



# Europe's cooperative banking models

REVISED EDITION

STUDY



*European Economic and Social Committee*

# **Europe's cooperative banking models (Revised edition)**

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## EUROPE'S COOPERATIVE BANKING MODELS

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## 1. Introduction

In February 2015, the European Economic and Social Committee approved, by a large majority, the opinion *The role of cooperative and savings banks in territorial cohesion – proposals for an adapted financial regulation framework*. The points below summarise its main conclusions and recommendations.

- In the transition to new banking and non-banking business models in the finance sector, the EESC considers it vital to preserve the "biodiversity" of the financial system, without this meaning the arbitrary application of rules.
- However, the main problem remains the proper application of the **proportionality principle** in the new banking rules (especially regarding the Capital Requirements Directive – CRD IV – and the Capital Requirements Regulation – CRR), which the Basel Committee suggested should be applied proportionately in keeping with the EU treaties. This means that the strictest requirements should apply to global banks, stringent requirements should apply to pan-European banks (of a systemic nature in Europe) and more flexible requirements should apply to national and local banks (guaranteeing a proper level of consumer protection).
- This does not mean freely granting privileges to certain segments of the financial sector. The EESC has always been committed to a level playing field and therefore recommends the use of objective parameters that justify a specific regulation for each business model. Essentially, these are financial and economic performance, contribution to the real economy, risk management, and governance. The EESC proposes that the financial authorities should offer incentives to those operators that best comply with these conditions.
- The EESC seeks to highlight the banking model provided by cooperative and savings banks. It calls for stronger ethical standards and codes of good governance across the financial services industry, as these are vital for restoring lost confidence.

Given how well received the report was and the high expectations generated during the course of the debates and public presentations, delving deeper into Europe's cooperative banking model seemed timely, the aim being to help to pave the way for new sustainable and socially-responsible business models.

This strategic study is therefore intended as a source of information on the situation of – and prospects for – cooperative banking in the European context, with reference to the models representing the sector in Germany, France, the Netherlands and Italy, since those countries have the largest institutions and the traditions of longest standing.

The research was conducted using a survey that comprised tailored interviews with experts in European cooperative banking by means of a questionnaire prepared in advance. The aim was to find out what changes in financial regulation were expected, what new plans for

cooperative bank restructuring and merger were in place, and what the future prospects of the cooperative banking model were.

The study starts with a brief analysis of the new European financial ecosystem to which cooperative banking belongs (the global economy needs a diverse financial ecosystem), which also considers the four-way interaction between the traditional banks, the new digital operators, the regulator and consumers.

These are not easy times for the European financial sector. Banking remains in a delicate situation, due to the low-interest-rate environment, the weakness of the economic recovery, regulatory pressures, the digital transformation and the last vestiges of the financial crisis. Currently, European banking's key concern is low profitability.

Bank restructuring has produced a smaller, more streamlined, but less inclusive, picture because, in recent years, households and SMEs have been deprived of financing. The process has gone hand-in-hand with a steady reduction in local branch networks and many job losses.

Obviously, cooperative banks have been affected, although they survived the international financial crisis that started in 2008 without too many difficulties. Yet, today, they are still facing the challenge of capital requirements, relatively small size and tightening profit margins. The process of restructuring the cooperative banking sector is therefore still not over, given the threats from the new financial environment.

The European Union is promoting larger banks and a move towards consolidation of the smaller ones. The supervisor acknowledges that there is excess capacity in the banking industry and recommends that institutions consider mergers as a solution to the sector's low profitability.

Using these arguments as a starting point, studies have been conducted into the sustainability of the cooperative banking model in times of change and into the new restructuring undertaken by European cooperative banks through cost-cutting and sectoral consolidation.

The cooperative banking models, analysed from a strategic perspective, are the ones most representative of the European Union. By country, the specific cooperative banking models studied are: DZ Bank and WGZ Bank in Germany; Crédit Agricole in France; Rabobank Group in the Netherlands; and Banco Popolare in Italy. The study focuses on finding out about the recent experiences of those institutions in the European context, with banking union in progress.

Lastly, by way of conclusion, the future trends for Europe's cooperative banking models, practical lessons derived from the experience and strategic orientations to be applied in future are set out. They are all part of the process of restructuring and of the changing understanding of the banking business, as the European financial sector enters truly uncharted waters.

## **2. Methodological approach to the research**

The research method provides an interpretation of the situation that can serve as the basis for rational decision-making by the senior figures in an organisation.

In methodological terms, it must be borne in mind that a cooperative bank is conceived of as an organic whole, the component parts of which cannot be separated out, and about which fundamental answers cannot be sought in single and isolated issues. The main idea that must be given precedence in running a cooperative bank is the interdependence of its activities.

The core methodology is based on the idea of a system; applied within certain limits and moderated with the use of other methods, this indisputably makes it easier to understand and implement business processes. In this context, applying systems theory offers a unifying and interrelated overview of cooperative banking in Europe's financial ecosystem. It is the appropriate tool for studying cooperative bank merger processes.

Decisions in the financial world are surrounded by risk and uncertainty, to such an extent that decision-makers must complement their intuition and experience with the information and reasoning provided by management techniques. The strategic bank-management model is the specific archetype used to explain the processes for managing cooperative banks, backed up with auxiliary tools such as the SWOT matrix, which is particularly useful for strategic analysis of the cooperative banking model.

The particular method used to conduct the research was the survey, conducted using tailored interviews with experts in cooperative banking to obtain objective and valuable information on the basis of prepared questions.

The intention behind using a properly structured questionnaire was to find out the expected trends and changes in the processes of restructuring and merger of cooperative banks in the countries of Europe – such as Germany, France, the Netherlands and Italy – from those involved.

The survey was conducted during the second half of May 2016. Those questioned were well-informed specialists in the field from the cooperative banks themselves, employers' associations, regulatory and supervisory bodies, competitor institutions and the academic world. All the interviews were conducted within the European Union.

Each of the people interviewed was given a systematised questionnaire, which was split into three sections based on the recipient and the substance of the questions formulated (all of them open).

Thanks to the methodology used in this study, it has been possible to structure the answers given by each interviewee (anonymity was respected where requested) and to carry out a thorough and in-depth analysis of them for the purpose of producing this discussion paper.

Other information sources on European cooperative banking models have also been consulted, a non-comprehensive list of which includes: institutional reports, yearbooks, Bank of Spain documents, sustainability and good governance reports, EU directives, EESC and Commission opinions, books, articles, etc.

### **3. Europe's new financial ecosystem**

With its range of business models, financing structures and customer bases, the diversity of the European financial system must be preserved, without this resulting in rules being applied arbitrarily. Shareholder-value banks must be effectively complemented by stakeholder-value banks. This is the only way to secure a stable and effective financial ecosystem that makes its full contribution to the development of the real economy.

#### **3.1. Sustainability of financial institutions**

The European banking system is sustainable inasmuch as it adapts to its changing circumstances (this is what Boulding calls "homoeostasis"). A financial institution's adaptability enables it to survive when anticipating change represents a success factor.

The banking business has been constantly evolving in recent times, owing to the dynamic and highly digitalised society in which we live, on the one hand, and to the regulatory and institutional improvements that have emerged in response to the international financial crisis, on the other. Tougher capital adequacy rules and the new resolution requirements under Europe's new banking union are some of the main new additions to the regulatory landscape.

European banks will have to adapt their business models (for example, by focusing more on services to make themselves less lending-dependent) and balance-sheet structures (for example, by increasing the availability, not just of equity capital, but also of other liability instruments that could absorb losses in the event of resolution), and commit themselves further to technological innovation and the digital transformation (Pérez, 2016). It may also be appropriate for financial institutions to consider possible mergers and acquisitions, with a view to adapting their organisation and structure to the demanding economic and regulatory environment in which they operate.

In the field of financial regulation, there is no "one-size-fits-all solution for institutions, bearing in mind that this is an approach that damages the current role of banks rooted in their local areas as providers of banking services and financing for the real economy. Regulatory differentiation should be based on size, business model and ownership structure, among other factors" (Fainé, 2016). This model would be more in line with the Commission's goal of producing clearer, simpler and less costly legislation.

To comply with the new regulatory requirements, a certain amount of flexibility is necessary because there is a risk that cooperative banks will be converted into commercial banks and thus lose their special nature, thereby depriving society of a major social asset that has been built up over several centuries.

Far from the comprehensive regulatory reform being complete, there are new issues that are unresolved. One emerging area will be digital regulation: the profound transformation that the financial industry is undergoing, with the emergence of new firms and services, requires a response from the authorities. Expanded banking supervision would enable monitoring of the activities in the shadow banking system.

The trend towards ever-larger banks, as a result of restructuring processes, is a cause for concern because of the systemic risk it entails. The EESC thus calls for a return to traditional business (back to basics) as part of a clear distinction between institutions that specialise in retail banking and those that combine that business with investment banking. Experience has shown that diversity, risk spreading and distribution are good for the European financial system (EESC, 2015).

Research has made it clear that, as a result of the global financial crisis, financial institutions have been involved in bail-outs, financial restructuring, mergers and acquisitions, and nationalisations (Martin and Palomo, 2010). The consequences of such changes for the European public are manifested as reduced capacity (branches and staff), which has an impact on jobs and financing for private individuals and SMEs.

In the case of savings banks, the model as understood before 2008 (institutions with the legal status of a private foundation) has disappeared: their business has shifted into banking and they are now controlled by bank foundations. Increased consolidation and capitalisation are other key factors in the intensive transformation the Spanish banking sector has undergone, where efforts go beyond those in some European countries' financial systems.

Consequently, moving towards a new model for running banks, based on institutions made profitable and efficient by their people and that have ethical values as their foundations, is a good strategy for restoring confidence in the banking sector and improving its reputation (Anzoátegui, Gómez-Bezares and González, 2014).

### **3.2. New challenges for banks**

The profitability of their business is the main challenge for European financial institutions, since they are under pressure from the ultra-low-interest-rate environment, the sluggish economy and the large amount of non-productive assets they hold. They therefore need to use technology to cut costs and increase efficiency. European central banks are also predicting bank consolidations – i.e. mergers and acquisitions – in a bid to boost profitability.

There is no doubt that many banks will cease to exist and that the business will look completely different as a result of new technologies and the emergence of more flexible and efficient competitors. Europe's future financial ecosystem will certainly witness a four-way interaction between the traditional banks, the challenger banks, the regulator and consumers.

The traditional banks will have to meet the new challenge of competition from outside the banking sector (in response to the public's new expectations) and be able to grow alongside and forge alliances with crowdfunding platforms and sharing-economy applications. The

advances of FinTech are also forcing financial institutions to adapt to the new financial environment.

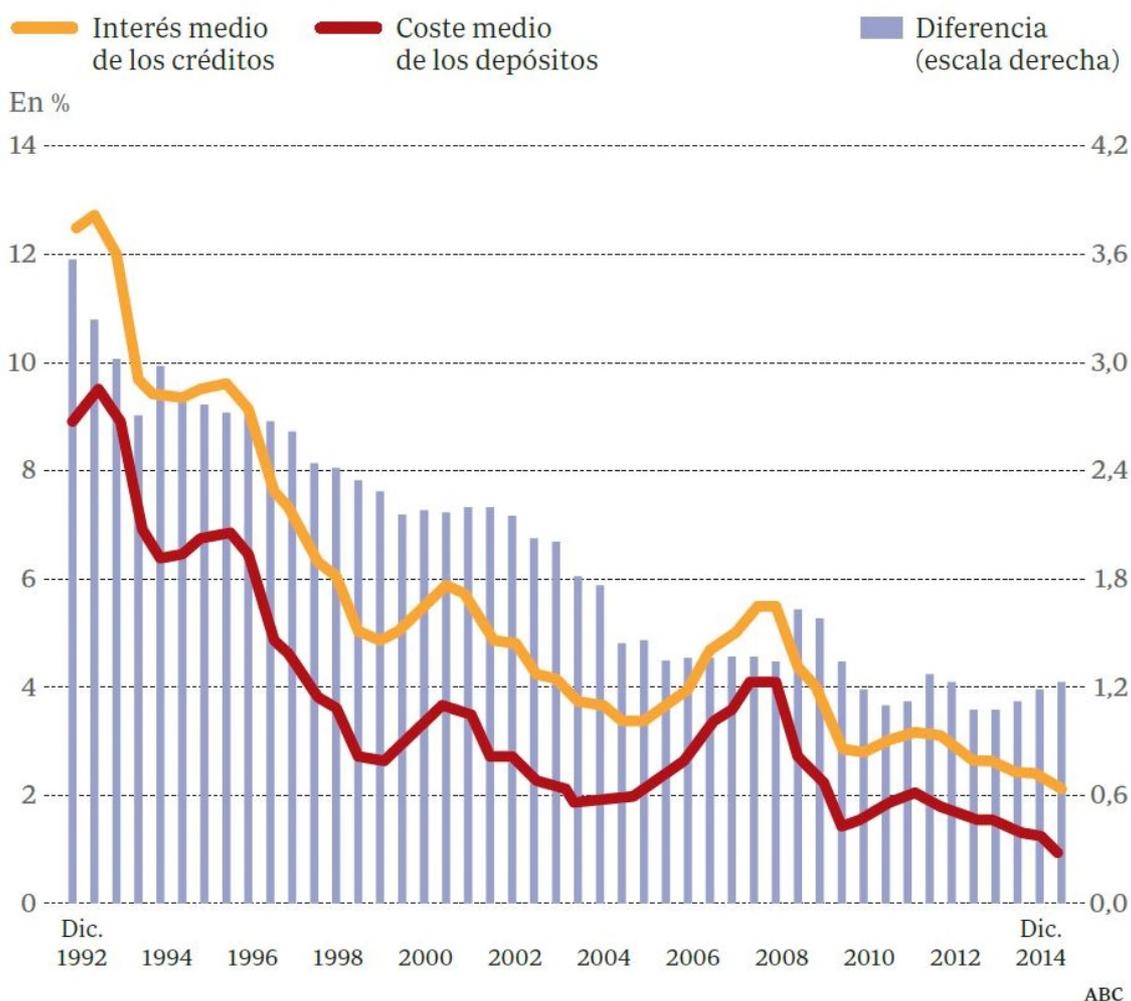
With 0% interest rates and the need to buoy up profitability, banks are moving the savings of conservative customers into accounts with better returns in exchange for greater loyalty to the bank.

The financial sector is facing one of the knottiest problems it has seen in recent years. Free money is forcing banks to close branches and start charging. Yet banks are aware that customers will only accept higher charges in exchange for new services. Institutions will have to carry out a lot of awareness-raising in this area. As far as branches go, they will not disappear, but they will increasingly focus on offering customers greater benefits rather than on transactions.

With the Euribor at historic lows, banks have seen their revenues from residential mortgage lending that uses this variable index diminish. In the current economic environment, institutions are encouraging the taking-out of mortgages at fixed interest rates in an attempt to shore up their turnover.

Greater size could be the solution being sought by weaker banks in this context of low net interest incomes (the graph below – reproduced from *ABC* of 27 March 2016 – shows the trend in recent years) as long as guaranteeing this would not lead to impoverished territories and negative effects on the local economy.

## Evolución del margen de negocio de las entidades



The current situation is very complex and the necessary adaptations cannot be avoided. The banks have made a great deal of progress with cleaning up their balance sheets, but the problems could return if they do not generate net interest income at a time of more stringent capital requirements. In the opinion of the Chairman of BBVA, this situation makes the "conventional banking model" non-viable and requires drastically improved efficiency from financial institutions, just when they should be coming to terms with the changes required by the digital revolution.

Banks are facing the dilemma of making cost savings (these will come in the area of operating costs, particularly on the branch network and staff), while simultaneously swelling their investment in technology to tackle the digital transformation. Those difficulties, along with new challenges, represent a threat to their profit and loss accounts.

The image problem that the banking sector has in many European countries is even worse in Spain. The image of banks was never positive, but it deteriorated during the crisis, with consequences that are serious, probably more so than the banks themselves believe (Toribio, 2015). Among the general public, a whole anti-bank culture has grown up and, regrettably, regulators, politicians and judges are responding to it. The banks may not have

made enough effort jointly to clean up their image. A good response would involve informative transparency and good governance.

While the financial services industry is on track to restore its credibility, trust still has important implications for a company's near-term success, according to the 2014 Edelman Trust Barometer (ultimately, without trust banks have no business). To tackle this challenge, bank staff must have three key qualities: integrity, intelligence and energy. The senior management of these organisations must be prepared to accept the new challenges and constant change.

As the then-chairman of the Spanish banking employers' association, Rafael Termes, pointed out: "The problem of ethical behaviour – in banking too – is not so much a problem of rules as one of individuals, who are made or destroyed by their actions." He considers the following the values most relevant to banking service provision: respect for individual freedoms; the fair exercise of the credit function; liberalisation in relation to risk; prudent resource management; truthfulness; and frugality.

The restructuring and recapitalisation carried out by European financial institutions in recent years and the implementation of the European banking union have managed to improve the health and stability of the system. However, together with the slowdown in the global economy, which could impact the banks through a rise in defaults, the extended period of low or negative interest rates and new regulations are hitting the profitability of the European financial system. The authorities' response to the international financial crisis (Linde, 2015) has entailed a profound change in financial regulation and supervision. Specifically, one of the priorities of the European Central Bank's single supervisory mechanism is close monitoring of financial institutions' business models and resulting risk to their profitability.

In any event, Euro-area banks remain vulnerable, particularly smaller institutions with assets of less than EUR 500 000. All those banks taken together control 50% of the assets in the European banking system. Ultimately, the system is considered excessive and bank consolidation and restructuring measures are necessary. In Spain, there are new plans for network adjustments and model changes for bank branches.

There are suggested additional transparency requirements on the horizon for banks' marketing of financial products to consumers (MiFID II will impose tougher protection requirements), along with the detection, through stress tests, of possible undercapitalisation or potential losses due to negligent or unethical behaviour. Such measures could boost confidence in the strength of the banking sector.

### **3.3. Cooperative bank mergers**

Cooperative banks escaped quite lightly from the financial crisis, proving more resistant and stable than other types of institution, while developing new business initiatives.

European cooperative banks' main activities are granting loans to their members, to households and to SMEs, alongside their presence in rural municipalities. In recent years,

cooperative banks have also taken steps to merge their local or regional institutions and have taken part in diversification and external growth programmes.

The ability to adapt to the new situations and requirements of the European financial market requires having the strategic vision to assess the convenience of addressing the merger processes involved in consolidating cooperative banks' businesses and earnings.

With that in mind, this report seeks to shed light on how to manage the transition to sustainable business models, building from the experiments that various European cooperative banks have been conducting, specifically those in a number of the Euro-area countries with the most developed banking systems.

#### **4. Europe's cooperative banking models**

Consumers' new expectations, technological development, tougher regulatory requirements and demographic change are shaping a different sort of banking, in which standing still is not an option.

The European banking system is an integral part of the economy and of society in a changing environment, so it must evolve too. Only those institutions that understand and anticipate the changes will have a successful business model and continue meeting their customers' expectations.

Against that backdrop, cooperative banking is in the midst of a process of change, with restructuring plans that seek to boost competitiveness, size and solvency transforming business models.

##### **4.1. Cooperating banking set-ups**

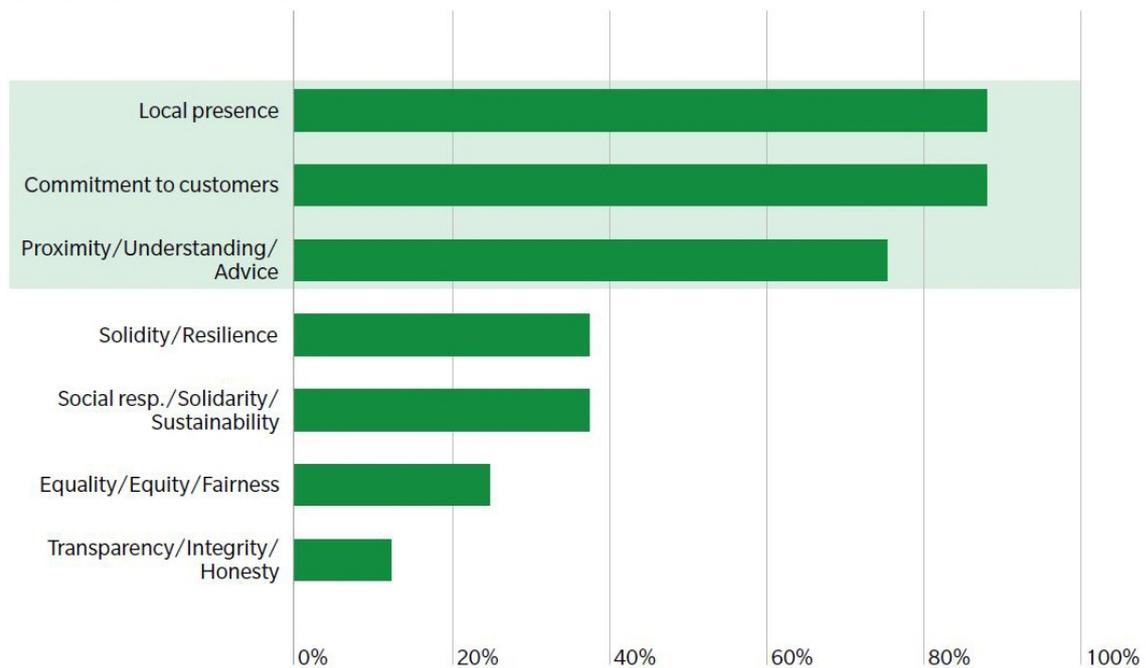
The cooperative banking model has played a key role in developing the economy over the years, by supporting agriculture, small industry and trade. Within the European Union, set-ups vary considerably from one Member State to another. The most representative models are those of countries such as Germany, France, the Netherlands and Italy.

Conceptually, cooperative banks are two things at once: they are both cooperatives and credit institutions, whose main aim is to provide financial services for their member/owners and customers. Their governance rests on the cooperative principles of democratic decision-making and participation (one person, one vote).

As a retail-banking business model, cooperative banks offer some very significant benefits: links with local producers; extensive local branch networks; close relationships with customers; financing of specific sectors; close ties with local interests and regional-rooted economic agents; and solidarity with the environment in which they operate. According to the European Association of Co-operative Banks (EACB), the cooperative banking model is based on the following key values: transparency, governance, resilience, proximity, social commitment and solidarity (EACB, 2004).

## Core values

IN PERCENTAGE OF RESPONDENTS



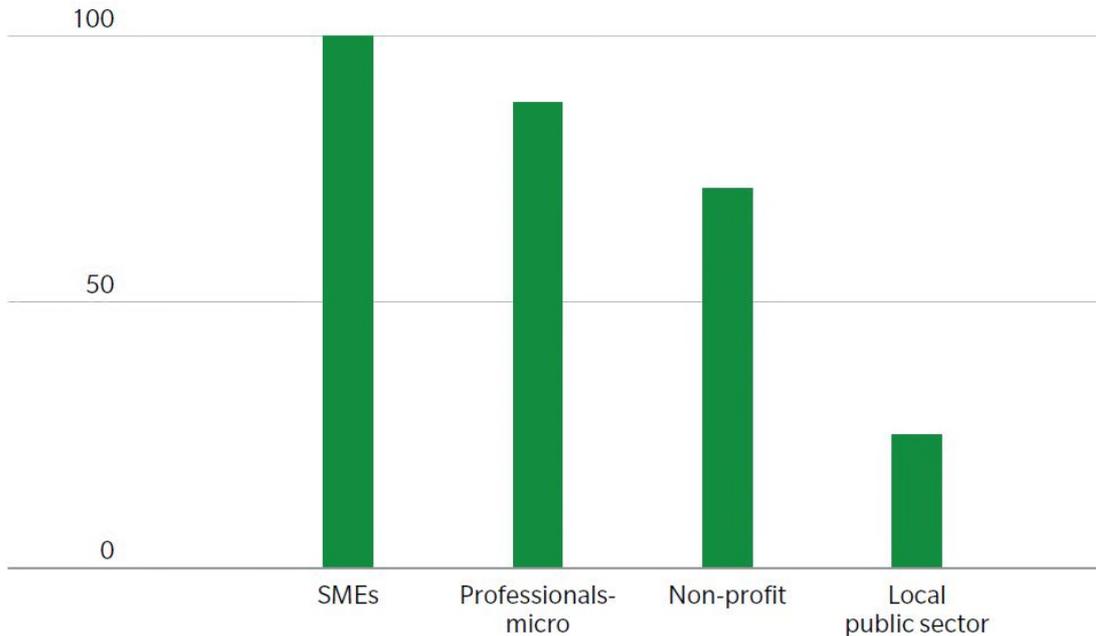
Source Interview data, Oliver Wyman analysis

Source: Oliver Wyman

In particular, cooperative banking gives the financial system roots in the real economy, generating stability and wealth for a region by means of its financial function (promoting savings, and granting loans to families and SMEs as priority segments) and its social function (foundational principles, allocation of surpluses) (Castelló and Trias, 2015). The result is that cooperative banking shapes the model known as social banking demanded by the EU public, founded on responsible, solidarity-based management rooted in the principles and values of the social economy.

## Financing for the local economy

IN PERCENTAGE OF RESPONDENTS



Source: Oliver Wyman

Cooperative banks have a European-level association that represents them and promotes and defends the common interests of their members. In that connection, the table below gives a description of the cooperative banking model in some key figures.

### Financial indicators

Quantities	2014	2013	Change
Local banks	4 200	3 700	500
Members (millions)	81	56	25
Customers (millions)	205	215	-10
Employees	805 000	850 000	-4 500
Branches	67 000	71 000	-4 000

Source: EACB

The Europe 2020 strategy has represented a new milestone in recognition of those forms of doing business that go beyond just focusing on the bottom line and are underpinned by the idea of using both specific financial and non-financial indicators (environmental, social and good-governance factors) that give an added dimension to the calculation of an institution's profitability (AECA, 2016).

In practice, the comprehensive report on cooperative banking will be able to compile the indicators specific to cooperative performance, tackling the unique concepts (financial and non-financial) connected to the application of cooperative principles and values: mutualisation, financial inclusion, corporate governance and socially-responsible investment (Castelló and Trias, 2011). That implies moving towards a new model of bank management focused on customers, and on institutions whose people make them profitable and efficient, while being based on ethical values. Responsible and sustainable banking is based on the intangible assets developed by corporate social responsibility as a source of opportunities for cooperative banking.

The twin factors of people and region are what have historically made cooperative banks highly resistant to the successive economic and financial crises that we have experienced in recent decades, since they can change, adapt and recover from the adverse effects of such crises quickly and efficiently. The following figures show the growth of the cooperative banking sector in 2008-2012.

**Growth in times of crisis**

Quantities	Rate of increase (%)
Members	4.5
Customers	5.0
Deposits	28.0
Loans	25.0
Assets	13.0

Source: EACB

In Europe, cooperative banks have approximately a 26% share of the market for deposits and they finance 27% of loans to SMEs. Their share of deposits and loans increased continuously in 2011-2014, which is an important demonstration of trust in these financial institutions.

**Market share**

Item	2011	2012	2013	2014	Change (%)
Deposits	25.7	26.3	26.5	26.4	0.7
Loans	26.3	26.6	27.0	27.2	0.9

Source: TIAS

Owing to the way they are structured, cooperative banks generally tend to have healthy capital structures, taking on reasonable risks and gearing their investment and capitalisation processes in line with in-house regional development policies.

Beyond the specifics of the cooperative banking model, a significant proportion of their problems and potential are not that different from those that European banks may have; specifically, cooperative banks face a range of factors that determine future business growth (EESC, 2015).

- Increasing competition and low interest rates have steadily reduced in financial intermediation margins.
- Multi-channel distribution requires substantial investment in technology.
- In some cases, the excessively small size makes it necessary for institutions to forge strategic alliances or merge.
- Local banking is difficult to combine with geographical diversification in international markets.
- There is uncertainty about the new regulatory framework for capital requirements and provision for bank resolution funds.

To tackle future challenges, cooperative banking needs to adopt the following strategic choices, among others, as a retail-banking business model:

- consolidate the local retail-banking model,
- go further with cooperation between institutions,
- improve internal risk-management systems,
- adapt to new regulatory and supervisory measures,
- increase the professionalism of their managers,
- boost management efficiency,
- protect their capital level to avoid insolvency, and
- promote transparency and good corporate governance.

Given the need to create value for local economies, the stakeholder-value approach is becoming increasingly important, along with cooperative banking. Nevertheless, there is a need for greater knowledge and recognition of the cooperative bank model. Regulation specific to each business model is essential to preserve the diversity of the European financial system (Guider, 2013). Likewise, financial education is a key tool in meeting the challenges of cooperative banking in the new financial context (Trias, 2016).

## **4.2 New restructuring plans**

The International Monetary Fund has identified the essential role of cooperative banks (2010): "These banks, less reliant on shareholders' expectations... dependably and safely supply the small and medium-sized enterprises and many households with their credit needs." As a specialist banking business model, cooperative banks are called on to keep providing this indispensable function in support of the real economy, in a globalised and competitive environment.

However, the drag caused by the international financial crisis on the low-interest-rate environment (negative-rate, in the case of Euribor), over-regulation and new digital

campaigns are making it increasingly difficult for the cooperative banking sector to boost profitability and efficiency.

Faced with this situation, both the European Central Bank and the European Banking Authority recommend (Institute of International Finance meeting in Madrid, on 24 May 2016) that financial institutions: cut costs by closing branches and reducing workforces; thoroughly clean up their balance sheets, since banks in some countries have too many non-productive assets; and enter into more national and cross-border mergers.

The new challenges to the financial industry affect in particular those small-scale cooperative banks that are not very profitable and could be caused serious problems by the new capital requirements and the opposition of non-bank competitors in the European financial ecosystem.

#### **4.2.1. Capacity adjustments**

Europe needs to complete its bank restructuring to head off the threats from the new financial environment, in which revenues are not picking up and interest rates remain ultra-low; the only way of achieving this that does not sharply reduce efficiency is to cut costs and keep consolidating the banking sector.

Although cooperative banks weathered the financial crisis better than other institutions, they need to overcome challenges by making the most of business opportunities and the strengths of specialist banks in the next content of European banking union. In any event, they need to absorb new capacity adjustments and continue with merger processes, given that the cooperative banking landscape has not yet settled into its new form.

The European banking sector has undergone a genuine transformation. In Europe, 29 000 branches have been closed and 200 000 jobs lost since 2008. Spain has accounted for half of the branch closures – some 14 000 – and a third of the job losses.

Tough as this has been, the process is far from complete. There remains scope for the Spanish financial system to reduce its capacity because it still has the largest number of bank branches per head of population: at closing date 2016 Spain has some 62 branches per 100 000 inhabitants, higher than the ratios of countries such as France (58), Italy (50), Germany (43) and the Netherlands (11). The way in which financial institutions (including cooperative banks) compete with each other has long focused on closeness to the customer, which requires a large number of branches, along with other factors, such as business model, and the cultural and demographic features of the country (Europe G, 2016).

In the context of Europe's bank restructuring, it is also relevant to consider that Spanish branches are much smaller than in the rest of Europe, where the model tends to be one of a smaller number of larger branches. Spain (6.3), along with Italy (10) and France (11), is one of the countries with the fewest employees per branch, followed by Germany (19) and the Netherlands (42); the figures are from 2014.

In relation to European cooperative banks, the number of branches fell by approximately 3.3% in 2011-2014, while the reduction for the banking sector as a whole was 10%. If employee numbers since the 2008 financial crisis are compared, the number of cooperative bank employees fell 4.6%, compared with 10.3% for the banking sector as a whole (TIAS, 2016), as the table below illustrates.

**Reduction in branches and employees in Europe (%)**

Item	Branches (2011-2014)	Employees (2008-2014)
Cooperative banks	3.3	4.6
Banking sector	10	10.3

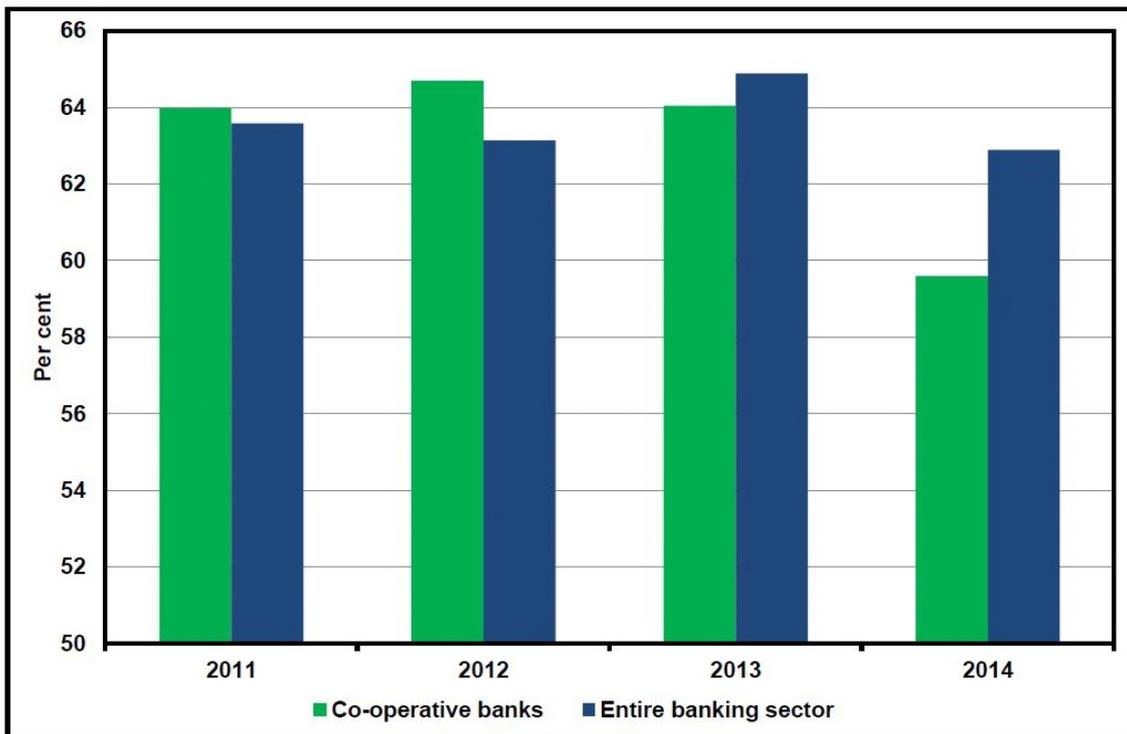
As the information provided shows, Europe’s banking sector as a whole has cut back more on both branches and employees in recent years than have cooperative banks. In 2014, cooperative banks closed approximately 1.2% of their branch networks and reduced their staff numbers by 3%. Nonetheless, the cooperative banking sector currently still has a large branch network, which enables it to be close to its customers and local communities in the provision of financial services.

Bank restructuring through closing branches (the least productive and profitable ones), normally located in smaller towns, has already left numerous municipalities without a branch at all, with some population centres running the risk of financial exclusion. Cooperative banks should rethink their business model of local banking.

Admittedly, the restructuring of the branch network is also driven by a change in customers’ consumption habits, with the increasingly widespread use of mobile banking. The financial distribution model must therefore be based on customers and efficiency (23rd Conference of the Spanish Financial Sector, 2016).

The efficiency ratio of Europe’s cooperative banking sector improved substantially in 2011-2014, going from 64% in 2013 to below 60% in 2014. The graph shows that cooperative banks are, on average, more efficient than the banking sector as a whole. Nevertheless, there is still much scope for a better ratio. Traditionally, the supervisor requires the banking sector to keep the ratio to below 50%.

## Efficiency



Source: TIAS

The European banking sector has obviously realised that capacity-reduction strategies based on downsizing branches and workforces enable it to enhance efficiency through cost rationalisation. Cooperative banks are following the same route to make their model sustainable and boost profitability.

In the banks of the future, branches will gradually be adapted (through technological change and new consumer habits) until it is known how many are needed and what their role will be. Within a few years, while there will still be branches, what is certain is that their role and number will be totally different. The trend is towards making the relationship with each customer profitable, while making them as loyal as possible. The change in the bank-branch model consists of increasingly shifting the focus from transactions towards financial advice, offering customers additional benefits.

### 4.2.2. The consolidation process

In the new financial environment, Europe's cooperative banks need a new strategic vision for their business and, in particular, an extraordinary capacity to adapt to new market situations and requirements.

Clearly, size enables access to markets under better conditions and financing at better prices, particularly at times like the present, when margins are so tight.

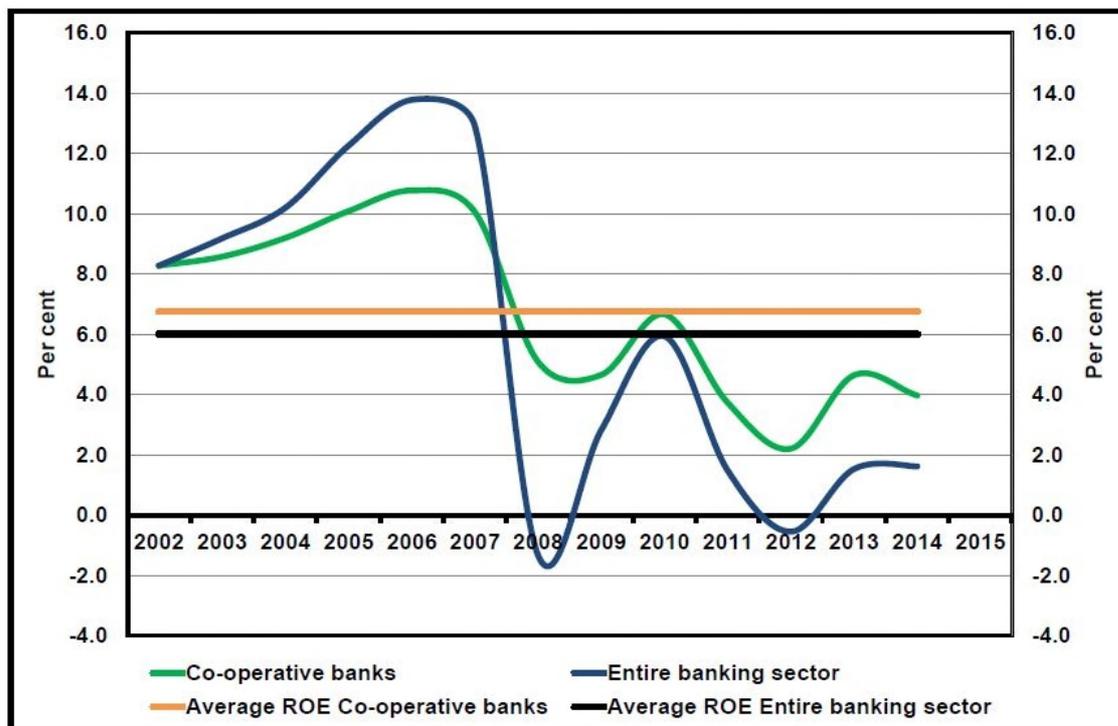
Rather than an end in itself, growth is the path that needs to be trodden to offer members and customers (the focal point) the best possible service. A combination of effort and resources, the cooperative model, is what will make it possible to consolidate the collective project and achieve shared goals.

That is the strategic vision with which Spain’s Banco de Crédito Cooperativo was founded in 2014. Made up of the 19 agricultural banks of the Cajamar cooperative group and a further 13 agricultural banks, it follows the model existing in other European countries, where agricultural and small local banks operate as part of larger financial cooperative groups.

The other Spanish cooperative model, represented by UNACC, has been also affected by a huge consolidated process, resulting in a decrease of ten entities in the last five years and the creation of an IPS (Solventia Group).

Financial institutions are expressing concern about the consequences of loose monetary policy for their profit and loss accounts and about the weak economic outlook. In 2014, European cooperative banks’ average return on equity (ROE) was 6.8%, above the banking sector average of 6%. The graph provided by TIAS (2016) offers a comparative analysis of ROE between cooperative banks and other banking groups in 2002-2014, based on statistical information from the EACB and the Swiss National Bank.

Return on equity (ROE)



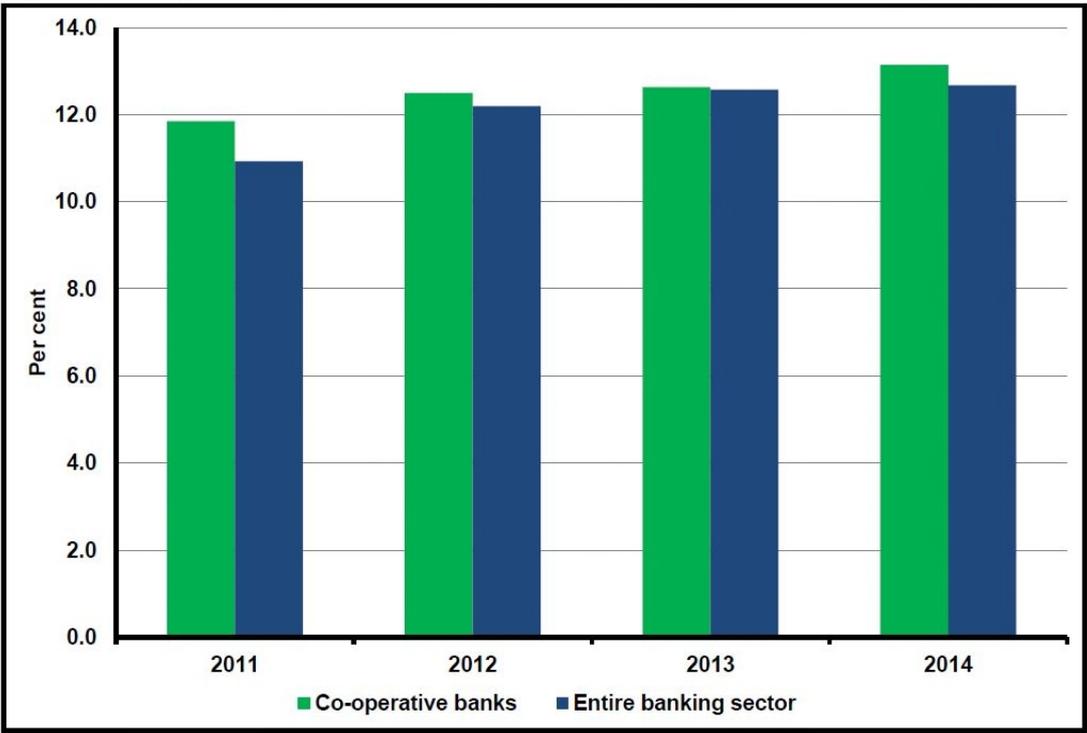
In the light of the new challenges for the financial industry, to return to pre-financial crisis levels of profitability, the European Central Bank recommends further bank consolidation, first between national institutions and then cross-border, so that the resulting institutions are more profitable.

For its part, the International Monetary Fund makes clear in its annual report that, as a result of European banks' excess capacity, there is a need for consolidation and for a paring-back of the banking system. It also explicitly mentions the EU process affecting the financial system, stating that Europe needs to complete the banking union and the capital markets union.

From a regulatory standpoint, the steps taken to date within the banking union to buttress capital structures make provision for more and better-quality capital, better risk management, the setting-up of leveraging and a new approach to liquidity. Those steps are likely to impact on bank balance sheets and may substantially reduce profitability.

European cooperative banks' average tier-1 capital ratio was higher than the average for the sector as a whole in every one of the years 2011-2014. From 2012, European cooperative banks' capitalisation level was over 12%; in 2014, they reached a ratio 0.4% higher than the average for the banking sector as a whole (see graph for details).

Tier-1 capital



The fact that cooperative banks channel a significant proportion of their earnings into bank reserves bolsters their capitalisation and gives the institutions sufficient capacity to weather adverse situations (more resilient).

In short, there is apparently an indisputable economic logic to the strategy of banking sector consolidation, enabling mergers to generate larger earnings and, at the same time, to reduce their operating costs through synergies and economies of scale. However, consolidation in the sector could entail major risks for the stability and the inclusive function of the financial system.

### 4.3. Representative models by country

The difficult situation for European banks, with muted demand and ultra-low interest rates, has led the banking sector itself and, in particular, the European Central Bank to begin raising the need for greater consolidation throughout Europe. In fact, the markets point to Italy, in particular, but also to France and Germany as countries where additional consolidation is necessary.

It was actually in the German financial system that, in 2015, Deutsche Bank posted the worst losses in its history and announced an eye-watering restructuring plan. On the other hand, local cooperative banks remained stable and were not harmed by the financial crisis. They kept financing the local economy.

Of the four largest Euro-area countries, France is the one that has made fewest adjustments. Its banking landscape has shrunk little more than 3%, in numbers of both branches and employees; it is now the country with the most branches (38 623). Furthermore, it is, like Spain, one of the systems with the most branches per inhabitant and fewest employees per branch.

The Italian banking sector has now built up some EUR 200 billion of toxic assets and some time has gone by without it promoting bank mergers. Since the start of the 2008 crisis, Italian banks have closed 11% of their branches and slimmed down their workforces by the same percentage. As yet, the country has not taken on a bank-consolidation process, however. It is a measure that the national authorities and European Central Bank are encouraging.

The Netherlands banking system, for its part, is characterised by a high level of consolidation. Specifically, the majority of business is shared between ABN AMRO, ING and the Rabobank Group. The latter is the only Dutch institution that offers financial services on the basis of cooperative principles.

The opportunity presented by the new framework of the banking union should be seized to apply uniform standards when conducting financial reforms in the various affected countries; otherwise the legislation on bank bail-outs, which requires shareholders and bondholders to bear the costs rather than the taxpayer, will not be worth the paper it is written on.

It should be stressed that Europe's largest cooperative banks are in the countries with the most-developed financial systems, in which they seek to serve certain market segments that differ from those of other bank models. The contribution of these credit institutions to economic and social development in their respective countries is inseparable from their activities, whether individually or in groups (Belmonte, 2011).

From that perspective, and given the situation described as regards the process of consolidating the European banking sector, there follows a succinct analysis of each of the

models representing cooperative banking in the following European countries: Germany, France, the Netherlands and Italy (Palomo, 2004).

As a starting point, the following table shows the total assets of the respective cooperative banking models that are the subject of the research in 2014, taking account of the size differences observed in absolute terms.

#### Total assets in 2014

Country	Institution	Size (billion Euro)
Germany	DZ Bank	400
France	Crédit Agricole	1 700
Netherlands	Rabobank	700
Italy	Banco Popolare	400
Average	Cooperative banks	500

The table below compares the specific proportion of savings attracted and loans granted by each cooperative banking model (DZ Bank, Crédit Agricole, Rabobank and Banco Popolare) in its country with the whole-EU total on 31 December 2014. It has been drawn up on the basis of figures included in the EACB's 2015 annual report.

#### Deposits and loans in 2014 (billion Euro)

Country	Institution	Deposits	Loans
Germany	DZ Bank	193	208
France	Crédit Agricole	623	709
Netherlands	Rabobank	326	430
Italy	Banco Popolare *	453	394
EU total	Cooperative banks	3 793	3 975

\*The figures relate to the ANBP.

With a view to providing an up-to-date view of the European cooperative banking movement and its future prospects, there follow details of the recent experiences or change processes of each of the selected models within Europe's cooperative banking sector.

#### 4.3.1. German model: DZ Bank

The cooperative financial network in Germany consists of DZ BANK and the local cooperative banks. The German Association of Cooperative Banks (BVR) represents 972 local cooperative banks. On 31 December 2015, it had 18.4 million members, 30 million customers, 11 784 branches and other distribution channels, and over 180 000 employees. Its total assets exceed EUR 1.2 trillion and it has a 24% share of the deposits market.

Cooperative banking is one of the pillars of the German banking sector and the merger process between the two central institutions – DZ Bank and WGZ Bank – will be completed on 31 December 2017.

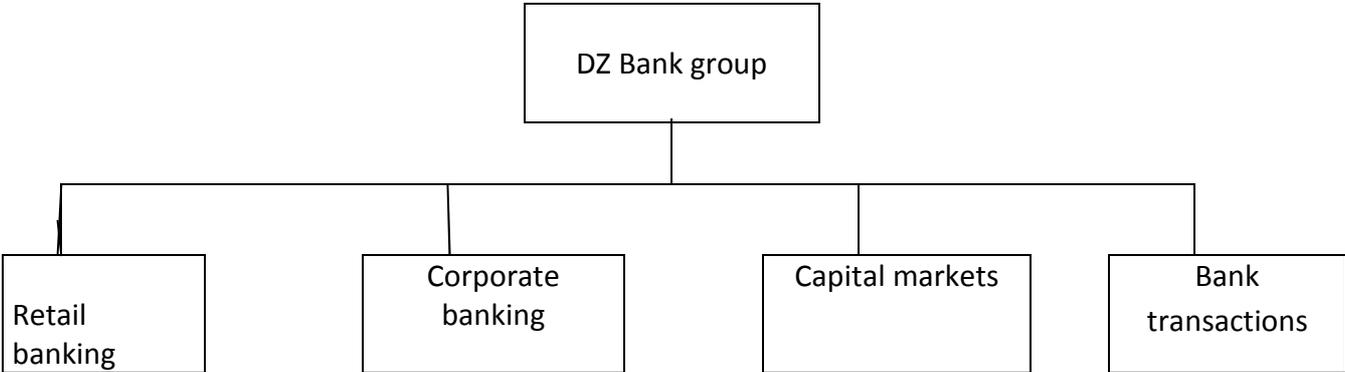
DZ Bank is the second largest banking group in Germany, with total assets in excess of EUR 500 billion and over 30 000 staff. In 2016, profit before tax was EUR 2.2 billion. Its efficiency ratio was 58.9% and tier-1 capital was at 14.5%.

In addition to its strong roots in Germany through its local cooperative banks, it has a presence in some other countries as a result of its strategy of geographic diversification to meet the needs of its customers.

Rating agencies such as Fitch have given it one of the best and most stable ratings in the German banking sector. It belongs to the German Cooperative Financial Network (CFN). The strengths of having an organisational structure completely integrated into the cooperative banking model include a uniform strategy, brand strength, transparent information, advice on risk, and solidarity through a protection scheme for each member institution and for customer deposits.

As part of the BVR cooperative financial network, DZ Bank rests on three pillars: product- and service provider for the local cooperative banks; the functions of the central bank (liquidity transfer for retail banks); and holding function for the subsidiaries.

The business model rests on the idea of offering financial products and services at competitive prices, which are divided into market segments, as set out in the diagram below.



Business activities focus on meeting customer needs as a provider of financial products and services. It makes a significant contribution to strengthening the position of the cooperative financial network through charges, profit distribution and cost synergies. It also provides free services, such as financial advice.

In recent years, there has been a large-scale process of mergers between German cooperative banks, so their number has shrunk considerably (from 7 000 in 1970 to 1 138 in late 2010). The immediate consequence has been the increased average size of those institutions.

The merger of DZ Bank and WGZ Bank in Germany will call time on the three-level (local, county/province and state) organisational structure that predominated in cooperative banks until now.

The new institution will be called DZ Bank and will have its registered office in Frankfurt. The merger is the first step towards the consolidation of the German financial sector, with the priority goal of all banks improving their low profitability levels.

There are substantial strategic, commercial and regulatory synergies, because the merger will lead to annual savings of at least EUR 100 million. There follow some of the most significant competitive advantages derived from the process of consolidating DZ Bank and WGZ Bank, according to information taken from a DZ Bank group working document (2016):

- ✓ Joining forces in strategic competition,
- ✓ Enhancing banking operations,
- ✓ Continuing to develop processes and structures with a focused, transparent and efficient network,
- ✓ Collecting revenues and achieving cost synergies,
- ✓ Distributing financing more efficiently and making resources available.

The philosophy of meeting commercial and social challenges together is the foundation on which the cooperatives are based and is also a fundamental principle of sustainability. For DZ BANK, responsible corporate management is an integral part of the corporate strategy and a prerequisite for successful business. As a central institution for the cooperative financial network, DZ Bank has embedded key values such as mutuality, fairness and partnership into our corporate culture. Our core values are drive, integrity, and trust. The Sustainability Report for 2016 was produced in accordance with Global Reporting Initiative (GRI) guidelines and the additional guidelines given in the supplement for the financial services sector. The report is prepared on the basis of the GRI-G4 guidelines and the core 'in accordance' option.

#### **4.3.2. French model: Crédit Agricole**

In France, cooperative banks are legal persons, the normal role of which is carrying out banking operations that include attracting funds from the public, credit transactions and managing means of payment.

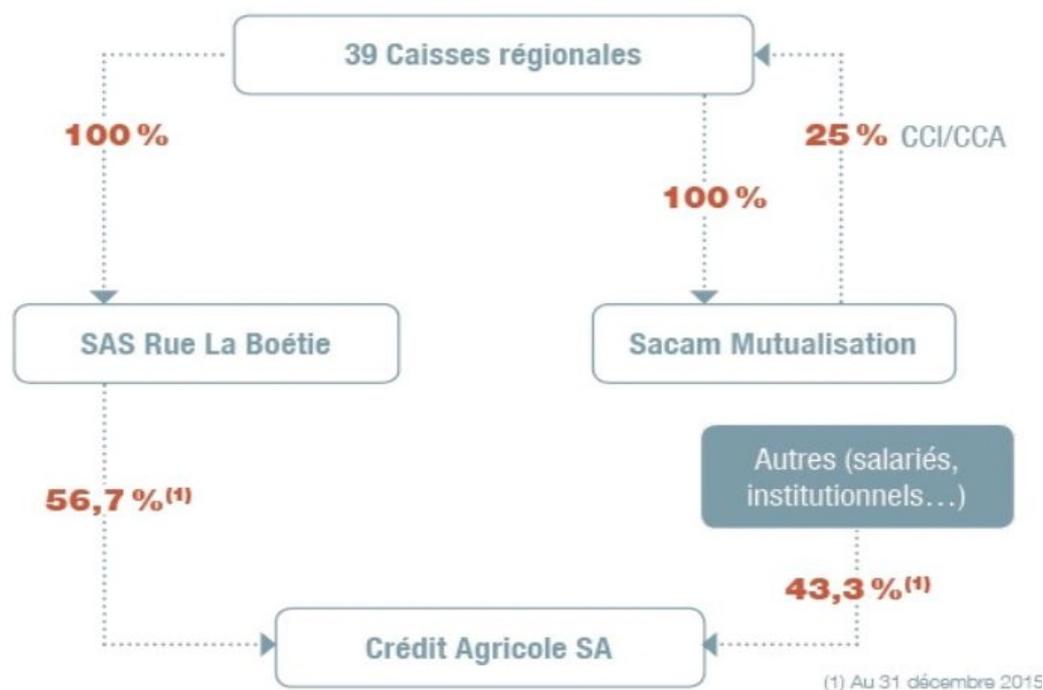
The cooperative or mutual banks belong to one of the following groups: Crédit Agricole, Crédit Mutual, Banque Populaire, Crédit coopératif or Caisse d'épargne.

The bedrock of the Crédit Agricole cooperative model is a total of 2 471 local banks, which have 9.3 million members who had contributed to the share capital, as of 31 December 2016. The local banks were the first cooperative banks in France; they are grouped into 39 regional banks, which are autonomous, with responsibility for their own management and development.

In addition to these local and regional entities, there is the Crédit Agricole National Federation, which is the level at which the group's major orientations are debated. It also represents the regional cooperative banks before the authorities, before both the banking and farming professional bodies and before the organisations with which Crédit Agricole works. It also performs various senior management functions for the regional cooperative banks.

In response to the changing market and supervisory authorities, Crédit Agricole has put in place a simplified group structure, which was concluded last year, as the graph shows (annual report, 2015).

### Crédit Agricole Group structure



With an eye on 2020, Crédit Agricole has put together the following three key strategies for growing its banking business better.

- Support for the regions with a sustainable growth orientation. To achieve this, it needs to listen to stakeholders, offer innovative products and services and respond to social change.
- Striving for excellence in operations, and in relations with customers and employees. Service quality needs to be improved, management made more professional and human resources made more responsible.
- Managing all risk, including non-financial risk. Incorporating non-financial criteria into management of the cooperative banks and ethical behaviour are priorities.

Crédit Agricole Group’s network of 11 000 branches, which employ some 138 000 people and provide services for 52 million customers, represents a strength as regards achieving its targets.

The new customers project rests on three pillars: a customer-focused universal banking model; a full multichannel distribution of products and services model; and strategic investment in customer relationships.

Crédit Agricole is seeking to enhance the group’s dynamic growth on the basis of the retail banking model through three priority business segments: personal, SMEs and farms, and corporates. Those pathways are increasing the pace of attracting customers and consolidation of leadership over the long term.

The personal segment could be grown through the offering of digital financial products and services, though young customers and loans to those of legal age. In the case of SMEs and farms, the cooperative bank is seeking to expand its presence in those markets. The corporates segment is particularly impacting the growth of regional banks.

In the coming years, the group’s strategic orientations are towards rolling out an ambitious customer project, enhanced by the digital transformation, strengthening the growth momentum in its core business lines and improving industrial efficiency.

The table below sets out an overview of Crédit Agricole’s main management indicators, compiled on the basis of figures provided by the EACB.

Crédit Agricole – 2014

Indicators	Percentage
Deposits market share	24.4
Loans market share	21.4
Efficiency	64.3
ROE	n.a
Tier-1 capital	16.7

Source: EACB

The principles of Crédit Agricole’s CSR are based on strong convictions. The commitments are expressed every day through groups of institutions with initiatives and tangible signs of progress, according to its 2014-2015 corporate social responsibility report.

Crédit Agricole believes that corporate social responsibility should be applied to all areas of the business and that it represents a tool for progress and for the development of the economic, social and environmental issues vital for the future. Within the group, factors such as diversity, sustainable development, the sharing of initiatives and operations with other institutions, the incorporation of non-financial criteria into management and commitment to stakeholders are essential.

**4.3.3. Dutch model: Rabobank**

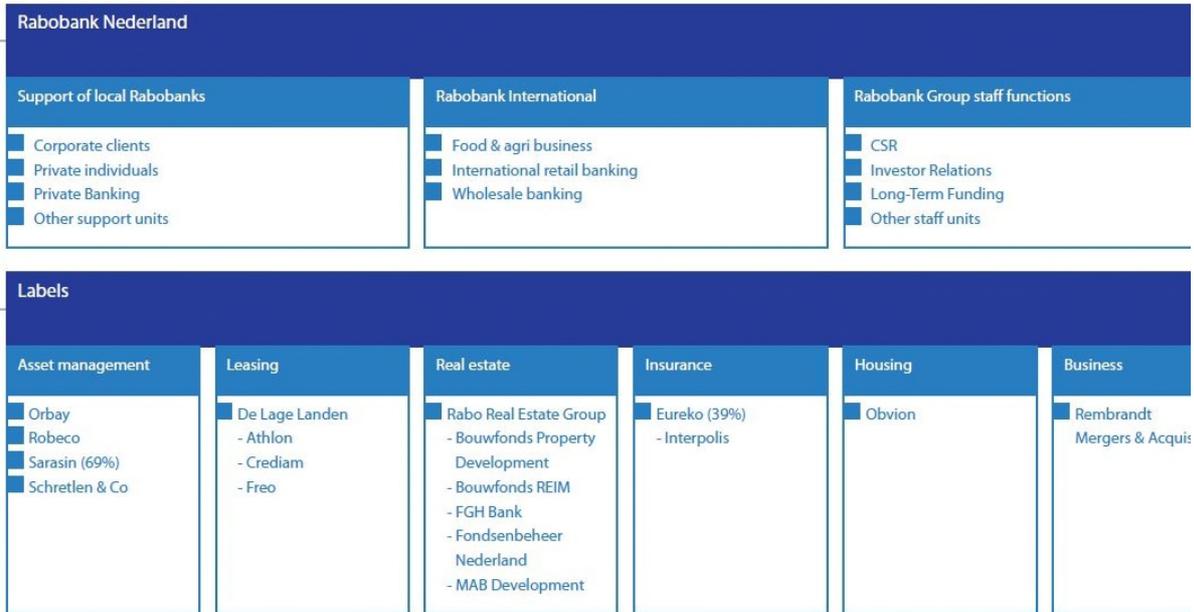
Rabobank Group is the only institution that offers financial services on the basis of cooperative principles in the Netherlands banking system. In the Dutch economy, cooperatives play a considerable role in the agricultural and horticultural sector, and in the banking and insurance sectors.

In the late 19th century, cooperative banks were founded in rural areas of the Netherlands to provide farmers with cheap loans. Those cooperative banks evolved into local banks, characterised by the requirement that their customers be members. As these local banks grew, the need for a central institution emerged, which led to the creation of Coöperatieve Centrale Raiffeisen-Bank and Coöperatieve Centrale Boerenleenbank in 1898. Those two institutions merged in 1972, giving rise to a single company: Rabobank (Groeneveld, 2016).

Rabobank Group is a cooperative banking organisation made up of Rabobank Nederland (cooperative registered as a credit institution in the Netherlands) and the local banks. In the Netherlands, RN and the local banks operate with one banking license since the fundamental governance revision in 2016. The group also has numerous specialist financial institutions and other subsidiaries. A system of reciprocal guarantees provides intra-group credit support between the one cooperative bank and some subsidiaries, in the event that one of the institutions suffers financial problems (Rabobank, 2009 and 2015).

On 31 December 2014, Rabobank Group operated through 113 local banks, 547 branches and 48 254 employees. It has 8.8 million customers and the local banks have 1.9 million members.

**Organisation of Rabobank Group**



Rabobank Group applies the *allfinanz* ("universal banking") concept, which involves providing both personal and corporate customers with a full range of financial services, from credits to deposits, insurance and investment services. The group focuses on transactions that bring in revenue from service charges, as well as the traditional proceeds of interest. For example, Rabobank operates in the field of insurance through Interpolis and leasing via De Lage Landen LL. Both companies are Dutch and among the largest in their specialism.

As the figure shows, the group’s transactions are carried out through a parent company, Rabobank Nederland, which oversees corporate strategy, solvency and liquidity for its subsidiary local banks. It also takes charge of planning the operations of the cooperative banks, at the same time as carrying out its own banking operations focused on financing for large national and international corporates. In short, the organisational structure of Rabobank Group has a two-level system: local and national.

Through the local banks and its branch network, Rabobank has achieved significant market shares, both in attracting deposits and in mortgage lending (36% and 22%, respectively). The vast majority of loans to the Netherlands agricultural sector are provided by cooperative banks. Loans to small and medium-sized enterprises are also particularly important.

At the end of December 2014, Rabobank had total customer deposits of EUR 326 billion, a total credit balance to the private sector of EUR 430 billion and a net profit of EUR 1 842 billion. Rabobank has had a triple A credit rating since it was first rated in 1981 and is the most solvent institution in Europe.

The table below sets out the financial indicators most representative of Rabobank Nederland.

**Rabobank – 2014**

Indicators	Percentage
Deposits market share	36.0
Mortgage market share	22.0
Efficiency	62.7
ROE	5.2
Tier-1 capital	21.3

Source: EACB

Rabobank is the Netherlands' retail banking market leader and a major player at international level: it focuses its activities on financing for the agri-foods sector, without neglecting the other services characteristic of a universal bank. One of its main challenges is building up its European operations. For some years, Rabobank divided its strategic programme into the following main areas:

- remaining *allfinanz* market leader in the Netherlands,
- boosting growth and enhancing synergies with subsidiary and partner companies, and
- strengthening its position internationally as a bank for the agri-foods sector.

Europe's bank-consolidation process is under way and Rabobank is preparing to work with other European partners in a way that preserves the character of the local level. There are more mergers and acquisitions on the horizon, which will shape the new European banking map.

For now, Rabobank will be launching a restructuring plan, with the aim of achieving greater profitability and making its business units more efficient. It involves 12 000 job losses in the first two years.

Rabobank has become a major supplier of financial products and services of all sorts, which values the spirit of the local community and seeks to support its long-term sustainability, combining the philosophy of the cooperative business with long-term customer relationships. Likewise, it is stepping up the active involvement of members and customers in its local banks. To that end, Rabobank invests purposefully in employees, paying particular attention to their training and professional development.

The cooperative mission reflects the ties between cooperative banking and the social economy; the main aim is to maximise customer value. Rabobank also places great emphasis on increasing the total number of members and their involvement in the business.

As regards corporate social responsibility, Rabobank Group has identified these goals: incorporating sustainability into mergers and acquisitions; strengthening new production methods and renewable energy sources; promoting participatory economics and diversity; and promoting social cohesion and solidarity.

In summary, it is trying to achieve a strong and robust financial position and to contribute to economic and social development in the community where the local banks operate.

#### **4.3.4. Italian model: Banco Popolare**

The serious crisis experienced in the euro area in recent years has not yet abated in some Member States, whose banking systems are suffering significant solvency problems. Italy is central to investors' concerns, owing to the high default rate, the losses on the stock exchange and the lack of structural reforms. The solution to this situation is to clean up balance sheets as quickly as possible, profoundly restructure the size and workings of the banking system and adopt the reforms necessary to ensure its solvency.

In this globalised economic environment, the founding principles of Italian cooperative banking have remained in place since the model first started to be developed in the country at the end of the 19th century, with the aim of making it easier for the disadvantaged social classes – such as rural workers, craftspeople and small-business owners – to access credit.

There are two types of cooperative bank: Credit Cooperative Banks or Mutual Banks (hereafter CCBs), and Banche Popolari (industrial cooperatives). Localism is the corporate purpose of both types of bank; in other words, they are committed to being credit intermediaries, with a view to serving the economy of the area in which they are based.

However, the industrial cooperative banks have constituted a distinct category in a number of important ways since the 1940s.

The Italian Association of Industrial Cooperative Banks (ANBP) is the institution officially responsible for protecting the standing of the industrial cooperative banks. To that end, it promotes, researches and analyses the sector, providing advice on issues of strategic importance to its members.

At the end of 2014, there were 70 industrial cooperative banks operating in Italy. They had 1.3 million members and 12.3 million customers.

The branch network has been regularly expanded and totalled 9 248 at that time. The network is denser in northern Italy and, in some regions industrial cooperative banks account for 32% of all bank branches in municipalities with 6 000-30 000 inhabitants. They employ 81 800 people.

The trend has been for the industrial cooperative banks to expand. This started in the late 1970s and coincided with the growing importance of small and medium-sized enterprises in the Italian economy. Currently, their share of the deposits market is 25.5% and that of the loans market is 25.9%.

Italian industrial cooperative banks have significant competitive advantages: as a result of the special relationship with the community they serve and their in-depth knowledge of the people who make it up, it is easier to segment their customer base to direct their product offering in a more suitable way.

However, the industrial cooperative bank model performs poorly in terms of profitability. Likewise, the efficiency ratio needs to be improved and capital needs to be shored up in line with new EU financial regulations. The table below sets out these indicators for the ANBP.

**Banco Popolare – 2014**

Indicators	Percentage
Deposits market share	21.5
Loans market share	25.9
Efficiency	63.6
ROE	-3.3
Tier-1 capital	13.6

Source: EACB

Recently, some issues have been raised around the Italian cooperative banking model, which include the outlook for the industrial cooperative banks in the era of economic globalisation and the potential risk of their becoming obsolete. In the opinion of some specialists, globalisation is compatible with greater local dynamism, in what is termed "glocalism".

On the other hand, the risks seem greater with regard to raising financing or to the greater competition from institutional investors. Industrial cooperative banks are also obliged to develop a system for managing credit risk consistent with their purpose of serving SMEs and households. The new capital-adequacy rules will bring substantial changes to the process of evaluating solvency.

The industrial cooperative banks need to make strategic decisions effectively. Increased bank size could be a solution to meet the challenges of the new financial environment.

The consolidation process has accelerated recently, with the adoption of a more liberalised new legislative framework for the sector in line with European single market rules. The reform of banche popolari was launched in 2015 (Decree 3/2015 converted into law 3/2015), obliging the banks with assets above EUR 8 billion to be transformed into SPAs (public listed companies), thereby losing their cooperative statute. This has led to bank consolidation within the Italian financial sector picking up with the merger of Banco Popolare and Banca Popolare di Milano (Gruppo BPM since 2017).

Concerning the BCCs, a reform has been started (the decree-law of 10 February 2016) to encourage cooperative banks to merge into a large cooperative banking group run by a public limited liability company, which will have over EUR 1 billion in capital and shares valued at around EUR 20 billion. The project has some negative effects (financial stability risk, services provided to local economies under threat and risk of financial exclusion). The question is whether this large holding company be able to serve the interests of the cooperative banking group without harming those of small cooperative banks and the local economies they serve.

As small-scale banks that particularly support local economies, cooperative banks are weighed down by the effects of the financial crisis and facing major financial problems.

Nonetheless, Italy's cooperative banks have spared no efforts in their work for the benefit of local communities. In keeping with their sense of their mission, they channel part of their annual net profit into cultural programmes, projects with an artistic element, and architectural conservation and restoration, where their efforts complement the work of the state. Equally important are the funds that go into grants and other contributions to the professional and personal development of young people.

It is important to remember that some BCCs (Ferdecasse and others) were the first in Italy to set themselves up as "ethical banks", with an employment policy that favours social and personal development initiatives. A different type of banking is possible today. What is more, it is as profitable as traditional banking, but operates differently, according to the European Federation of Ethical and Alternative Banks (FEBEA).

#### **4.4. Analysis of the survey results**

As stated above in the section on the methodological approach to the research, a survey was conducted by means of tailored interviews with executives and experts from the cooperative

banks themselves, employers' associations, regulatory and supervisory bodies, the academic world, and so on within the European Union.

The questionnaire was designed and drafted in advance, using open and specific questions. Once the results had been obtained, they were presented, along with systematic analysis of the substance, in the ten points detailed below, which were used as fundamental information for strategic decision-making.

#### **4.4.1. Diversity of bank models and regulatory framework**

- **Diversity of models in the financial ecosystem**

The process of diversifying the financial system is essential for the European economy. Shareholder-value banks must be effectively complemented in their wholesale, retail and investment activities by stakeholder-value banks. This is the only way to secure a stable and effective financial ecosystem that makes its full contribution to the development of the real economy.

The structure of the European banking sector is rather consolidated. There are 130 large banks that own 70% of the assets. Those large banks are supervised by the European authorities. However, there are some 8 000 smaller banks that could pose risks. Therefore, the focus on whether a bank is systemic should be considered in relation to each country's size (collection of small banks making up a network).

One of the problems detected, regardless of bank size, is that of the bad loans still existing in the portfolios of many European banks, which have a negative impact on their earnings. Admittedly, the large amount of non-productive assets, the low interest rates, the regulatory pressures, the weak economic recovery and the digital transformation are shaping the banking business, which is putting new adjustment and bank consolidation processes to boost profitability and increase efficiency on the agenda for the European financial industry.

Experience has shown that diversity and risk spreading and sharing are good for the European financial system. In particular, there is no single model for cooperative banks in Europe. There are differences between each country's legislative framework and traditions. However, there is a European cooperative status with characteristics shared by all European cooperative banks: ownership rights and, consequently, governance using the one member one vote rule. This has an impact on an organisation's equity instruments, reserves and performance.

While commercial banks are more inclined towards short-term profit and maximising value for shareholders, cooperative banks advocate sustainable development over the long term and at local level. That is one of the explanations for the resilience of the cooperative banking model during times of financial crisis.

Cooperative banks compete with savings banks, which have historically played a key role in the economic and social development of their territories of origin, particularly by supporting families and SMEs; they remain heavily involved in the European financial system. Recently,

what is known as ethical banking has emerged, which facilitates financial inclusion by fostering entrepreneurship, and the launch of crowdfunding and socially responsible investment schemes.

In the new context, cooperative banking is complemented by forms of non-bank financing (crowdfunding, venture capital, business angels, etc.), which have emerged as a result of the credit crunch and the stringent guarantees demanded. Likewise, it must face competition from new company types, such as the shadow banking system, and from the newly emerged digital operators, such as the FinTech firms, which can offer high-value-added digital services within the world of finance.

In short, a new European financial ecosystem is developing through a process of transition towards bank and non-bank business models. In this context, the cooperative banking model is sustainable and should retain its distinguishing features – the cooperative principles that serve as the basis for its governance – and make the most of its strengths, while bracing itself for the threats from an uncertain, complex and changing environment. The model's essence needs to be guaranteed and its survival promoted in the face of future challenges, as an essential component of the European financial system, which is recognised by the regulators and supervisors for its contribution to stability, solvency and competition.

- **The new financial regulation and supervision**

Beyond the specifics of the cooperative banking model, a large proportion of its difficulties are not that different from those that European banks may have: the process of adjusting to the new requirements of the regulatory framework following the financial crisis; consolidation of the single market in financial services; the supervision and resilience measures; the liquidity and solvency conditions derived from Basel III; implementation of the European banking union with its three pillars (single supervisory mechanism, single resolution mechanism and European deposit insurance scheme); and expectations for Basel IV.

However, the main problem remains the proper application of the proportionality principle in the new banking rules (especially regarding the Capital Requirements Directive – CRD IV – and the Capital Requirements Regulation – CRR), which the Basel Committee suggested should be applied proportionately in keeping with the EU treaties. This means that the strictest requirements should apply to global banks and more flexible requirements should apply to national and local banks (guaranteeing a proper level of consumer protection).

It does not mean freely granting privileges to certain segments of the financial system. There is a commitment to a level playing field and objective parameters that justify a specific regulation for each business model are recommended. Essentially, these are financial and economic performance, contribution to the real economy, risk management, and governance.

It is important to stress that there is a need for change, that the new regulation was drawn up with the aim of harmonising and stabilising the banking system, and that recognition in the new international rules has been achieved for the specific features of Europe. One of the

goals of the European Banking Authority is to simplify the information procedure and cut compliance costs, at the same time as maintaining a uniform level of supervision of each organisation.

To address the various aspects of proportionality, a range of factors must be borne in mind, such as size, the simplicity of the activity and the level of interconnectedness. That could be used to evaluate the extent to which a bank is systemic.

On the other hand, the mere fact that there is a "single rulebook" for small cooperative banks too has cut costs. The main difficulties for cooperative banks come not from the capital requirements, but from the complexity of the rules. The sound capital base of cooperative banks offers them the flexibility to explore new business opportunities, tackle innovation and finance the real economy.

It is important that the cooperative banking model should not be damaged by the new rules. For the majority of European banks, regulation accounts for 15% of total operating costs and 9% of total resources goes on complying with rules; that figure rises to 20% for small banks. Ad hoc plans must be implemented to enable banks to hire staff and take care of their business.

Promoting banking models that root the financial system in the real economy – providing stability and strengthening local communities, as cooperative banks do – is a priority issue when applying the proportionality principle, given that, in addition to the size of the bank, consideration must be given to the business model and, above all, the level of risk. In the long term, a stakeholder-value mentality gives them a lower risk profile. It is a case of maintaining profits and shoring up the capital base to restore the production fabric.

The first problems that arise are regulatory barriers and compliance costs. The regulatory and supervisory authorities are aware of the benefits of diversity in the banking sector and are trying to reflect the application of the proportionality principle, but the issue is one of focus. Both diversity and proportionality in European banking need to be incorporated into the international debates. The current legislation is unpredictable, unstable and inconsistent; if the future rules are unknown, that causes banks serious problems when planning investments.

The new rules were designed with large financial institutions in mind, which have greater capacity to absorb the costs that compliance entails. On the other hand, the negative consequences for small financial institutions, such as cooperative banks, are significant. In short, cooperative banks, which did not cause the financial crisis, which have remained stable during this period and which contribute to social development, now have to deal with prudential rules that hit their business model hard.

#### **4.4.2. Cooperative principles and the retail banking business**

- **Cooperative banking principle and values**

In many European cities, a cooperative bank forms part of the community's identity. That model's essence needs to be guaranteed and its survival promoted. It forms part of the social capital and relationships that foster economic well-being.

The dual status of cooperative and credit institutions, the system of relationships with their members and customers in the provision of financial services and the model of governance are core values of cooperative banks.

Their governance rests on the cooperative principles of democratic decision-making and participation (one person, one vote) and they are required to plough a significant proportion of their earnings into bank reserves and social funds.

Bearing in mind that cooperative banking models are different in every European country, one of the main characteristics is membership. Cooperative banks were created in the 19th century to provide their members – above all, farmers – with support and financing, which is the core of their identity.

The irrefutable proof of the identity of the cooperative banking model is the distribution of their surpluses, given that the purpose of making profits is their social commitment and the benefit of the local community, which are the characteristics most visible to the public. For cooperative banks, the financial and social functions are closely intertwined in their commitment to territorial cohesion.

Specifically, the characteristic features of cooperative banks' contribution to the philosophy of the social economy can be summarised as follows: their contribution to local economic growth, the principle of financial non-exclusion and the large-scale social work derived from those initiatives create sympathy within the environment in which they operate, which really sets them apart.

In short, the EACB defines the cooperative bank model as having the following core values: transparency, governance, resilience, proximity, social commitment and solidarity. Preserving social and territorial cohesion is a fundamental attribute of this unique banking business model.

- **Retail banking business model**

Cooperative banks display the characteristic features of a retail banking business model, such as focusing on financing for families and SMEs, close ties to a region and responsible management.

The purpose of cooperative banking is to promote savings and make it easier for their members to access credit. What sets them apart is their specialisation in the world of cooperatives, in the rural setting and in the agri-foods sector.

Owing to the way they are structured, as a general rule, cooperative banks tend to have healthy capital structures, taking on reasonable risks and gearing their investment and capitalisation processes, in line with in-house regional development policies.

Their main strengths are their long-term relationships with, and closeness to, customers. That is the strength of the local retail banking model. Their capitalisation depends, above all, on non-distributed profits. As a result of this approach, they are far less affected by fluctuations in return on equity than other banks. The Commission believes that the major challenge for the cooperative banking model is maintaining contacts with customers and personalised services. Other strengths are: contribution to stability, to local economies and to society as a whole.

Weaknesses include speed and could also – to an extent – include size, with new financial regulations seeking to promote centralised models with large banks. Yet the most stable banks are the smaller ones with decentralised models. Consequently, while the legislation takes into account the difficulties of cooperative banks so that they are not penalised for their legal status, cooperative banks have to opt for either a renewed traditional structure or for the large structures created in some countries that can compete in international markets and offer all financial products and services. Other weaknesses of the cooperative banking model relate to its governance and customer-centred orientation. Ultimately, the issue that arises is that of maintaining the balance between the cooperative company structure and growth.

In the current globalised environment, the opportunities for cooperative banks consist in strengthening personal relationships with, and advice for, customers, committing themselves to new technologies, making the most of customers' trust and making the cooperative model more "democratic" and beneficial for local economies. In relation to threats, the new changes in the financial regulation and supervision environment need to be tackled in a way that does not jeopardise the cooperative banking model. It is critical to continue investing in people, being proactive and not giving up on cooperative status, which is their essence in the face of demutualisation.

It is important for the cooperative banking sector to be close to the real economy, offering a wide range of financial products and services. Families and SMEs are the priority customer segments. The main business is financing for the agri-foods sector, which is a key and anti-cyclical sector in which the default rate has traditionally been lower than in other economic activities.

Although retail banks' main activity focuses on credit financing for small businesses, other significant areas include mortgage lending, household financing, means-of-payment services, attracting savings, insurance products, international trade transactions and financial service models based on digitalised banking. Combining the traditional focus of retail banking on providing products and services with those of international banking is part of the success of the cooperative banking model.

- **Reassessing so-called local banking**

The business of cooperative banks combines in-depth knowledge of the local socio-economic situation in the places where they operate with a healthy dose of prudence in managing institutional flexibility; they are currently the main financial support for agri-food cooperatives and companies.

The business of such banks is to look after and respond to people, offering them a personal and effective service. So-called local banking makes it possible to support their professional activities, to help them improve and grow their business and to know and anticipate their needs.

Consequently, cooperative banks are defined by their desire for close relationships and by their commitment to the socio-economic development of local production systems through their large branch networks. The physical presence of these credit institutions in small, rural towns (to give an idea: one in two branches is in a town with fewer than 25 000 inhabitants) means closeness to customers in the provision of financial services, which fosters the financial inclusion of a large proportion of the population. Some geographical areas, on the other hand, are so unprofitable that no other banks have a presence there.

The closure of cooperative bank branches in Europe as a result of the crisis (3.3% in 2011-2014) represented the redefinition of their business model as local banks. In addition to that comes the change in customers' consumption habits with the increasingly widespread use of mobile banking, which has been a driving force in the restructuring of banks' branch networks.

Reconsideration of the viability of cooperative banks' current retail banking model based on an extensive branch network (the employees-per-branch ratio in the European Union is 12) implies a process of gradual adaptation until it is known how many will continue to exist and what their role will be in future. In some cases, branches closed in small towns for reasons of duplication and productivity are being replaced by a new network of banking agents who take care of the business in those areas, particularly in the countryside.

The new (multi-channel) model for distribution of financial products and services must be based on customers and efficiency. The trend is towards making the relationship with each customer profitable, while making them as loyal as possible. The transformation of bank branches consists of increasingly shifting the focus from transactions towards financial advice, offering customers an additional benefit.

Cooperative banks' closeness to customers requires a large branch network, which is expensive to maintain. This does not mean that branches should be scrapped, but perhaps there is a need to reassess local branches in the geographical areas where they operate to enable personal contact with customers and, at the same time, continued bank digitalisation without the loss of the cooperative identity. Cost rationalisation may require the shutting-down of less productive and profitable branches, but also the opening of new branches in line with each European country's cultural and demographic characteristics. Perhaps one

solution would be to reduce the number of employees per branch to maintain the local banking model as a competitive advantage of cooperative banks.

Cooperative banks will still have their branch networks in future, but they will be different and so will their number. However, better provision of financial services for customers requires enhancing the physical branch, which involves guaranteeing against the financial exclusion of towns and regions. In short, cooperative banks need to combine their strength as a local model (from knowing individuals and commitment to community projects) with the use of new information and communication technologies to support new initiatives to help the real economy recover.

#### **4.4.3. Non-bank business models**

- **Emergence of new digital competitors**

Cooperative banks must commit themselves to the technological innovations (the Digital Agenda) involved in the new European financial ecosystem, which will witness a four-way interaction between the traditional banks, the new digital operators, the regulator and consumers.

The growing competition in the banking sector from the emergence of FinTech (technology platforms providing financial services) and the technology giants (Google, Apple, Facebook and Amazon) presents an opportunity for cooperative banks to make the most of their strengths and undertake a digital transformation. In any event, it falls to the regulatory and supervisory authorities to provide a common framework so that the new technology companies start along the right lines to compete in the financial market. In other words, competition is good, provided that there is a level playing field.

In this new situation, cooperative banks need to keep improving the new financial distribution channels (Internet, mobile banking, etc.), with one eye on the millennials, who have grown up with digital and do not tend to go into branches. Even so, the branch network needs to be retained as a strength of cooperative banks, to forge closer long-term ties with customers through financial advice. This involves two main areas for investment: technological innovation and training for human capital. The development of financial distribution – physical and virtual – demonstrates a responsible attitude from cooperative banks in relation to their financial intermediation operations, supported by professionalised management of human resources.

With advances in digitalisation and the emergence of new competitors in the sector, cooperative banks need to act as quickly as possible in transactions and decision-making. Likewise, the setting-up of innovation management platforms for the branch network is considered a key initiative. In short, the digitalisation of cooperative banks represents an opportunity to attract customers and, in particular, to cut costs. The streamlining of processes involves making local banks more efficient in a challenging financial environment.

There is no chance that the new non-bank digital operators will replace what the banks can offer. Yet they are a threat, creating greater competition. Every cooperative bank needs to

open up to new sales channels, offering initiatives for providing its customers with services, so as to adapt quickly to the needs and expectations of new financial consumers.

The true challenge of digitalisation now consists in how it impacts on the behaviour of customers. They are now used to a 24-hour service all week (24/7), via various financial distribution channels. Rather than obliging customers to operate through a given channel, they must be given the freedom to use whichever channel they want. In conclusion, for cooperative banks this is a process of continuous adaptation to the digital revolution without changing their purpose, preserving personal relations with the customers, who are the true source of human and sustainable development. The overall message is that digitalisation is an opportunity to promote the cooperative banking model.

#### **4.4.4. Restructuring and organisation of cooperative banking**

- **Levels in cooperative bank structures**

The cooperative banking model tends towards a two-level system (local banks affiliated with a national organisation) when, in a competitive and globalised environment, it is difficult for small, local cooperative banks to provide effective financial services. The characteristics of each cooperative group depend on the percentage of its services managed at local or national level.

In the case of Crédit Agricole, which provides banking services of all kinds, the organisation is founded on local banks, which are grouped into regional banks (they are autonomous regional banks, completely responsible for their management and development). In addition to these local and regional set-ups, a national-level central organisation completes the organisation of this French cooperative banking model.

The German cooperative banking sector has a two-level structure. The central institution acts as a central bank for the banks and parent portfolio company of DZ Bank Group. The goal is to offer effective financial products and services. This central institution seeks to act as a partner for the local cooperative banks, which provide customers within their geographic area with whatever banking services they need.

In general, there is a clear tendency for mergers and acquisitions to lead to a two-level system (rather than the traditional three). For it to be possible to make effective use of the synergies inherent to this structure, there is a need for compliance with basic principles such as subsidiarity and regionalism. Under those conditions, cooperatives can develop a unitary image design and present themselves to the public as a family of legally distinct members. This situation paves the way for developing and applying shared market strategies, which are much more economical for the individual banks.

There are a number of variations of the two-level cooperative bank set-up, depending on the responsibilities of the central institution and how the local banks are integrated. In any event, the two-level model already exists in many countries, and it is a very appropriate idea because each institution does what it can and knows well and the two levels work together and complement one another.

- **Consolidation of the cooperative banking sector**

Broadly speaking, bank restructuring has produced a smaller, more streamlined, but less inclusive picture because, in recent years, households and SMEs have been deprived of financing. The process has gone hand-in-hand with a steady reduction in local branch networks and many job losses. This trend may worsen if local banks are pushed out of the retail market.

Moreover, as a result of the 2008 global financial crisis, there have been bail-out and restructuring processes, mergers and acquisitions and nationalisations; there is even a risk that cooperative banks will be converted into commercial banks and thus lose their special nature, thereby depriving society of a major social asset that has been built up over several centuries.

Cooperative banks have also been an oddity in the financial system, both because of their market share and because of their specialisation, social nature and internal workings. They have responded to the crisis by cleaning up their balance sheets, cutting operating costs and launching merger processes. Still today, they face the challenge of capital requirements, relatively small size and tightening profit margins. For European cooperative banks, the consolidation process is still not over. Clearly, in Europe's new banking union, if proportionality and EBA mandates do not adapt sufficiently, it will be capital, solvency and profitability needs that could oblige cooperative banks to undertake merger processes to keep growing and become more competitive.

While European banks have made major progress with solvency (the Commission believes that EU institutions are increasingly resistant), the stress test results published by the European Banking Authority on 29 July 2016 show that the question is whether this is enough to enable the European banking sector to face up to its major current challenge: the search for profitability.

The challenge of achieving greater profitability will inevitably give rise to the need for a thoroughgoing reform of the financial industry, by means of mergers and acquisitions between institutions, at least within each country. The possibility also exists of a major cross-border merger in the EU.

In the cooperative banking sector, excessively small size requires some institutions to forge strategic alliances or merge. For example, cooperative banks in Germany often merge because they are required to do so by the financial regulations and business environment; that is in a network of over 1 000 local cooperative banks. In Germany, cooperative banks are one of the pillars of the banking system and BVR represents all the small, local cooperative banks. Clearly, size could lead to synergies and economies of scale, giving access to national markets under better conditions and making operations more international in the current globalised environment.

The consolidation process is speeding up as a result of globalisation. In that regard, reduced costs, greater efficiency and growth are the key factors. Against this backdrop, the new structure of the Dutch cooperative banking model – Rabobank – offers a template for a clear

international expansion strategy. Rabobank Group is a cooperative banking organisation made up of Rabobank Nederland, the local banks, numerous specialist financial institutions and other subsidiaries. A system of reciprocal guarantees provides intra-group credit support, in the event that one of the institutions suffers financial problems. It is one model for mergers within Europe's cooperative banking sector.

In Italy, the cooperative banking model achieves poor results in terms of profitability, so government reforms are transforming the sector with the threat of demutualisation or a change in legal status (public limited liability company). Likewise, the efficiency ratio needs to be improved and capital needs to be shored up to meet the requirements of new EU financial regulations. This situation has accelerated the consolidation process, with the merger of Banca Popolare and Banca Popolare di Milano (BPM). By adopting that approach to strategic management, cooperative banks are facing up to the effects of the financial crisis and their major solvency problems.

The consolidation of Europe's banks and cooperative banks will continue in the coming years. The best way of increasing profitability is to cut costs by means of economies of scale. In the case of France's Crédit Agricole cooperative banking model, the consolidation took place within the cooperative group because it has a single identity and cooperative culture; two years ago, it went from 104 regional banks to the 39 that exist now. The regional banks share a large number of centralised services, technological systems, marketing services, etc., which reduces their benefit/cost ratio. One of Crédit Agricole's goals is increased efficiency through rationalisation of the branch network, and by achieving competitive advantages derived from consolidation.

Regardless of the reasons behind mergers and acquisitions within Europe's cooperative banking sector, institutional protection schemes (IPS) – so-called cold mergers – are particularly important in mergers of cooperative banks in Spain (in other countries, there are solidarity mechanisms within cooperative groups). The Cajamar cooperative group (made up of 19 agricultural banks) used an IPS to merge a collection of local cooperative banks around a single cooperative bank project equivalent to those that exist in more advanced European countries, as this paper has shown; owing to its capacity for initiative and forward-thinking, the Cajamar cooperative group received no public funding for this merger.

In the Cajamar cooperative group, each of the agricultural banks continues to serve its members and customers and maintains its own governance and management bodies, staff and branches. Meanwhile, the backing of the group (Banco de Crédito Cooperativo) is what guarantees the institutions' solvency; it provides resources and financial muscle, in such a way that, if an institution ran into difficulties, the group would provide it with the capital necessary to resolve them. In other words, what happens with a consolidated group is that business is pooled and earnings are mutualised. It is a model in which local- and county-level agricultural banks carry out their activities in their own areas, while being incorporated into a large national group.

In conclusion, there is a trend towards consolidation in the European cooperative banking sector, not just to comply with the new banking union measures, but also to increase

efficiency and boost profitability in a highly competitive retail environment, with the new digital operators and squeezed profit margins due to the low interest rates.

#### **4.4.5. Governance and corporate social responsibility**

- **Modernisation and improvement of cooperative governance**

The cooperative banking model is aligned with management concepts such as corporate social responsibility and governance (social and ethical values are considered priority in managing the business). The European banking system as a whole has suffered reputational damage and loss of trust because of the financial crisis. A good response would involve informative transparency and good governance.

There is a significant body of opinion that banking should promote its ethical side and create a new model. The change of course should be visible and the business must be profitable, so that the transformation results in robust, stable banks. A change in culture is needed, which must start with employees and be communicated to the outside so that customers notice it. Specifically, what is needed is responsible banking, in which information is not hidden, in which customers are the focus, in which there is no bad practice by banks, in which financial exclusion is avoided, etc. That implies moving towards a new model of bank management focused on customers, led by competent professionals and based on ethical values.

In that regard, cooperative banks could improve their cooperative governance, giving continuity to an appropriate management and checks on operations, steps intended to increase professionalism, modernisation of their governance to ensure sustainability and competitiveness, establishment of a code of conduct in the governing bodies, enhancement of internal and external communication, etc. This would contribute to promoting and giving new impetus to the cooperative banking model within the European financial system.

Governance should be evaluated in proportion to an institution's size, and to the challenges and risks it faces. Cooperative banks are firmly committed to transparency, responsibility, solidarity, democracy and ethics, according to the EACB. Consequently, regulators and supervisors should be open to cooperative banks as "good governance"; this should apply to organisation and structures, rather than just being limited to the rules on governing bodies. Corporate culture and values are a critical component of good governance based on responsibility and ethics.

The regulatory framework should respect the cooperative governance model and the specific features linked to their very roots; cooperation is in their DNA. Good governance is essential to the smooth running of the banking sector. While aspects of governance tend to be similar across the various bank business models, there are some features specific to cooperative banks: knowledge and experience, independence, number of appointments, respective roles of directors and managers, workings of the board of directors, committees, prevention of conflicts of interest, remuneration policies, bail-outs and resolution.

European cooperative banks have created new platforms, new management bodies or a new dimension that represent other major players in governance to keep the organisation

running smoothly. For example, innovation management plays a role in governance, with the goal of reporting directly to the board of directors, and real powers in budget distribution (DZ Bank).

Members of the governing bodies of cooperative banks should be prepared to accept the new challenges facing the European financial industry. Bank staff must have these qualities, among others: integrity, intelligence and energy. The problem of ethical behaviour is not so much a problem of rules as one of individuals, who are made or destroyed by their actions.

In the cooperative banking sector, the measures required by the new governance rules are being adopted, such as filling posts on governing bodies with finance professionals (Crédit Agricole). The cooperative governance model is strong, although it could always be improved with a far-reaching bank-transformation process.

Other good governance initiatives include cooperative banks' participation in a number of programmes intended to unite senior figures in commitment, in active involvement in general meetings and in increased awareness and understanding of mutual companies. Indeed, member status is the cornerstone of cooperative governance and of proper accountability at all levels.

- **Social commitment of cooperative banks**

A socially responsible model is one of the founding principles of cooperative banking. Since the financial crisis, banks' new philosophy is intended to incorporate social responsibility into strategic management.

The need to introduce a framework of social responsibility into the industry has contributed to the emergence of sustainable finance. Cooperative bank executives should operate responsibly and sustainably. The solution lies in the intangible assets developed by corporate social responsibility as a source of opportunities for cooperative banks.

The new financial consumer demands greater commitment to society from financial institutions. Thus, the Edelman Trust Barometer shows that 8% of the population believe banks should have a social purpose. Financial institutions can set themselves apart from the competition by meeting their customers' rational, emotional and social needs. From this perspective, there has been a three-stage process in the evolution of financial theory: classic financial theory, behavioural finance theory (which considers the influence of investors' psychological characteristics on investment decisions) and sustainable finance theory (social, environmental and good-governance considerations in investment decisions). The latter theory corresponds to financial products defined with socially-responsible investment (SRI) criteria, which have a positive social impact. Along with traditional financial criteria, modern sustainability reports incorporate new, non-financial criteria into a comprehensive vision of the banking business.

Cooperative banks make it easier for people in small rural towns to access financial services, through their large branch networks (local banking). Microcredit programmes form part of their credit offering and provide a boost for social projects, which emphasise their concern

about European society's social problems. The intention really is to give strategic management a social aspect.

According to Oliver Wyman's 2012 report, cooperative banks donate three times more of their revenues to social action than commercial banks. The fact that cooperative banks plough part of the profits from a region back into society achieves the goal of developing the local economy. This contribution to society could be the measure of an institution's value in terms of investments with an impact. It forms part of cooperative banks' social capital and relationships.

Concern for staff training is a priority for cooperative banks in all social initiatives. The cooperative nature of these institutions makes it easier for employees to learn together by exchanging information, knowledge and actual experiences of the banking business in a "campus cooperative", as an education centre. Professionalisation of management is a significant challenge, so there is a need for continuous training programmes as an investment in the future and a symbol of progress.

Providing customers with a financial advice service in the new branch set-up requires a large degree of preparation of cooperative banks' human resources. Likewise, the people who form part of their governing bodies should have broad economic and financial knowledge for good cooperative governance.

In short, Europe's new financial ecosystem requires the promotion of corporate social responsibility as a model for socially responsible and sustainable banking, ethical finance, and educational efforts from supervisory bodies to improve the financial culture. In this context, the cooperative banking model occupies ground that stands out because of its very nature, of where its profits go and of territorial cohesion.

#### **4.5. Future strategic orientations**

The necessary strategic vision and, in particular, an extraordinary capacity for adaptation to new situations and requirements are fundamental to future plans for Europe's cooperative banking sector. As José Ortega y Gasset said, "We can only move forward by looking ahead."

Europe's financial industry is currently engaged in a transformation process, against a backdrop of volatility, uncertainty, complexity and ambiguity due to a range of political/legal, economic, social and technological factors that are contributing to change. Money and uncertainty do not mix and instability is not profitable.

Profits are increasingly challenged by a persistently low-interest-rate environment, which is eroding net interest income (with little prospect of institutions being able to raise average loan rates, in a very competitive marketplace). There are also some vulnerabilities as regards capital and asset quality. On top of that comes competition from the new digital operators and regulatory pressure, which are eroding profit and loss accounts.

While the results of the latest stress tests (the first carried out since the European Central Bank became the sole supervisor) show that the European banking system is more stable now than in 2014, there is a markedly negative feeling towards the banks, which saw the

sector's shares mercilessly punished in early 2016. It is very positive that the banks have been restructured to face up to their new challenges. However, there is a perception that future profitability is hard to see.

To return the banks to profitability (a precondition for solvency), three strategies could be applied: cost-cutting, increased income from charges and mergers. These adjustments in the bank-restructuring process define management-efficiency criteria. Specifically, increased efficiency is one of the strategic priorities for banks' future digital transformation.

Cooperative banks help to give the European financial system stability, solvency and competition. Nevertheless, to deal with future challenges, retail banks need to adopt the following strategies as a business model:

- ✓ Adapting to regulatory, supervisory and resilience measures,
- ✓ Maintaining so-called local banking,
- ✓ Moving forward with bank-restructuring processes,
- ✓ Enhancing internal risk-management systems,
- ✓ Encouraging investment in technological innovation,
- ✓ Protecting their capital levels to avoid insolvency,
- ✓ Boosting their profitability and increasing efficiency,
- ✓ Promoting staff professionalism, training and development,
- ✓ Fostering transparency and good corporate governance,
- ✓ Championing social values and ethical behaviour.

In the new regulatory environment of European banking union, there is a certain amount of policy uncertainty weighing down on cooperative banks, such as with the application of the "proportionality principle" and the Capital Requirements Regulation. A commitment must be made to a level playing field and the use of objective parameters advocated that justify a specific regulation for each business model.

Cooperative banks play an important role as intermediaries for European Union instruments and programmes. Administrative requirements should therefore be simplified to give cooperative banks easier access to a role as an intermediary for European Investment Bank and European Investment Fund financial instruments. Simplification is a key element in implementing the Juncker Plan. That would represent recognition of the role that these institutions' financial, social and territorial functions have been playing in implementing the Europe 2020 strategy, while supporting implementation of the social business initiative.

The presence of cooperative banks in small towns, particularly in rural areas, gives them a comparative advantage over other banks due to their close ties to the region through their extensive networks of small branches, which puts them within easy reach of their customers (local banking), to community interests and to civil society organisations. This strategy is something that sets the cooperative banking business model apart, by strengthening territorial cohesion, and social and financial inclusion.

In the current financial environment, there is a pressing need to survive by cutting costs, reducing capacity, attracting capital and lending money. Among the important points, there

are two critical ones, which are intrinsic to the banking business: boosting profitability and increasing efficiency. Branch and staff downsizing is a strategic priority for cooperative banks, as is the transformation of the branch, which will be more focused on financial advice than on transactions in future. Likewise, the financial distribution model (physical branches and digital channels) must be more efficient for profitability to be sustainable.

Specifically, Rabobank Group is implementing a restructuring plan to make its business units more efficient by reducing workforces over the coming years and reassessing its branch network (operational efficiency and reduced distribution costs). For its part, future strategies for Crédit Agricole's model focus on rationalising the network by reducing the number of local and regional cooperative banks, deepening mutualism, and bolstering growth. One of the best ways for a bank to increase its profitability is to use economies of scale to cut costs.

The economies of scale debate in cooperative banking seems clear, given how small many of the institutions are and the new capital and digital transformation requirements. Therefore, the way is being paved for another wave of European mergers in the context of banking union but, at the same times, regulators are assuming that cooperative banking models are generating less risks than others and this fact is balancing the last financial regulation. It is a question of increasing competitiveness, size and efficiency through consolidation of the cooperative banking sector.

Consolidation processes under way within European cooperative banking include the DZ Bank/WGZ Bank merger in Germany and the Banco Popolare/Banca Popolare di Milano in Italy. The weakness of Italian banks is threatening to unleash another storm in the markets. It therefore seems logical that cooperative banks should contemplate consolidation processes as a future strategy; they would confer financial solidity, reduce risk and make management more efficient. In short, cooperative banking reform is not complete.

The continuous mergers that have been taking place within the European cooperative banking sector have resulted in a trend towards a two-level organisational structure; in scrapping the regional level, the strategy is to maintain a presence at municipal level as well as representation at national level. However, the predominant consolidation choice for adapting cooperative banks to the future is the mixed model, in which a parent institution is owned jointly by cooperatives and public limited liability companies. It also represents a guarantee that the cooperative banking model is here to stay.

That is the route followed by the Cajamar cooperative group and Banco de Crédito Cooperativo, its parent bank, whose founding purpose was to be an instrument for the merger of some Spanish agricultural banks. Its strategic vision is to lead all those agricultural banks in a single joint project based on people and cooperation, so as to keep growing and make Spain's cooperative banks competitive.

The growth of the sector offers many opportunities for developing cooperative banks' strategies for expansion within the national market and, in particular, internationally, with particular focus on the agricultural and horticultural sectors. Cooperatives also play a considerable role in the banking and insurance sectors. For example, Rabobank Group's organisational model includes the Rabobank International division. One initial target is to

achieve a strong, robust financial position and, in particular, to have a clear international expansion strategy.

Should the cooperative banks diversify their sources of revenue and thereby hit the cost-cutting target set by the institutions, that would improve the sector's health. One solution urged by the European Central Bank itself is to boost revenues from charging. The adoption of this strategy is focused on promoting investment-fund sales, insurance, savings products, ATM charges and loss leaders to attract customers and achieve the cross-selling of products. Specifically, it is a case of bringing in revenue on the basis of banking service charges, as well as the traditional proceeds of interest. Cooperative banks can apply the strategy of universal banks, which entails providing a comprehensive range of financial services.

The carefully calibrated use of technological innovation and of the digital transformation (internet banking, mobile banking, etc.) could contribute to making the distribution of financial products and services more efficient, meet the demands of customers such as the millennials and tackle competition from the FinTech firms and technology giants. That represents a challenge for the traditional business and requires major outlay from cooperative banks.

Families and SMEs are the traditional customers of cooperative banks, which are the major financial support for agri-food cooperatives and companies in Europe's more advanced countries. Nevertheless, there is currently competition in the market for their lending operations from non-bank forms of financing (crowdfunding, venture capital, business angels, etc.) which have, in large measure, emerged as a result of the credit crunch and the stringent guarantees demanded. In the face of growing competition and the increasing complexity of the banking business, cooperative banks need to bolster their internal risk-management systems. Their debt ratios and credit-risk indicators must show whether they are performing their role of serving SMEs and households properly.

The cooperative banks of the future need to make strategic decisions effectively. The multitude of adjustments and profound changes that are being introduced and those that will result from European banking union require cooperative banks to be more robust and efficient and to allocate growing risk responsibly. At the same time, transparency and good corporate governance need to be increased, while respecting the cooperative model based on social responsibility and ethics. Moreover, particular attention needs to be paid to staff-training and professional development strategies.

Ultimately, the major strategic orientations of European cooperative banks for the coming years should strengthen mutualism, stand strong in resisting regulatory and supervisory pressure and maintain key elements of the cooperative banking model, such as close relationships with customers, strong ties to their regions and a long-term focus. Likewise, bolstering capital, attaining an appropriate size and increasing efficiency must go hand-in-hand with maintaining the core attributes of a unique business model.

## 5. Conclusions and recommendations

The diversity of company types in Europe's new financial ecosystem – commercial and investment banks, savings banks, cooperative banks, non-bank finance mechanisms, FinTech firms, etc. – contributes to the stability and effectiveness of the financial system and adds to the development of the real economy. In the field of finance, bank business models now coexist with non-bank models; this maintains diversity in the financial services sector.

European banks have cleaned up their balance sheets since the global financial crisis and now have more liquidity, but the sector still has not adapted to the new regulatory environment, which entails a cost. Furthermore, low interest rates are weighing down on net interest income and undermining profitability. The priority goal of creating the single supervisory mechanism for European banking union is greater depth of analysis of business models in the financial industry to check that they are sustainable in the long term.

The turbulence in the financial markets in early 2016 was a warning sign which has led the European Central Bank to take a raft of anti-crisis steps (against the threat of another recession when the results of the previous one are still being felt). The intention is to stimulate economic activity through increased consumer spending and investment. The measures encourage banks to lend to households and businesses at reduced interest rates.

A framework is currently being set up to be shared by all financial institutions, which face common problems and challenges: profitability, reputation, regulation, the digital revolution and resilience. Consequently, the European Central Bank's single supervisory mechanism has identified a number of areas that require close monitoring: preventing banks from offsetting low profitability by taking on too much risk, high default rates, monitoring of banks' capacity to meet the new regulatory requirements on solvency matters, risk relating to governance, and continued close monitoring of liquidity.

There is a new process of change in European banking, which is expressed in the following ways: regulations are forcing banks to capitalise; the supervisor is demanding correction of the excess capacity that seems to be the rule at the moment; and bank directors are being asked to consider mergers as a solution to the sector's low profitability. Moving towards a model for running banks based on profitability and efficiency constitutes a future strategy to recover customer confidence and improve the banking sector's reputation.

In the new financial environment, political uncertainty, market volatility and the complexity of the banking business are all added to growing competition. New finance mechanisms, such as crowdfunding, are emerging as alternatives to bank lending, on the one hand, and new digital competitors are appearing, on the other. This means that, in the future, there will be a four-way interaction between the traditional banks, the new digital operators (FinTech), the regulator and consumers.

In the context of the European financial system, the cooperative banks offer a retail-banking business model, specialising in financial support for families, small and medium-sized enterprises, entrepreneurs, and local producers. As institutions with close ties to the real

economy (such as financing for the agri-food sector) since their origins in the 19th century, they seek to meet the new needs of their members and customers as a model for running a bank. Their governance rests on the cooperative principles of democratic decision-making and participation (one person, one vote). The EACB sums up the key values of the cooperative banking model as transparency, governance, resilience, proximity, social commitment and solidarity.

The financial crisis that started in 2008 had only limited effects on cooperative banks. The pairing of people and region is what has historically made cooperative banks highly resistant. However, some cooperative banks have suffered the consequences of moving away from their traditional business model, while others still face the challenge of capital requirements, relatively small size and tightening profit margins. Consequently, the restructuring process in Europe's cooperative banks is not yet complete.

Faced with this situation, both the European Central Bank and the European Banking Authority recommend that financial institutions: cut costs by closing branches and reducing workforces; carry out far-reaching cleaning-up of their balance sheets, given that banks in some countries have too many non-productive assets; and undertake more national and cross-border bank mergers.

In Europe, cooperative banks have approximately a 26% share of the market for deposits and they finance 27% of loans to SMEs. They have extensive branch networks, with a presence in small, rural towns, which enables them to be close to their customers (local banking) in the provision of financial services. In any event, the digital revolution and the change in customers' consumption habits is raising the prospect of a new people-based branch model for the future, more focused on financial advice than transactions.

The scaling-back of branch and employee numbers in recent years has been greater in the banking sector as a whole (40% and 10.3%, respectively) than the reduction for Europe's cooperative banks (3.3% and 4.6%). However, the threats in the new financial environment could push cooperative banks into adjusting their capacity to cut costs as part of more efficient management.

Increased efficiency is an essential requirement for cooperative banks to make their model sustainable and boost profitability. In 2011-2014, these institutions' efficiency ratio improved substantially: it was below 60% in 2014 (it was some 63% for the banking sector as a whole). Nevertheless, there is still much scope for a better ratio through cost rationalisation.

To return to pre-financial crisis levels of profitability, banks could adopt these strategies: cutting costs, encouraging new charges for customer benefits and negotiating mergers. The alternative of the European cooperative banking sector's consolidation process has not yet run its course. It will entail redrawing the banking map of Europe.

In 2014, European cooperative banks' average return on equity was 6.8%, above the banking sector average of 6%. As for cooperative banks' capitalisation level, it was over 12%, which was 0.4% higher than the ratio for the banking sector as a whole. The fact that cooperative

banks channel a significant proportion of their earnings into bank reserves helps to bolster their capitalisation and gives those institutions sufficient capacity to weather adverse situations (more resilient).

Notwithstanding the above, the European experience reveals the tendency to increase the average size of cooperative banks and confirm the process of consolidation through mergers and acquisitions, particularly in countries such as Germany and Italy. Specifically, the merger of the German cooperative banks DZ Bank and WGZ Bank will create the country's second-largest financial institution, after Deutsche Bank, with total assets of EUR 500 billion. The strategic, commercial and regulatory synergies are substantial, and the merger will lead to annual savings of at least EUR 100 million.

To resolve the problem of cooperative banks' solvency in Italy, a reform was started in 2016 to make these institutions part of a large cooperative banking group run by a public limited liability company, which will have over EUR 1 billion in capital. This holding company, which will oversee and coordinate the operations of its small partners, could become one of Italy's three strongest banking groups, along with Intesa Sanpaolo and UniCredit, and could be the largest institution in the cooperative banking sector. For the moment, in the Italian cooperative banking sector, the merger of Banco Popolare and Banca Popolare di Milano (BPM) has already been announced.

The process followed by Europe's cooperative banks in mergers and acquisitions is as follows: the local cooperatives continue to serve their members and customers and maintain their own governance and management bodies, staff and branches. Meanwhile, the group's parent company is what guarantees the institutions' solvency; it provides resources and financial muscle, in such a way that, should one of the institutions run into difficulties, the group would provide it with the capital necessary to resolve them. What actually makes the group consolidated is that business is pooled and earnings are mutualised. That is the initiative that Spain's Cajamar cooperative group is following, having joined forces with institutions of a huge range of sizes in 2014, to set up Banco de Crédito Cooperativo. The mechanism known as the IPS – or "cold merger" because of the weakness of the initial commitment – has entailed unprecedented consolidation, as a guarantee system not backed by public funds, to shore up the mutualist nature of cooperative banks.

The purpose of the trend towards consolidation in cooperative banking is to abolish the regional representation level because a two-level structure – local and national – is preferable. Under this system, local cooperatives each carry out their activities in their own areas, while being incorporated or assisted into a large national group. That is the case with the most robust cooperative models, such as those of the Netherlands (Rabobank) and Germany (DZ Bank).

Diversity is characteristic of the cooperative banking sector, which still has large numbers of customers in Europe. By country, it has considerable market power in Germany, France and the Netherlands, while its relative importance is less in Italy and Spain. For its part, the European Union is promoting larger banks and a move towards consolidation of the smaller ones, as a solution to low profitability. Therefore, size, growth, competitiveness, cost-

cutting, increased efficiency and greater profitability are cooperative banks' strategies for the future.

Specifically, the major strategic orientations of the French cooperative model (Crédit Agricole) for the coming years provide for increased mutualism by rationalising the structure (fewer regional and local banks) and the branch network and by taking part in diversification and foreign expansion operations. Cooperatives need to seek new ways of offering benefits to customers and strengthening ties with their members. That will set them apart from the competition and create a comparative advantage.

Ultimately, in Europe's recently created banking union, it will be capital, solvency and profitability needs that could oblige cooperative banks and other small-scale financial institutions to undertake further restructuring to keep growing and competing in the national and international financial market.

In the new transformation of the financial industry and of cooperative banks, technological and product-innovation strategies occupy a priority position in the face of the advent of the digital revolution and the demands of the 21st-century financial consumer, such as the millennials, who have grown up with digital and are used to virtual financial transactions and small numbers of physical branches.

Cooperative banks must improve their commercial strategies in an environment where new competitors are arriving. They need to marry digitalisation with customer services and increase transparency. Another important step is moving forwards with customer protection, by adapting some core principles of MiFID II when marketing products online. A balance between the interests of institutions and customers is crucial. Regulation alone is not a silver bullet. Competition itself will also force cooperative banks to compete for the best customer satisfaction levels.

Any cooperative bank that aspires to a sustainable business model needs to foster transparency and good governance, establishing codes of conduct to ensure professionalism in the various ways interests are represented in their governing bodies. Likewise, a genuine effort towards corporate social responsibility, education to improve the financial culture, internal and external communication of the benefit of cooperatives and improved visibility within society are recommended.

Value creation for local economies supports the focus on stakeholder value, which is in line with cooperative banks as a model for responsible and sustainable banking. In turn, the development of tools that strengthen best banking practice and the incorporation of financial and non-financial information (social, environmental, governmental) to measure the contribution of intangible assets to running a banking business and its compliance with EU rules are considered essential.

To achieve these goals, greater involvement of the employers' association representing these institutions – the EACB – is recommended, both in international forums, and in the future projects of the financial regulators and supervisors in the context of European banking union. In the coming years, the process of change for the cooperative banking

sector must be visible and the business must be profitable, so that the sector provides solidity and stability while maintaining the principles and values that are its defining features within the European economy.

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