essentially by the same provisions as commercial banks and, in order to be considered as savings banks, almost 10 % of the capital should be owned by a foundation. Equity is composed by accumulated reserves through retained earnings and since 1987 they have the option to raise capital in the market through the issuance of primary capital certificates or PCCs (known as equity certificates since 2009). In fact, this instrument is one of the main sources of tier 1 capital of Norwegian savings banks. PPCs are marketable securities similar to shares, with the difference that they do not give ownership rights over entity's assets. Instead, PPCs holders elect ¼ of the committee of representatives, independently of their share within total capital. Profits are distributed between reserves; the gift fund, created to serve social and cultural purposes; and cash reserves, which are distributed among PPCs holders. The gift fund is created in order to fulfil some of the commitments that savings banks have with the communities where they operate, although there are not specific legal provisions to pursue specific social or welfare gains. In some sense, Norwegian savings banks have evolved through a mixed model allowing the access to capital for shareholders with some representation in the management while maintaining their double bottom line.

Finally, prior to the recent restructuring, Spanish savings banks were organized as foundations of private nature combining financial activity with social vocation [Pérez Fernández et al. (2007)]. They had strong local roots; in fact, they were prohibited to expand their activities outside their municipality of origin (principle of territoriality). Since 1989 they enjoyed freedom of operation. Most of their capital came from accumulated reserves; at least 50 % of total profits should be devoted to raise capital. These institutions are regulated and supervised by the Bank of Spain, while Regional Governments set other legal considerations relative to their governance structure. For example, inter-regional mergers were subject to the authorization of the Autonomous Communities concerned. Regarding to their governance bodies, the General Assembly was formed by different stakeholders, including employees, representatives of depositor, local and regional government bodies (up to a limit of 50 % of total voting rights), founding entities and community interest groups. Savings banks could issue capital in form of equity units *(cuotas participativas)* which could not exceed 50 % of total equity and no one could hold more that 5 % of all equity units in circulation. Since their approval only one savings bank (Caja de Ahorros del Mediterráneo) has issued capital through this instrument. However these instruments do not incorporate voting rights and thus they do not enhance market discipline on the management of the entity, making these equity units relatively unattractive for investors [Centro PwC/IE del Sector Financiero (2010)]. They can also issue preference shares with non-voting rights. Profits were thus distributed between reserves, community toward projects *(Obra Social)* and dividends paid to equity units and preference shares.

In France and United Kingdom stakeholder financial entities are governed by the basic principles of the cooperative banking model. In the case of United Kingdom, the structure is much more restrictive. Building societies are mutual organizations in which the governance bodies follow the principle of "one member, one vote", which does not take into account how much money each person has invested or borrowed or how many accounts she has. They were created to foster the access to some financial services; in particular, their basic purpose is to make loans secured on residential property and which are funded by its members.[7] In fact, mortgage loans must represent at least 75 % of total assets. Capital is mostly raised through retained earnings (which represent around 85 % of total core Tier 1 capital)[8] and, since 1981, they are able to issue deferred shares in the market in the form of Permanent Interest Bearing Shares (PIBS). PIBS carry a fixed non-cumulative coupon and they have no fixed maturity date, although they can be redeemed at the issuer's discretion, which is the main reason why they count as non-core Tier 1 capital. UK building societies have principally (although not exclusively) targeted capital issuance at wholesale investors rather than members. PIBS have voting rights, although the representation of these investors is reduced compared with that of members, since buildings societies are prohibited from raising more that 50 % of their funds from non-member deposits. As a way to compensate this, retail deposits are subordinated to wholesale funding in case of liquidation (although the first £50,000 is guaranteed by the Financial Services Compensation Scheme).

In France, cooperative banks are organized as local or regional independent banks belong to a federated structure with two or three layers Local or regional layers *(Fédérations* or *Caisses Fédérales)* have a majority ownership of the national body *(Confédérations).* Central Network institutions exercise a top-down authority as local or regional institutions have delegated a great variety of functions, including treasury and risk management, mutual support,[9] investment activities, debt issuance, group representation and back office functions such as IT support [Ayadi et al. (2010)]. Local and regional institutions still have their autonomy in decision-making and management, and provide banking services enhancing access to credit for households and small and medium enterprises. Cooperative banks cannot raise capital in the market and they have the legal obligation to allocate profits as reserves.[10] Nevertheless, they can issue shares similar to preferred shares and customers may also be required to subscribe for additional shares to access a loan [Ori et al. (2004)]. These listed non-voting shares receive an annual dividend determined by the banks' statutes and legal ceilings. The role of cooperative banks has gained importance as a result of their expansion through mergers and acquisitions (financed through accumulated reserves). These developments have allowed the increase in the number of financial services offered through the involvement in wholesale banking, insurance asset management, etc. (activities which are carried through specialized subsidiaries).

3 Pros and cons of stakeholder-based banks activity

As previously mentioned, the financial inclusion of some segments of the population is no longer the main argument supporting the existence stakeholder-based banks. Thus, alternative arguments have been proposed, such as those related to their idiosyncratic risk management.

Some authors[11] argue that stakeholder-based banks mitigate better the risk on an inter-temporal basis than commercial banks. These entities tend to accumulate less risk through the cycle than commercial banks given that they are more strategically oriented towards the long run. Managers of stakeholder-based banks tend to be more prudent given that they cannot rely on external capital to compensate the losses derived from business mistakes. In some respect, it could be argued that stakeholder-based banks complement the commercial banks

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7. Building Societies Commission. Factsheet, 1999. **8.** Building Society Capital and related issues: a discussion paper. H. M. Treasury. March 2010. **9.** Under the French Monetary and Financial code, the central organs of the cooperative institutions are required to guarantee the liquidity and solvency of the entities within their networks [Ayadi et al. (2010)]. **10.** For example, in the case of Banque Populaire, the group-wide minimum rate is set as 10 % of profits and members have no rights on these net assets. The reserves are treated exactly as equity in Crédit Agricole and Crédit Mutuel, i.e. distributable to members and stockholders in the event of a default [Ayadi et al. (2010)]. **11.** See Ayadi et al. (2009).

risk managing approach and improve the overall financial stability of the system [Michie and Llewellyn (2010)].[12] These authors argue that this contribution to financial stability arises since *"the more diversified is a financial system in terms of size, ownership and structure of businesses, the better it is able to weather the strains produced by the normal business cycle,..."* In this sense assuring financing to some sectors financially constrained during stress periods, Delgado et al. (2006) find that the gain in size among savings banks between 1996-2003 implied a relative specialization in relational lending towards small and medium size, more opaque, firms, something that has not been observed on the commercial banks.

An additional argument supporting the existence of these entities is related with the alignment of the interests between investors in the institution. Conflicts of interest between holders of debt (that receive a fixed coupon and are more risk averse) and those of equity (that have a limited liability and encourage a risk taking behaviour) in commercial banks are not characteristic of stakeholder-based banks. In cooperative banks, the owners are both the customers and the debt holders so that they share similar interests and are particularly concerned about the sustainability of the activity of the company. However, in the case of savings banks some problems related with ownership structure could emerge, since it includes a mixture of agents (local or regional public authorities, employees, depositors, non profitable foundations...) with potentially very different kind of interests. Under this framework, the local public authorities tend to exert a great influence over the management of the entity. As a result, managers´ incentives could be related with the short term political cycle and less so with those of debt holders. Obviously, the relevance of these problems became more apparent during the last decades as savings banks progressively extended the range and complexity of their business. As an example, during the last years, in some countries, savings banks accumulated higher levels of risks in sectors like real estate – linked to regional government funding – than commercial banks.

There are some additional drawbacks related to the existence of stakeholder-based banks. Both cooperatives and saving banks are less exposed to market discipline than commercial banks. Although this independence could have some positive effects – as it favours the intertemporal management of risk – it also creates significant drawbacks because the monitoring of managers' performance is softer making them more prone to accumulate higher levels of inefficiencies.

Another additional weakness is that under their ownership structure, it is difficult to see any hostile takeovers even within the sector. As a direct consequence, this sector usually remains very fragmented and represented by relatively small entities. Under this situation, it becomes more difficult the adaptation to a new environment of competition and to improve their economies of scale or scope through mergers in areas such as information system, control of risk or business diversification. Moreover, their reduced dimension could be an obstacle to diversify their funding sources (i.e. access to some wholesale markets requires a minimum issuance size). Some institutions try to circumvent some of these problems (for example, the access to markets) by creating associations of saving or cooperative banks, as it is the case of the *Landesbank* in Germany or the Cooperative holdings in France.

Finally, another argument usually raised relies on the fact that economic viability of some stakeholder-based banks was based on the explicit or implicit public support that they received. These guarantees could create important competitive distortions; indeed the European Com-

12. The UK Government has announced its intention to foster competition in the banking system through an increase in the diversity in financial services and the promotion of mutuals.

mission and banking representatives accorded in 2001 the gradual removal of this public support. *Landesbanken* and savings banks do not enjoy these guarantees since July 2005. However, as it is discussed later on, the ownership structure and the involvement of the local public sector create some implicit guarantees for these entities that could be as complicated to mitigate as those that enjoyed too-big-to-fail institutions.

4 The evolution of stakeholder-based banks during the financial crisis

4.1 THE FINANCIAL ANALYSIS OF STAKEHOLDER-BASED BANKS DURING THE CRISIS

The aforementioned advantages and disadvantages of stakeholder-based banks suggest that there may exist differences related to their financial performance in comparison to commercial banks. This section reviews some indicators of this performance focusing on different financial ratios with regard to profitability, liquidity, solvency and asset quality. Table 3 includes information about some financial highlights for stakeholder-based banks (savings bank/thrift/mutual) and commercial banks in 2007 and 2009. In particular, data is based on median values since the presence of extreme values in our sample may distort the view of the sector as a whole. These medians are calculated over the sample of shareholders or stakeholder-based banks available for each of the countries included in this study (France, Germany, Norway, Spain and United Kingdom). The interpretation of the results should be made with extreme caution and should take into account limitations arising from using medians. This information does not provide detailed information of the entities included, neither of the most successful ones nor of those that have worst evolved through the financial crisis.

Data comes from SNL Financial Banking (Europe), a new database that includes information for commercial, cooperative and savings banks, listed and unlisted, in Europe. The database offers data obtained directly from the public accounts of these entities and allows to distinguish between stakeholder-based banks and commercial banks.[13] However, some additional adjustment has been made to classify as stakeholder-based banks those entities that are not controlled by shareholders. The main adjustment consists on including as stakeholder-based banks entities like the Landesbanken and the French cooperative banks and excluding pure public financing institutes (like *Instituto de Crédito Oficial)* or national institutions (like *Dekabank or Confederación Española de Cajas de Ahorros).* Obviously, a fair comparison between these models requires a longer time horizon and some control variables like their size or specialization, however the required data for this exercise is not yet available. The sample includes 52 commercial banks and 78 stakeholder-based banks.[14] Given the size of the sample it is not possible to perform a detailed analysis discriminating between savings and cooperative banks; instead the comparison is made between the median stakeholder-based bank and the median commercial bank.

In terms of profitability, commercial banks displayed better ratios than stakeholder-based banks, although the deterioration has been more pronounced for them between 2007 and 2009. However, these figures are likely to be affected by the absence of the aforementioned control variables – specialization, size, etc –. The efficiency of stakeholder-based banks was slightly lower than commercial banks in 2007, although these figures have converged in 2009 given the improvement in terms of cost-to-income of the former and the deterioration of the latter.

Regarding to their liquidity positions, the weight of deposit funding in terms of total assets was larger for stakeholder-based banks in 2007. However, there is almost no difference when

13. Other studies rely on data obtained from alternative sources with a wider coverage of entities. However, these databases do not classify banks based on their ownership and, usually, provide adjusted measures that sometimes differ from the public financial statements. **14.** The sample includes 3 stakeholder banks and 7 commercial banks for France; 36 and 16 for Germany; 14 and 9 for Spain; 16 and 1 for Norway; and 9 and 19 for United Kingdom. Nevertheless, data was not available for all of the variables considered in Table 3 so the number of entities in each group varies among the different variables included in this table.

FINANCIAL HIGHLIGHTS - MEDIANS TABLE 3

	STAKEHOLDER-BASED BANKS			COMMERCIAL BANKS		
	2007	2009	Δ BPS	2007	2009	Δ BPS
PROFITABILITY (%)						
ROAA	0.36	0.19	–0.17	0.69	0.31	–0.37
ROAE	8.41	3.88	–4.53	15.95	7.84	–8.11
Net Interest Margin	1.55	1.54	–0.02	1.26	1.38	0.12
Cost to Income	60.67	59.04	–1.63	55.08	58.48	3.40
BALANCE SHEET RATIOS (%)						
Deposits/Assets	56.06	60.95	4.88	45.42	47.25	1.83
Deposits/Loans (Retail)	72.60	79.10	6.50	73.12	79.40	6.28
Net Loans/Assets	58.35	59.74	1.39	50.42	54.82	4.40
Mortgage Loans/Net loans to customers	49.18	50.07	0.90	44.56	42.73	–1.84
Tier 1 Common Ratio	8.05	9.37	1.32	6.62	8.70	2.08
Tier 1 Ratio	8.68	10.59	1.91	7.45	10.10	2.65
ASSET QUALITY (%)						
Impaired & Delinquent Loans/Loans	2.32	4.49	2.18	3.85	6.05	2.20
Impaired Loans/Tangible Equity & Reserves	9.85	32.37	22.52	12.30	34.61	22.31
Provisions/Average Amortized Loans	0.11	0.49	0.37	0.36	1.12	0.77
Credit Costs/Pre-impairment Operating Profit	20.43	39.67	19.23	17.92	49.59	31.67

SOURCE: SNL Financial.

NOTES: includes data for France, Germany, Norway, Spain and United Kingdom. For each variable those entities for which data is available are included, thus the number of entities between each variable may vary. The group of stakeholder-based banks includes those entities that are not controlled by shareholders, including entities like the Landesbanken and the French cooperative banks and excluding pure public financing institutes (Instituto de Crédito Oficial) or national entities (Dekabank). Δ bps: difference in basis points.

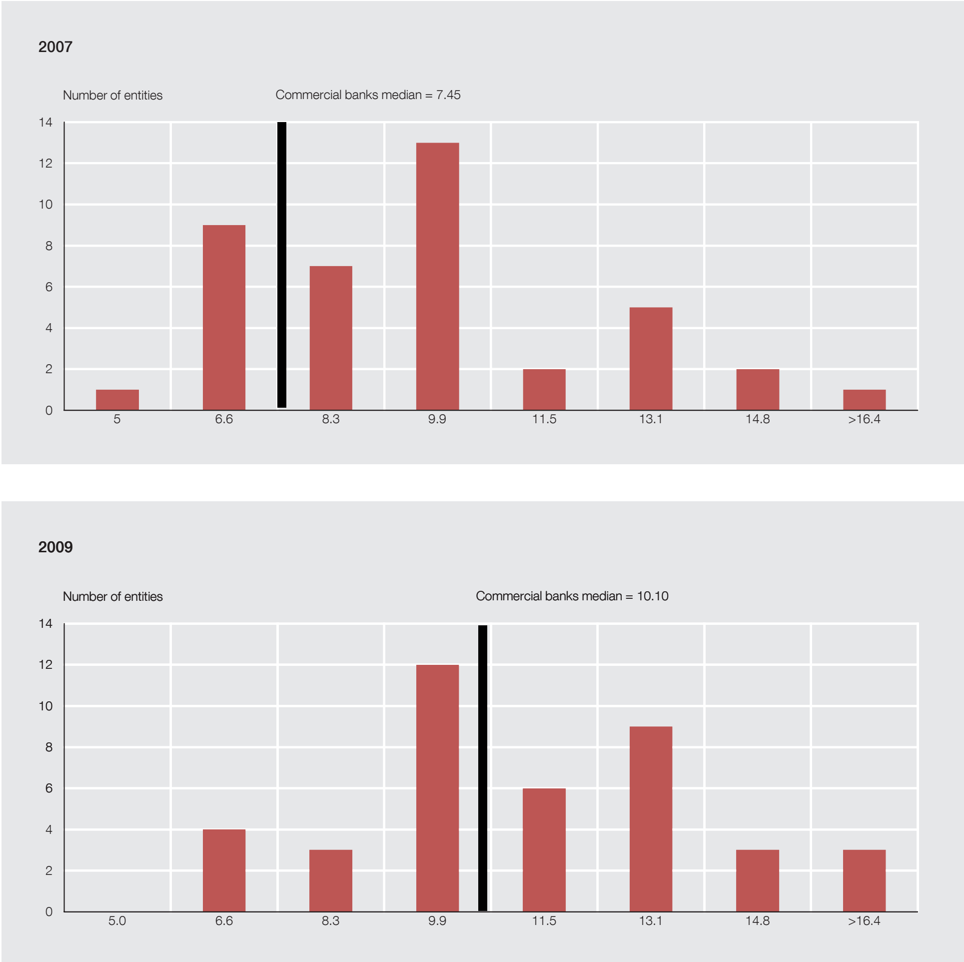
comparing this type of funding in terms of loans instead, since the share of assets devoted to loans has been larger for stakeholder-based banks. Related to their loan composition, they are more exposed to the mortgage sector perhaps as a consequence of the link of savings banks with real estate and also due to the specialization of building societies. Moreover, it is worth to emphasize that during the financial crisis, although there has been an adjustment in real estate in some of the sample countries, stakeholder-based banks have not been able to reduce their exposure to it as commercial banks.

As previously mentioned, stakeholder-based banks cannot raise capital in the market, which may be an important restriction, especially in periods of crisis when their solvency may be affected by the deterioration in asset quality. Following this argument it could be expected that their solvency may be larger compared to their commercial peers. Indeed this argument is confirmed in the data, the median stakeholder-based bank displayed a larger level of Tier 1 capital ratio than commercial banks during these years. Both types of institutions could improve their capital levels during the financial crisis, while there has been a convergence among them as a result of the faster improvement in the case of commercial banks.

There exists heterogeneity among the group of entities considered in Table 3 and not all of them may display the same characteristics as the median institution. As an example, Chart 1 presents the histograms of the ratio of Tier 1 capital for stakeholder-based banks in 2007 and

TIER 1 CAPITAL HISTOGRAM FOR THE STAKE-HOLDER BASED BANKS GROUP

CHART 1



SOURCE: SNL Financial.

NOTES: includes data for France, Germany, Norway, Spain and United Kingdom. The group of stakeholder-based banks includes those entities that are not controlled by shareholders, including entities like the Landesbanken and the French cooperative banks and excluding pure public financing institutes (like Instituto de Crédito Oficial or Dekabank).

2009, together with the commercial banks' median value. The majority of these institutions held higher levels of capital than the median commercial bank at the beginning of the financial crisis. The graph also points out that there has been a reduction in the dispersion of solvency ratio among stakeholder-based entities.

Given their strong local roots, which allow them to assess better the credit worthiness and risk of costumers at local level [Groeneveld and De Vries (2009)], and their retail oriented business model, stakeholder-based banks are expected to follow a conservative banking approach. Thus the asset quality of these institutions could be expected to be more solid as this behaviour is translated into stronger balance sheets and lower credit risk. The data suggests that this was true in 2007 in terms of the percentage of problem loans, although credit costs were slightly larger. The deterioration in asset quality over the financial crisis hit both types of institutions leading to an increasing need for loan loss provisions and an important increase in credit costs.[15]

15. Differences in non performing loans could partially be explained by the composition of the assets and the relative importance of mortgage loans, which tend to have a lower delinquency rate.

PUBLIC CAPITAL INJECTION IN STAKEHOLDER-BASED BANKS FROM 2007 (a) TABLE 4

	AMOUNT	% ALL ENTITIES (c)	NUMBER OF ENTITIES
Germany (b)	21.65	37	6
France	22.80	49	3
Spain	16.13	100	33
Norway	4.10	100	28
United Kingdom	1.60	2.4	1

SOURCES: National authorities press releases.

a. Final Injected Amount. National Currency.
b. Includes the capital injection from the Lander Government.
c. Public capital injection received by stakeholder-based banks as a percentage of the total public capital injection to the banking sector.

4.2 THE PUBLIC SUPPORT OF STAKEHOLDER-BASED BANKS DURING THE CRISIS

An approach to appraise the behaviour of the most affected institutions by the financial crisis could be the revision of the public support received by them. Stakeholder-based banks could be expected to better deal with some features of the financial crisis, in particular, with those related with the unexpected write-downs and the necessity to obtain public capital injections. However, as it is highlighted in the previous section, their financial record has not been very different to commercial banks. Moreover, with the exception of the English building societies, stakeholder-based banks have received significative amounts of public capital injections (see Table 4),[16] which, in general, have been instrumented through preferred shares (ordinary shares participation would require the transformation of their legal status).

Most of the stakeholder-based banks that have received public funds are saving banks. The only exception is France, where at the heights of the crisis cooperative banks required public capital support that has been already repaid to the Treasury. The origin of the losses incurred by these institutions varies among countries: In some cases stem from their national markets, as some German and Spanish saving banks, while in others came from their foreign positions (some *Landesbanken* in Germany).

However banks did not only receive explicit public support, but they also benefited from the implicit guarantees of the government. This factor is important since financial markets consider that some banking entities enjoy this implicit guaranty based on resolution difficulties. These difficulties could be related with the size or complexity of the banks (too big or too complex to fail) or with the ownership structure and the difficulty to remove some political counsellors from the board. Moreover, these guarantees are specially relevant to assess the viability of these institutions since, conversely to explicit guarantees, they use to have a permanent nature. In this sense, this measure could give an idea of the economic impact that a new resolution framework with no public support or that, for example, imposes the share of losses by even senior debt holders.[17]

16. The financial crisis also revealed the importance to reassess the liquidity risk in some markets. This kind of risk has been misperceived by most of the analyst, regulators and managers and stakeholders managers were not an exception. Therefore they participate - like commercial banks- in all the emergency liquidity measures introduced in the aftermath of the crisis. **17.** A clear example was that after the approval of a new resolution regime framework in Germany Moody's decided to downgrade subordinated banking debt ratings for a number institutions (among them several sparkassen and landesbank). See Moody's rating action of 17 February 2011. In March 2011 this agency also downgraded senior debt of several small and medium size spanish financial institutions based on the perception of a reduction of the public support [see Moody's (2011)].

In order to approximate the importance of this guaranty one can compute a rating-based measure. Obviously this will be an incomplete indicator since ratings are only an indirect measure of cost of finance and rating agencies do not rate all the stake holder based banks. The steps taken to obtain this measure are:

1 The traditional "issuer ratings" – which take into account the likelihood of Government or group support in case a bank is in stress – are compared with the "standalone rating" – which reflects a bank's intrinsic strength [see Moody's (2007)] –. The difference in terms of notches between the two ratings provides a qualitative measure of the subsidy because ratings have an impact on bank funding costs.

2 Map ratings into bank bond yields by assigning the yearly average funding cost corresponding to long term and standalone rating using indices for the banking sector from Reuters. Then, the difference between these funding costs is multiplied by rating-sensitive liabilities of each bank.[18] This exercise provides a quantitative assessment of the subsidy for each bank.[19]

Chart 2 compares the difference btween the two ratings for commercial banks as opposed to stakeholder-based banks (Step 1). In this case the sample is more reduced than in the previous section by focusing only on those institutions similar to commercial banks. In this case, some specialist stakeholder-based banks in Germany have been excluded since some of them are related with very specific sectors – like pharmaceutical or automobile. The data provides several interesting insights. First, at present in all countries both categories of banks enjoy a substantial implicit support (2 to 5 notches on average). Second, in some countries, such as UK and Spain, there was little or no implicit support before the crisis, whereas in Germany and France there was already a large support, especially for stakeholder-based banks. Finally, a comparison across bank categories suggests that in Spain, UK and Norway commercial banks currently enjoy roughly the same implicit support as stakeholder-based banks, whereas in Germany and France these institutions seem to have a higher support than commercial banks (around 2 notches above). Moreover it should be noticed that during 2011 ratings agencies reconsidered the willingness of governments to provide this kind of support to small and medium entities in case of failure. This revision has produced a significant decline of the importance of this factor and the subsequent rating downgrading for most of the spanish entities (see the dotted line).

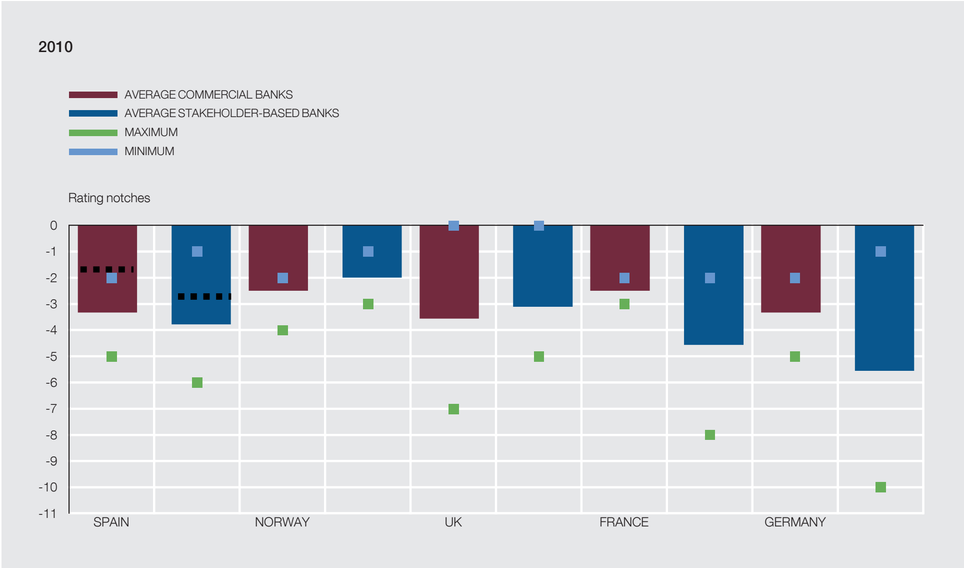
Chart 3 shows the total amount (€bn) of the implicit subsidy for each country in 2007 and 2010 (Step 2). At the beginning of the financial crisis the public support was reduced for most countries, although it was remarkable for commercial banks in United Kingdom (4.1 €bn) and stakeholder-based banks in Germany (6.0 €bn). It should be noted that the ratings computed by Moody's take into account the support received within the group, that is, some of the implicit subsidy displayed is related to the effect of the group's support. The implicit subsidies increased over the next two years in all countries in an asymmetric way . In 2010 Germany, Spain and France presented a greater public support for stakeholder-based banks while in the case of United Kingdom the implicit subsidy is more important for large commercial banks.

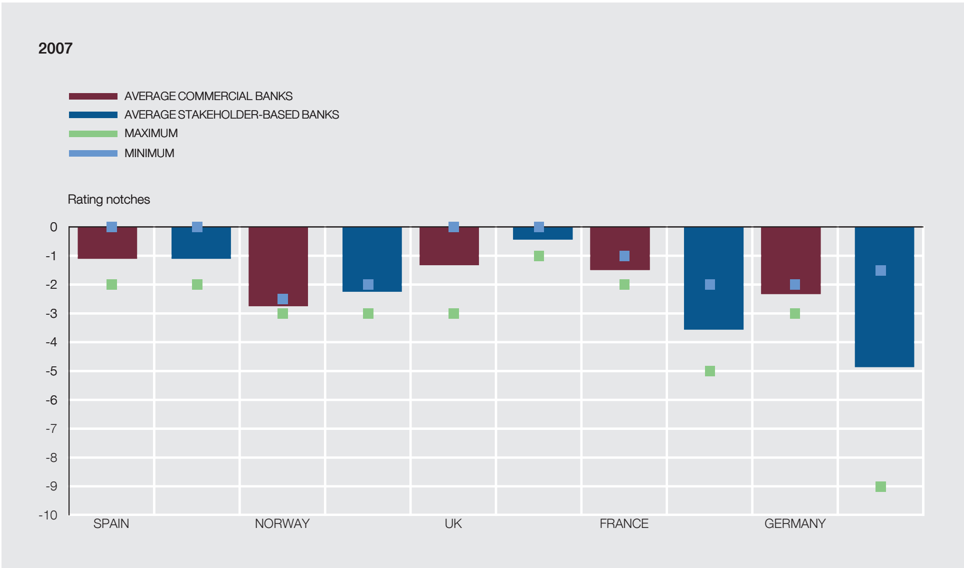
5 Main challenges in the aftermath of the financial crisis: Back to the future or learning from past experiences?

The process of innovation and liberalization in the financial sector over the last decades has changed substantially the competitive environment of the financial industry, posing important

18. Rating-sensitive liabilities are defined as deposits from banks and other financials, financial liabilities designated at fair value, debt securities in issue (excluding securitizations and covered bonds) and subordinated liabilities. **19.** See Haldane (2010).

IMPLICIT PUBLIC SUPPORT FOR FINANCIAL INSTITUTIONS - RATINGS NOTCHES DIFFERENCES (a) CHART 2





SOURCES: Moody's, and own calculations.

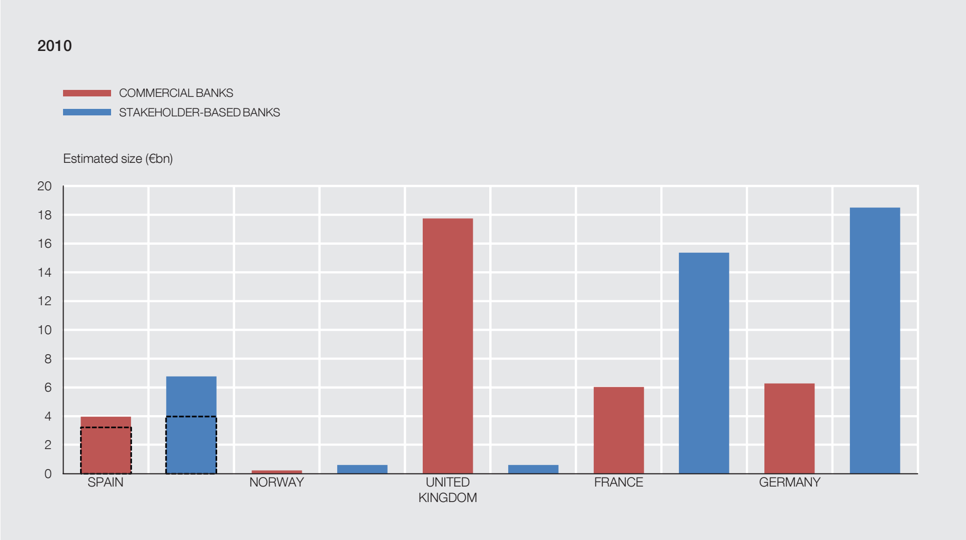
a. The average has been calculated for the financial entities rated by Moody's. The dotted line in the case of Spain shows the difference in rating resulting from the review of the ratings of the senior debt of these institutions made by Moody's in March 2011 [Moody's (2011)].

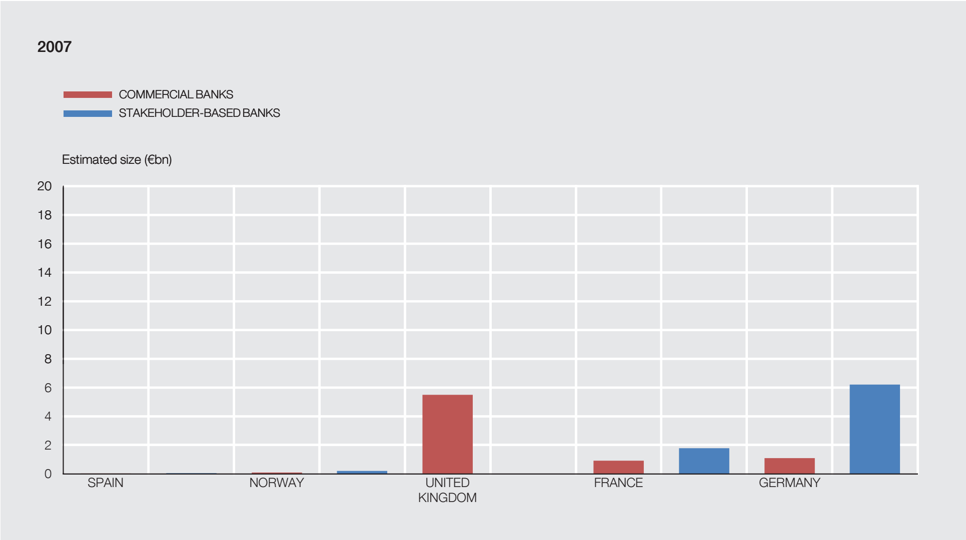
challenges for banking institutions, in general, and for stakeholder-based banks, in particular. On top of these structural changes, the financial crisis evidenced the importance of these challenges:

Corporate governance: The financial crisis highlighted the difficulty to manage institutions whose owners have a mixture of different targets as in the case of saving banks. This difficulty becomes especially problematic if short term objectives conflict with achieving long term economic viability. As mentioned in Section 2, these problems became more apparent as savings banks progressively extended the range and complexity of their business model. In this context it is important that corporate governance assures the long term viability of the entity.

Capital: Stakeholder-based banks only rely on retained profits to increase their capital level. This creates important difficulties in order to achieve the new requirements of Basel III, especially under an adverse economic environment to generate profits. To address this issue, sev-

ESTIMATED SIZE OF THE IMPLICIT PUBLIC SUPPORT FOR FINANCIAL INSTITUTIONS (€bn) CHART 3





SOURCES: Bankscope, Dealogic, SNL Financial, Moody's, Reuters, and own calculations.
NOTE: The dotted line in the case of Spain shows the implicit public support taking into account the review of the ratings of the senior debt of these institutions made by Moody's in March 2011.

eral options could be considered, such as: Easing the injection of temporary public funds in order to achieve the new requirements, or lengthening the transition process towards the new regulatory framework. Furthermore, the reliance on retained earnings create also a structural problem since it is difficult for these entities to reinforce their solvency levels under a stress scenario. Some proposals try to overcome this burden through the introduction of new equity instruments, like contingent capital. However, in order to access to a suitable investor demand, their marketability is a crucial factor, which may be hampered under by the mutual principle of "one member, one vote". In this context, a greater participation in the management from new equity-shareholders could be considered as a way to make this instruments more attractive for external investors (as it is the case of the Equity Certificates in Norway or the modifications considered for the Permanent Interest Bearing Shares in UK).[20]

20. In the case of United Kingdom [see H. M. Treasury (2010)] there are some proposals for new capital instruments in order to allow the access of building societies to alternative ways such as Contingent Convertible Notes or Rabobank Contingent Notes. In any case, it is recognized that, in order to access to a suitable base of investors, they should consider allowing institutional shareholders to represent their views directly to the societies' management whilst ensuring mutual values.

Funding: The new environment highlights two new tendencies in the funding of the banking sector: The weight of securitization and complex structured financial products is being reduced and there is an increased attention to the composition of funding with respect to assets (liquidity and funding ratios). Under this framework, stakeholder-based banks should maintain their traditional funding sources based on retail deposits but, taking into account the increased competition, they should also search for alternative forms of funding. One of the challenges for small and medium financial entities is the access to new funding sources such as covered bonds or the issuance of senior debt (for example, through a pooled funding model)[21], although this can imply the need to increase the weight of debt holders in their management.

Activity: There is a growing need to adapt these entities to an increased competitive framework. This could imply that some entities need to expand their activity, which is usually concentrated in areas like mortgages or loans to the real estate sector. In order to do this it is important the aforementioned reform of the corporate governance in order to avoid political influences and foster the profesionalization of its board of managers. Moreover it could also be relevant to avoid some restrictions such as the territoriality principle in the case of Germany. Nevertheless, in the case of cooperative banks, it is not clear that the expansion of their business model is a viable alternative for their adaptation to the new environment. Given that their existence is conditioned on the viability of some activity, the fact that it becomes unprofitable may imply a disappearance of the reason why they were created. That is, if it is not viable to maintain some cooperative banks that give loans to some sector it could be because their members are able to obtain cheaper funding through alternative sources.

Some of these challenges have already been addressed by some countries in the past. In particular, there are different approaches that have resulted in a different development of the stakeholder-based sector among countries and configured some of the differences commented in Section 2:

a) *Orderly privatization process:* Italy applied a gradual privatization process of the savings banks sector, mainly as a consequence of the several negotiations and different legislations that took place. The process started with the legal separation of the activities through the "Amato" law. The banking business was transferred into new joint-stock banking companies and the original savings banks were converted into foundations that assumed all the socially oriented activities. The "Amato" law required that these foundations should keep the ownership control of the joint-stock savings. Thereafter, through a series of implementation decrees, the authorities incentivized them to divest progressively their participation in the capital through fiscal advantages and, in 1998, the "Ciampi" law required foundations to relinquish control of the banks. The new joint-stock savings banks are financial entities governed by the civil code and the banking code, operating on an equal footing with all other banks.

   Some studies have described this reform as a success as a result of the increased profitability and competition of the banking sector [Carletti, Hakenes and Schnabel (2005)]. The privatization produced an important effect on the consolidation of the sector. Some studies show [Campa and Hernando (2006)] that fi-

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21. The UK Treasury reviewed some alternatives in order to adapt building societies to the new financial climate. In particular, it explores the idea of pooled funding models by which participating societies could gain access to new sources of wholesale funding by, for example, issuing covered bonds through an issuing entity owned jointly by a number of societies.

nancial mergers usually improve the efficiency and productivity; in the Italian case [Fiorentino et al. (2009)] the gains in productivity were reinforced by the effects from the privatization and the removal of political interest in the management of the entities.

b) *Re-dimensioning stakeholder-based banks sector through a rapid liberalization and consolidation:* The case of United Kingdom offers an example of a fast re-dimensioning of stakeholder-based banks sector that is still relevant in its banking sector. During the 1980s four savings banks grouped their operating activities around a holding company, the Trustee Savings Bank Group (TSB Group). The initial public offering in 1986 of the TSB Group implied the privatization of the savings banks and the conversion into a public limited company. The cash obtained from the IPO allowed the group to acquire one of the biggest UK investment banks, Lloyds. The socially oriented activities were transferred into new created foundations (Lloyds TSB Foundation) which owned a part of the capital of the group, through which they were able to finance these activities. At the end, the restructuring of savings banks implied their complete disappearance from the banking sector.

   It was precisely the same year of the privatization of the savings banks, 1986, when the restructuring of the building societies sector begun with the allowance to convert themselves into public limited companies. As a result, during the 1990s a demutualization and consolidation process took place with eleven building societies becoming private banks (including the largest one, Halifax). On the contrary to the Italian case, the conversion of savings banks was voluntary, requiring two-thirds of existing members to vote in favor of it. By 2008 no one of the converted building societies maintained their independent status either because commercial banks acquire them (e.g. Abbey National or Alliance and Leicester) or because they were forced into public ownership (Northern Rock and Bradford & Bingley). It seems that one of the potential gains of the privatization process that was suggested – easier access to capital markets [Cook, Deakin and Hughes (2001)] – turned out to be one of the main problems that affected these entities as a result of the lack of management experience of wholesale funding and expanded financial activities. On the contrary, the performance of building societies during the last financial crisis has been comparatively better which has motivated a new debate towards the protection of this sector. Moreover, some authors have proposed the remutualization of failed financial institutions like Northern Rock [Michie and Llewellyn (2010)].

c) *Private ownership inclusion and the maintenance of the stakeholder-based banks model:* In Norway the reform of 1987 provided savings banks with the possibility to raise external capital issuing primary capital certificates (PCCs) that give some ownership over the capital. In 2009, in order to improve the marketability of PCCs, the influence of external investors increased with the introduction of Equity Certificates. This reform brings this capital instrument closer to ordinary shares, with the exception that their influence is limited to a 40 % of the General Assembly and the existence of the compensation fund that reduces their risk in case of a winding up. At the end, the reforms have maintained the nature and legal status of these companies while, to some extent, addressed the challenges related to the corporate governance problems and the difficulties that these institutions face raising equity in the market.

d) Towards a more aggregated cooperative bank model: In some countries the stakeholder-based banks sector has evolved towards an aggregation of these entities through central bodies that maintain the independence of the entities. These central bodies are able to maintain a diverse funding and create important economies of scale. In this case, stakeholder-based banks still keep their social vocation but their management maintains a high level of independence with respect to stakeholders. This is the case of Rabobank in Netherlands (the only European financial institution that maintains the AAA rating) and cooperative banks in France.

These experiences give a sense of the different approaches that could be adopted in order to reform the stakeholder-based banks sector. Nevertheless, it should be noted that the different country conditions imply that the effects of the reforms could differ significantly among them. The selection of each model, which is neither the purpose of this paper nor possible before having evidence about the performance of these entities after the regulatory reform, depends to a great extent on the political willingness to maintain or privatize the sector. In economic terms, it is not easy to find which model has better properties. In fact, in order to do this one would need to see the performance of the sector over several decades and study which advantages or disadvantages it presents with respect to prior models.

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