European co-operative banks in financial and economic turmoil

Contribution of the EACB to the Expert Group Meeting
on "Co-operatives in a world in crisis" and the International Year of Co-operatives
United Nations, New York, 28-30 April 2009

Introduction

We are witnessing an unprecedented financial and economic crisis. While a system crisis in the financial sector has so far been averted by the draconic measures deployed by national governments and central banks, the future is uncertain. Despite extensive interest rate cuts, liquidity injections, support measures and nationalisations the financial markets are still not stable. At the same time, the full extent of the real consequences of the credit crisis for the European economies is becoming clearer all the time. Recent figures show that the global economy will experience a deep recession in 2009 and perhaps also 2010.

Against this background, the UN Working Group will discuss at its meeting in New York the impact of the credit crisis on co-operatives and the consequences for provisions of services by banks. The preparations for a co-operative year in 2011 are also on the agenda, as well as the messages that could be formulated regarding the role of co-operative banks in the financial system. The European co-operative banks are pleased to take this opportunity to provide a contribution from Europe to these debates.

This paper is structured as follows. Section 1 provides a brief description of the EACB and its members. Section 2 outlines the EACB views on the impact of the crisis on the European co-operative banks. Section 3 addresses the issue of access to credit and uses the example of SMEs. Section 4 discusses the measures co-operative banks have taken in response to the crisis. Section 5 highlights contributions of co-operative banks to the economy and to development. The paper ends with conclusions and policy recommendations.

1. About the EACB and Europe's co-operative banks[1]

The EACB is an international non-profit association based in Brussels and is one of the leading associations in the financial sector. It represents co-operative banks from the 27 EU countries and its associate members are Raiffeisen Schweiz (Switzerland), Norinchukin Bank (Japan) and Caisse Desjardins (Canada). The association acts as their representative organisation vis-à-vis the European Union's institutions and governing bodies, as well as vis-à-vis international organisations or bodies such as the IMF, World Bank and the International Accounting Standards Board.

Co-operative banks are strong market players in the retail banking industry in Europe, with a total of 4,200 local co-operative banks, approximately 60,000 branches and an average market share of 20%. The co-operative banks serve 45 million members and 159 million customers.

The co-operative banking business model in Europe can be differentiated based on the level of integration between the local entities, the regional entities and the national entities. There is, however, a key difference between co-operative banks and credit unions, namely that co-operative banks are a network of banks with an apex body (central bank) or with local banks affiliated to a strong regional entity (DZ Bank in Germany). Co-operative banks in the European Union must comply with the same regulations as banks that operate based on a different business model. Co-operative banks do not enjoy any special privileges or tax exemptions.

2. Impact of the crisis on co-operative banks

Co-operative banks are traditionally strong in retail banking, which is characterised by stable returns and comparatively good access to savings and deposits. Most co-operative banks had only minor direct interests in the market for 'subprime mortgages'. In addition, income from wholesale banking was relatively limited for most co-operative banks, the smaller ones in particular. Losses on complex credit as a result of the crisis and losses of income from wholesale banking are therefore limited in relative terms.

Nonetheless, the amounts involved are still considerable for the co-operative banks as well and the large co-operative banks have unfortunately had to suffer losses on wholesale banking operations and

---

[1] More information about the banks can be found in the Annual Report of the EACB on the EACB website, www.eurocoopbanks.coop or in the following study 'The European banking sector and the co-operative banks', January 2009, published by the Economic Research Department from Rabobank.

structured products. Their losses are incurred at the level of the APEX-bank and its subsidiaries, not at the level of the local banks. Naturally, write-offs in the co-operative banking sector were largest for the main co-operative banks in Europe that are heavily involved in the international financial markets. Compared to the balance sheet totals and equity, the write-offs/losses at co-operative banks are fortunately still well bearable in relative terms.

We expect that the *economic crisis* will however have more of an impact on the local co-operative banks compared to the *financial crisis.* The economic crisis impacts the financial position of private clients (pension, housing prices, value of investment funds, etc), as well as of enterprises (sales, cost of credit and access to credit, etc.). Moreover, the competitive playing field has been tilted by the government interventions and funding costs have risen for all banks. The deposit rates are now very high compared to the ECB libor rates, reflecting the fight in the market for funding. When government supported banks offer very high deposit rates and force the market to follow, this is unfair competition. In addition, marketing of the guarantees should in our view be prevented. At the same time all banks understand the extraordinary market circumstances and the need for support to safeguard stability. It is thus a complex situation.

We will now highlight several characteristics of co-operative banks that we believe set them apart from other banks. These characteristics consequently affect the banks' position in the current economic crisis.

Co-operative banks are first of all *rooted in the local economy* and actively *supporting their customers* during this period of severe turbulence. Some 159 million Europeans are clients of Europe's co-operative banks. The European co-operative banks' involvement in financing the local economy is further illustrated by the fact that 29% of their lending is to SMEs. While several co-operative banks have expanded the scope of their activities in recent years by moving into cross-border markets and rolling out new services, the main focus of most banks is still on the domestic market.

Co-operative banks provide *straightforward retail banking products*, such as property and personal insurance, asset management and payments, and they achieve healthy results providing these products. Co-operative banks grant mortgages, for example, according to the borrower's ability to repay the loan rather than on the uncertain future value of the asset being financed. These mechanisms continue to function normally. The continental Europe co-operative banks' business model is consequently based on traditional banking and long-term relationships with customers.

The difficulties *that co-operative banks may be experiencing are predominantly linked to the global economic recession* and not to hazardous and imprudent decisions. Their intervention capacity can therefore be focused fully on supporting their customers and on initiatives aimed at helping to accelerate the restoration of confidence. The co-operative model also features a strong screening and monitoring ability. In our view this represents a valuable quality that can be leveraged to rebuild banking and finance after the crisis.

Satisfactory solvency ratios (the overall Tier 1 ratio of European co-operative banks on 31 December 2007 was 8.6%) mean that European co-operative banks are not being forced to resort to the recapitalisation plans introduced by government authorities. In the few instances in which co-operative banks have resorted to these facilities, they have done so with the intention of sustaining a rate of growth in their lending tailored to a severely degraded and risky environment, such as in Austria or in France with subsidiaries.

Co-operative banks also generally have *conservative risk management*. This can be explained by the type of business, the mission of co-operative banks and the governance structure. The type of business that co-operative banks engage in has already been discussed above. The mission of a co-operative bank is to provide maximum customer value and to act in the best interests of its members. One of the main preconditions of being able to do this in a sustainable manner is that the reserves, i.e. the endowment built up over generations, are kept intact and passed on to next generations of members. Co-operative banks therefore retain their profits and are less inclined to take large risks. There is also a strongly held belief that this money should be kept safe. Furthermore, co-operative banks cannot turn to the capital market to raise capital in the way that publicly listed banks can. Recapitalisation is consequently difficult. These are the main reasons why co-operative banks tend to employ higher capital reserve criteria.

The *governance structure also contributes to a high level of risk control*. Local banks, in their capacity as members of the central institution, monitor the performance of the central institution and the risk it takes. They are the owner of the group and use its services. This bottom-up control is carried out in practice through representation in governance bodies.[2]

The *internal guarantee system specific to each co-operative group enhances its resilience* and strengthens customer confidence. While each bank has its own system, the crux is that it constitutes an additional system in addition to legal protection systems such as the national deposit guarantee scheme. It consequently serves as extra security. The key significance of this added security in the current situation can be illustrated with an example from Rabobank. During the crisis, Rabobank saw its market share in savings, loans to SMEs and mortgage lending soar to 42%, 39% and 29% respectively in 2008. Its local member banks recorded a sharp influx of savings of approximately 20% and extended 16% more business loans in 2008 than in 2007. This is a flight to security. State support for competitors will, however, change this advantage of strong financial solidity and will unfortunately cause a major distortion in the market. More information regarding this situation can be provided at request.

Box: Information asymmetry

Information asymmetry remains an extremely important issue to this very day. It is, in fact, one of the causes of the huge losses that have recently been incurred on structured credit portfolios. This is due to the fact that, in the case of these products, the bond between the customer and the buyer of these tradable bundles has been broken and the risks have been incorrectly assessed and insufficiently managed. Too many intermediaries, banks and investors focused excessively on chasing profits and shifted the risks to the next link in the system in the process. Not all the customers are entirely blameless either, considering that at least some of them must have known from the outset that they would be unable to repay the loans. These financial innovations have consequently encouraged transferring risks rather than spreading risks. Viewed against this background, the fact that co-operative banks continue to operate nearby their customers is a major benefit. It means that if customers encounter difficulties, the bank is close at hand to work with them to find solutions.

[2] See: Corporate governance principles in co-operative banks, EACB 2006.

3. Impact on access to finance

SMEs are a decisive driving force for the economy and employment. It is consequently crucially important that there is continued lending to SMEs. Co-operative banks in Europe continue to fulfil this role as providers of finance. At a high level meeting of co-operative banks with the European Commission in February 2009 , the EACB indicated that the co-operative banks have not changed their policies towards the supply of credit to SMEs.[3] The EACB also stressed that the co-operative banks continue to assess the individual person and business plan when making the decision to grant or not to grant the credit. This, of course, does not mean that the tariffs will always remain the same. Risk premiums have risen to reflect the changes in the economic circumstances. There are furthermore difficulties concerning the demand side of credit. The recession and economic gloom do not motivate SMEs to invest or innovate. A specific issue involves the procyclicality of the increase in capital requirements that is demanded by regulators. This does not have a positive effect on the capacity to provide credit.

In conclusion, the co-operative banks continue to provide credit at realistic prices. It is also important to note that it is ultimately not in the interest of private customers or SMEs to receive a loan that they cannot repay. Moreover, banks have an obligation towards their members and other customers to maintain their financial solidity. The hope is consequently that the economy restructures successfully and that the problems in the financial markets will be solved relatively quickly.

There are examples in each market of how co-operative banks have developed in terms of SME finance and market share in comparison to the other banks in the countries. An overview of this information is unfortunately not yet available at this time. Some of the examples will be presented at the meeting of the working group.

---

[3] See www.eurocoopbanks.coop

4. Measures taken by the co-operative banks in response to the challenges

The European co-operative banks have undertaken several initiatives to respond to the crisis. We are convinced that they form the foundation for the co-operative banking groups of tomorrow. A summary of these measures is provided below. Our member banks will also be pleased to provide further information on request.

The main measures are:

- Implementing immediate refocusing of subsidiaries that no longer meet current needs based on the example of Calyon, the Credit Agricole Group's corporate and investment bank.
- Realising capital increases. RZB, for example, has just increased its capital base by €1.75 billion.
- Ongoing innovation in everyone's interest. Co-operative banks will consequently play a leading role in financing the 'green economy'.
- Continuing efforts to achieve cost reductions, to improve risk control and supervision and to realise innovations.
- Ongoing commitment to promote the core values of co-operative banks that are more in tune with today's world than ever before. This will include participating in programmes to combat poverty, drawing up environmental strategies and promoting Corporate Social Responsibility (see the next section).

5. Support for the economy and development

In Europe, there is a common opinion for supporting the co-operative business model, taking into consideration the implementation of the European Co-operative Statute. An important feature in this respect is that co-operative banks finance the local economy with the funds raised or collected at the local level. Furthermore, co-operative banks are committed to development and matters such as financial education. Several other illustrations can be provided of the role co-operative banks play in the local economy and the contribution they make to social cohesion.[4]

[4] See: Co-operative banks: Catalysts for economic and social cohesion in Europe, EACB 2007. And an example of Rabobank's co-operative dividend (annex).

Co-operative banks also attach value to CSR and take initiatives regarding the environment. Although we are all aware of the need to invest in green energy, the economic crisis prevents many financial investors and even governments from entering into long-term investments at the present time. The co-operative banks are still committed to investments in green finance and make efforts to combat climate change. Examples of programmes introduced by organisations including Rabobank, BVR, Credit Mutuel and Credit Agricole regarding green energy and sustainable policies are outlined in their respective annual reports.

In the past the co-operative banking business model was sometimes seen by the policymakers as an old-fashioned model that was not appropriate for a modern economy. Now the opinions have changed. We have lived through an era where too often, short-term gains prevailed over long-term prosperity. In this respect the business model of co-operative banking has demonstrated its relevance to the local and national economies. Co-operative banks will be a key player to restore confidence in the banking industry.

Conclusions

As has been demonstrated, most co-operative bank groups have fortunately been able to weather the financial crisis relatively well so far and have not required state support. This is due to the fact that they generally have limited exposure to toxic assets, a predominant focus on domestic retail banking with stable results, strong capital buffers and principally conservative risk management. The co-operative banks that did report losses due to the subprime crisis were affected primarily at the level of subsidiaries and at the level of the APEX institutions. The local banks were not hit directly by the financial crisis. Moreover, they continue to lend money to SMEs and retail customers. Co-operative banks are consequently solid and robust at the local level and accordingly demonstrate the stability of the retail banking industry in Europe.

The EACB nonetheless cautions against too much optimism. The worldwide economic crisis will impact local banks' results and credit risks and all banks, indiscriminate of their ownership structure, will be confronted with this development.

The most important measure co-operative banks have taken is the increased focus on the core activity of domestic and local retail banking. We have seen, and will increasingly see, a realignment of subsidiaries with the needs of retail customers of local branches.

Besides combating the crisis, the co-operative banks also continue to invest in local development, in social development, and in the environment. In this way they contribute to social cohesion. Moreover, these policies and the member-ownership structure make co-operative banks distinctive from other banks.

Policy recommendations

This paper concludes with two policy recommendations. Firstly, the EACB asks policymakers to pursue diversity in the banking industry and to provide a level playing field for all categories of banks in respect of equal treatment in regulation and supervision. In the current times of crisis this means equal access to support and a clear eye to prevent market distortions as much as possible. In more general terms it means to take into account specificities of non-listed enterprises when drafting new legislation or new supervisory policies.

Secondly, the EACB calls for further acknowledgement for the role of co-operative banks as financiers of SMEs and supporters of local development. In this respect, the EACB fully supports the proposal to envisage a year of the UN devoted to co-operatives and their role in the economy and in development. The EACB is also prepared to provide assistance for such a programme and to contribute to e.g. conferences about these topics.

-0-

For more information, please contact the EACB secretariat:
Hervé Guider: h.guider@eurocoopbanks.coop – General Manager

With thanks to Rabobank and Credit Agricole for their assistance regarding this research.