economics as if people and the planet mattered

Stakeholder Banks

Benefits of banking diversity

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nef (the new economics foundation) is a registered charity founded in 1986 by the leaders of The Other Economic Summit (TOES), which forced issues such as international debt onto the agenda of the G8 summit meetings. It has taken a lead in helping establish new coalitions and organisations such as the Jubilee 2000 debt campaign; the Ethical Trading Initiative; the UK Social Investment Forum; and new ways to measure social and economic well-being.

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Executive Summary

Stakeholder banks have both social and financial objectives, and make a major contribution to financial stability, local economic development, business lending, and financial inclusion. Banking policy should explicitly recognise their role as distinct from that of commercial banks, and aim to promote and preserve them.

We surveyed data from 65 countries to identify successful alternatives to commercial banks, which we define as banks that have the main objective of maximising shareholder value. Four distinct forms were identified: cooperative banks, credit unions, community development finance institutions (CDFIs), and public interest savings banks. Their common characteristic is the goal of creating value for stakeholders, not just shareholders. Several trends emerge across all four types of bank:

- Greater focus on the needs of customers, including more competitive products, better service, and longer term lending.
- Explicit aim to provide for customers who are underserved by commercial banks.
- Positive impact on local economic development through lending to small and medium businesses, preventing capital drain from regions, and maintaining branch networks.
- Positive impact on financial stability through less volatile returns, higher levels of capital, prudent balance sheets, and expansion of credit provision after the financial crash.

Criticisms that stakeholder banks are inefficient and distort competition are found to be unconvincing. However, lack of access to capital is a constraint on growth, and there are lessons to be learned from those institutions that failed during the financial crisis.

We conclude that certain factors are critical to the success of stakeholder banks:

- Maintaining independence of locally focussed and controlled institutions, while collaborating in networks to gain economies of scale, expertise and pooled liquidity and risk through central institutions and infrastructure.
- Favourable regulation that recognises the distinct nature of stakeholder banks, and does not force them to become more like commercial banks.

We recommend that banking policy explicitly acknowledges the benefits of banking diversity – including to global financial stability – and seeks to nurture a vibrant stakeholder banking sector.

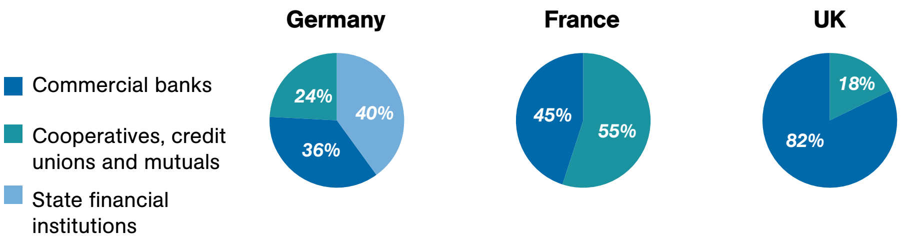
1. Introduction

Many countries have a mix of commercial banks and alternative financial institutions that pursue both social and financial goals. In this report we examine four different models of such 'stakeholder banks', assess their benefits and pitfalls, and draw conclusions for banking policy.

Some countries, such as the UK, are dominated by a small number of very large commercial banks listed on stock exchanges. However, international comparisons reveal a diverse range of thriving alternative banking institutions. For example, in France cooperative banks have a larger share of the banking market than commercial banks, and Germany has a 'three pillar' banking system comprising commercial, cooperative and state-owned savings banks (Figure 1).

We identified four distinct forms of alternative financial institution with different characteristics. However, we also found one unifying theme that set them apart from commercial banks. Instead of having a single overarching objective of maximising shareholder value, they all seek to balance profit with social goals, or in other words to maximise stakeholder value. Hence we refer to them as stakeholder banks.[1]

Figure 1 – Market shares of deposits in Germany, France and the UK



Source: World Bank (2011)[2]

For this research we examined 65 countries across four income groups (20 high income, 18 upper middle income, 19 lower middle income and eight lower income) to explore the prevalence of alternative banking institutions. We looked in more detail at countries where alternatives appeared to thrive and assessed the advantages and disadvantages of the different types of institutions, how they fared during the financial crisis, and the factors in their success. Finally, we put forward recommendations on how governments can encourage and foster such institutions.

The research was conducted by interviewing alternative banking institutions, their trade groups and other experts (listed in the appendix), by analysing data sets provided by central banks and other institutions, and by examining existing academic and policy research into the different sectors.

2. Four Forms of Stakeholder Bank

Stakeholder banks have a broader set of objectives than simply maximising profits, including customer value, financial inclusion, and local economic development. They are usually small local institutions that collaborate in networks to gain economies of scale. We examine four models: cooperative banks, credit unions, community finance development institutions (CDFIs), and public savings banks.

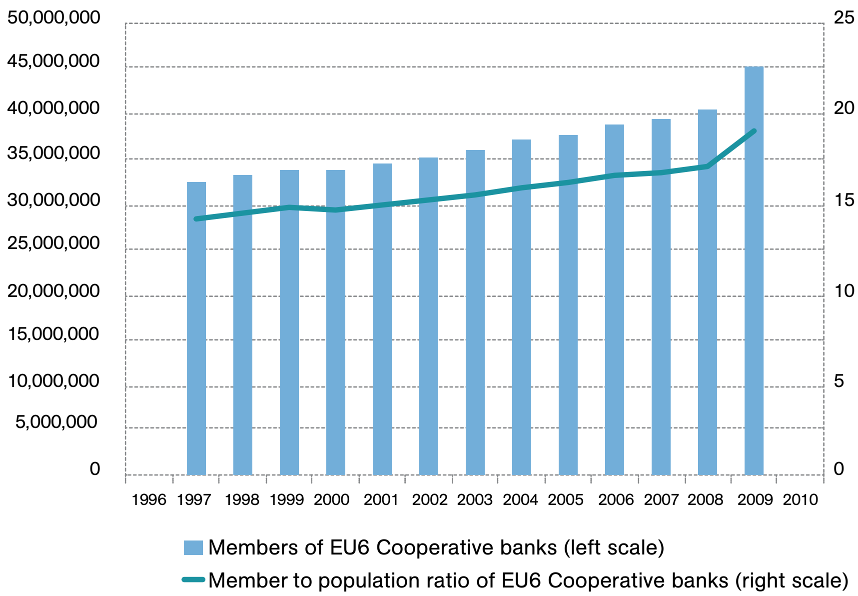
2.1 Cooperative Banks

Although varying in size and structure, cooperative banks have a significant presence in many countries. In Europe alone, there are 4,200 cooperative banks with 45 million members that operate 60,000 branches and serve 159 million customers.[3]

Financial cooperatives emerged in the mid-nineteenth century out of self-help movements that believed they could work together to cater for the needs of communities not served by commercial banks. They typically focus on personal savings and loans, mortgages, and SME lending within a specific local area.

Cooperative banks survived the financial crisis and maintained or expanded service better than commercial banks[4], and have not suffered anywhere near the same level of reputational damage. The number of customers and members of cooperative banks increased between 2007 and 2010[5] (see Figure 2).

Figure 2 – Membership of European cooperative banks



Austria, Finland, France, Germany, Italy, and the Netherlands. Source: 'The value of European Cooperative banks for the future financial system.' Hans Groeneveld [6]

Cooperative banks are owned and controlled by members on the basis of one vote per person, rather than by shareholders in proportion to their financial stake. Any customer can choose to become a member by investing a small amount of money in the cooperative. However, unlike commercial banks, members of cooperatives cannot sell their stake to a third party and do not have any legal claim on the profits or capital accumulation of the bank.[7] Cumulative profits are owned by the cooperative itself and used to reinvest in the business by, for example, reducing borrowing rates or increasing savings rates to invest in community projects, to be paid out to members in the form of dividends, and to accumulate a prudent capital endowment for current and future members.

Mutuals are similar to cooperatives, but customers of mutuals automatically become members without having to buy a share. Building Societies in the UK are a type of 'mutual' that traditionally focus on providing mortgages, although they also provide other retail banking products and services

Cooperatives have developed large formalised networks with central institutions that enable them to achieve economies of scale in a wide variety of activities, including systems and product development, public relations, marketing, risk and liquidity management, training programmes, and lobbying efforts. Some central institutions also help coordinate intra-network deposit guarantee schemes, which help increase stability and confidence within the group and improve individual cooperatives' credit ratings.

2.2 Credit Unions

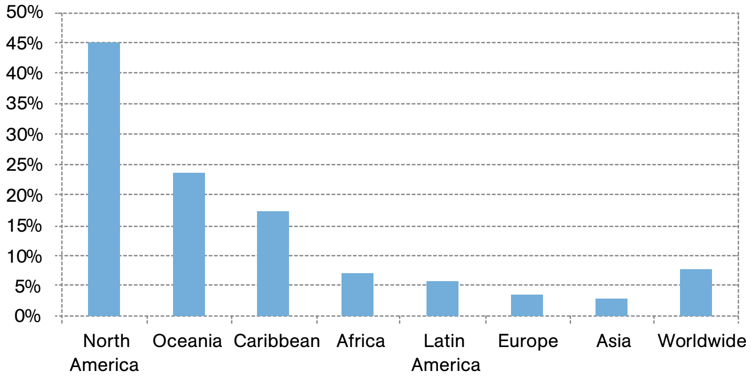
Credit unions are a type of non-profit financial cooperative that offer a restricted range of financial services to members within a community that shares a 'common bond' such as living or working in a particular geographical area, or working for the same organisation. These close relationships help them to assess loans and ensure repayment. They often focus on the needs of the most financially marginalised.

Friedrich Raiffeisen is credited with starting the credit union movement in 1864 in rural Germany where communities were overlooked by mainstream banks. These formed the basis of today's cooperative bank movement in Europe. In Canada and the USA credit unions arose in the early 1900s and took off during the Great Depression.

Credit unions are regulated under different legislation from banks, including cooperative banks. They can only provide services to their members, not the general public, and are classified in many countries as non-profit[8] institutions, receiving tax breaks on the core activity of lending to low-income households. However, credit unions vary enormously in scale, scope, and professionalism from substantial financial institutions to ones run by volunteers from a church hall.

According to the World Council of Credit Unions, in 2011 there were over 51,000 credit unions operating in 100 countries, serving over 196 million members, and managing over $1.5 trillion worth of assets.[9] The prevalence of credit union membership across continents varies considerably from 3% in Asia to 45% in North America (Figure 3).

Figure 3 – International comparison of Credit Union membership



Source: World Council of Credit Unions[10]

One of the keys to the success of credit unions in Canada and the US has been the formation of networks that share central services. For example, Canada has a three tier system, with credit unions being supported by regional centrals, which are in turn supported by one national central called the Credit Union Central of Canada. Credit unions participate in a shared liquidity pool and gain access to the payments system through the central. Corporates in the US have been around since the 1970s and serve a similar function.

In the US, credit unions can also achieve economies of scale on activities by buying a stake in a Credit Union Service Organisation (CUSO), which serves two roles:

- Pooling operations, for example by running ATM and branch sharing networks.
- Operating as brokers to help sell insurance products and investment products to credit union members.

As a result of centrals, corporates and CUSOs, North American credit unions are able to offer a large suite of financial products, including cheques, credit cards, debit cards, and money transfer services.

2.3 Community Development Finance Institutions (CDFIs)

CDFIs are specialised financial institutions whose mission is to provide financial products and services to people and communities underserved by traditional financial markets. These markets can be defined in terms of low-income, ethnicity, geography or even the sector in which they operate. This form of stakeholder bank is most developed in the USA, although a smaller sector also exists in the UK. In this report we focus on US CDFIs, which emerged in the wake of legislation aiming to end discriminatory practices in banking.

CDFIs are accredited and regulated by the CDFI fund, part of the US Treasury Department. As of 2010 there were 907 certified CDFIs in operation in the United States of which 54 per cent were cooperatives, 37 per cent non-profit and 7 per cent for profit enterprises.

There are also a number of wholesale funds and holding companies registered as CDFIs. The wholesale funds allow CDFIs to access capital markets by pooling investment opportunities to spread risk for investors, aggregating and standardising data, and reducing transaction costs.

CDFIs take a variety of forms, of which there are four main types:

Community Development Banks (CDBs)

CDBs are fully regulated depository institutions that offer a wide range of banking and financial services to low income communities. They are for-profit, private corporations with community representation on their boards of directors. They are covered by Federal Deposit Insurance and must meet strict self-sufficiency criteria. This means that CDBs must cover their costs from earned income, unlike non-depository CDFIs that can be more reliant on grants and donations.

Community Development Credit Unions (CDCUs)

CDCUs are non-profit financial cooperatives owned by their members. They provide affordable credit and retail financial services to low-income people, often with special outreach to minority communities. Unlike in the UK, CDCUs can offer mortgages and business loans. Whereas traditional credit unions exist simply to serve the interests of their members, CDCUs have a specific mission of serving low-income or minority communities. More than 60% of CDCUs are chartered in areas designated as economically distressed by the CDFI fund. CDCUs are also covered by Federal Deposit Insurance and must be self-sufficient, although they often rely on volunteers to keep operating costs low.

Community Development Loan Funds (CDLFs)

CDLFs provide financing and development services to businesses, organisations, and individuals in low-income communities. They tend to be privately owned non-profits with community representation on their boards. They do not take deposits and so can therefore be more reliant on grants and donations. The majority of CDLF funding comes from bank loans with the remainder comprising grants, donations and retained income.

Community Development Venture Capital (CDVC)

CDVC funds provide equity and quasi-equity for SMEs in low-income areas. They can be either for-profit or non-profit and include community representation.

2.4 Public savings banks

Savings banks emerged in Europe to encourage thrift amongst the poor, and were typically set up by municipalities or local philanthropists. They now have a dual financial and social mission to serve a defined local area and address financial exclusion, while operating on a commercial and financially sustainable basis.

They concentrate on retail banking – SME financing, personal banking including mortgages and funding community projects – and are primarily funded by customer deposits rather than inter-bank or wholesale lending. They do not engage in trading or investment banking activities.

Germany, Switzerland, Spain and Austria have significant savings banks, while Belgium, Italy and UK used to have such institutions but allowed them to consolidate and become privatised.

Public savings banks have much in common with cooperative banks, with key differences in ownership and governance. Their ownership structures often reflect a public interest mandate. For example, German savings banks are public law institutions for which local governments act as the responsible institution. However, they do not have ownership rights over profits or capital, or the right to sell the bank. Swiss Cantonal banks can have minority private shareholders who are usually people or institutions in the region.[11]

They generally have a stakeholder governance structure with an Executive Board made up of banking professionals who have operating responsibility and report to a Supervisory Board, which is generally composed of a wider group of stakeholders including staff, representatives of local government, and customers.

Savings banks also typically operate decentralised networks with central institutions to pool services and gain economies of scale. German Sparkassen co-own regional banks, called Landesbanken, to help them manage liquidity, engage in investment banking activities, and handle larger corporate clients. They also have a mutual guarantee system to protect customer deposits. Deka-Bank acts as the central institution for the Landesbanken network, and specialises in investment management.

However, not all savings banks developed regional and central infrastructure. For example, the Spanish Cajas have never formed such institutions.

3. Benefits of Stakeholder Banks

The essence of stakeholder banks is to deliver broader social and economic value. They fulfil a social mission and have a strong positive impact on local economic development. In general, they deliver more stable returns and lending than commercial banks and performed well during the financial crisis.

All four forms of stakeholder bank examined in this report share a defining difference from commercial banks. Instead of maximising profits for shareholders, they explicitly aim to deliver a range of broader benefits to stakeholders while earning sufficient profits to ensure financial sustainability and security. This strategy yields benefits for customers, for the community, for local and national economies and even for the global financial and economic systems.

3.1 Stakeholder value

The democratic nature of many institutions might be counted as a good in itself, particularly in the case of cooperatives, including credit unions, which offer individual members a direct influence over the important institutions in their local community on the basis of one person one vote.

Furthermore, it is argued that because stakeholders have no legal claim on profits or capital, but act more as stewards than owners, they take a long-term view and prudent attitude to risk instead of being incentivised to maximise short-term gains. We found evidence of better deals for customers, willingness to provide longer-term lending and lending to a broader range of non-financial sectors.

Better deals for customers

US credit unions, on average, offer higher deposit rates and lower loan rates than commercial banks.[12] Similarly, they perform significantly better than commercial banks when it comes to customer satisfaction.[13] Canadian credit unions also seem to perform better than other types of banks in customer satisfaction surveys.[14]

Savings banks in Finland on average paid higher deposit rates than commercial banks between 2003 and 2011.[15] Similarly, savings banks in Switzerland attract 35 per cent of deposits and savings despite only accounting for 16 per cent of total banking assets in Switzerland.[16]

Willingness to provide longer-term lending

Sparkassen outperform commercial banks at long-term lending to domestic enterprises. In 2012 commercial banks provided 46 per cent of short-term lending to domestic enterprises compared with 33 per cent from Sparkassen. However, commercial banks provided only 20 per cent of long-term lending compared with 45 per cent from Sparkassen.[17]

Lending more to non-financial sectors

In 2012, German Sparkassen lent over three times as much to enterprises and households as they lent to other banks.[18] In contrast, commercial banks' lend slightly more to banks than non-banks. Even within commercial bank lending to non-banks, one quarter was to insurance and finance companies, whereas Sparkassen non-bank lending was spread much more widely across different sectors of the German economy.[19]

3.2 Social mission

Financial inclusion and literacy

Credit unions and CDFIs in particular aim to reach people who are excluded from access to commercial banks, and are vulnerable to high-cost credit providers. People without basic bank accounts find it difficult to get formal employment, and often end up paying more on their utility bills.[20] In Canada, 38 per cent of the communities in which credit unions are located have no other financial institution.[21] Credit unions and CDFIs also often actively seek to increase financial literacy amongst their membership. Savings banks have also been found to play a key role in tackling financial exclusion.[22]

Community investment

In 2010 Canadian credit unions gave, on average, 4 per cent of their pre-tax income to community projects compared with 1 per cent from the five biggest commercial banks.[23] In 2006 Spanish savings banks made investments of €1.7 billion in community and environmental projects generating 34,816 jobs,[24] and German Sparkassen invest approximately €500 million per year in community projects.[25]

3.3 Local economic development

SME lending

Local banks can maintain intimate knowledge of local people and the local economy, and evidence suggests that they are better than commercial banks at seeking and assimilating the 'soft' information needed to holistically assess the prospects of small firms.[26] In contrast, commercial banks in search of cost savings have relied more heavily on centralised 'credit scoring'[27] and have withdrawn from local relationship banking.

Large banks also appear to lend proportionally less to SMEs than smaller banks.[28] For example, in 2010 cooperative banks had a significantly larger share of SME loans than their overall market share in Austria (46 per cent of SME loans, compared with 33 per cent of all loans), Germany (28 per cent vs. 17 per cent) and the Netherlands (43 per cent versus 29 per cent).[29]

Credit unions in Canada have 17 per cent of the SME lending market, despite holding only 5 per cent of total banking assets,[30] and they have nearly doubled their share of the SME market over twenty years.[31] SMEs report that they value the lower turnover of branch managers than at commercial banks, as this allows the formation of long-term relationships and understanding.

Savings banks also play a vital role in supporting local SMEs, with 80 per cent and 58 per cent of medium and small Swiss enterprises respectively having a relationship with their Cantonal bank, and 75 per cent of German SMEs banking with their local Sparkassen.[32]

Preventing capital drain from local economies

Empirical studies in Italy[33] and Germany[34] found that cooperative banks and savings banks help reduce 'capital drain' to urban centres and thus regional inequality, most probably because of their strong SME lending. Preventing such a capital drain can help create jobs and encourage people to stay in their local area, rather than having to migrate to economic centres to look for work.

Branch access

Cooperatives provide more extensive branch networks than commercial banks, increasing their share of European bank branches over the past fifteen years from just under 25 per cent to over 28 per cent,[35] and frequently concentrating their branches in more sparsely populated areas that are neglected by commercial banks. Despite the rise in digital banking, branch services are still essential for small businesses and individuals who are not online or who need more personal assistance. Branches are also crucial infrastructure for maintaining close face-to-face relationships with customers.

3.4 Safety and stability: performance during the crisis

Less risky activities

Cooperative banks engage less in speculative activities. For example, derivatives account for 28 per cent of German commercial banks' balance sheets, but only 14 per cent of cooperatives' central institutions and none for local cooperatives.[36] In the UK, derivatives account for over a third of the balance sheets of RBS and Barclays but only 2 per cent for the Cooperative Bank.[37]

Although accounting for one fifth of the entire European banking market[38] cooperative banks suffered only 8 per cent of total losses incurred during the financial crisis. In contrast, UBS alone accounted for 12 per cent and HSBC for 10 per cent.[39] No cooperative network needed to be nationalised.[40]

The Credit Union Central of Canada reported that credit unions simply were not involved in the risky ventures that caused problems during the crisis. Credit unions in the US had a more mixed fate, with central institutions requiring bailouts but local credit unions generally performing better than commercial banks during the crisis.

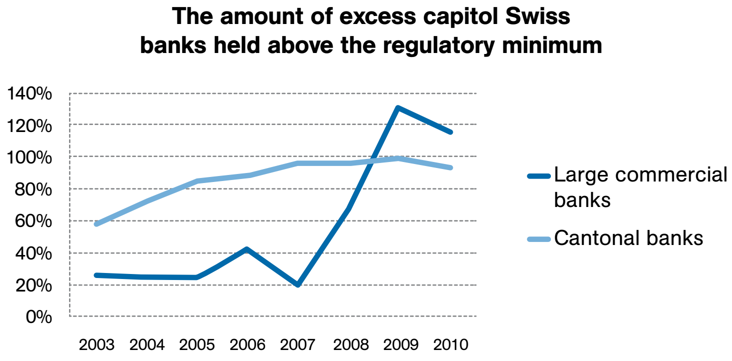
In response to the financial crisis, US CDFIs are effectively fulfilling missions by increasing lending activity at the expense of higher default rates then their conventional peers, but have demonstrated sound financial and risk management in doing so.[41]

Savings banks tend to have conservative balance sheets, for example with Sparkassen having over 60% of their assets in loans to non-banks and over 70% of liabilities being customer deposits.[42] As we examine later, the Spanish Cajas and German Landesbanken were exceptions to this.

Higher capital

In general, stakeholder banks were better capitalised before the crash than commercial banks. European cooperative banks had higher average core capital ratios (4.7 per cent vs. 3.6 per cent) and higher Tier 1 capital ratios (9.2 per cent vs. 8.4 per cent).[43] In 2010 the average US credit union capital ratio was 10 per cent, despite the fact that the regulatory minimum was 6 per cent.[44] In 2007, Swiss commercial banks only held capital 20 per cent above the regulatory minimum in comparison to the Cantonals' 96 per cent (see Figure 4).[45] Commercial banks capital ratios only overtook savings banks as a result of state bailouts.

Figure 4 – Excess capital held by Swiss banks

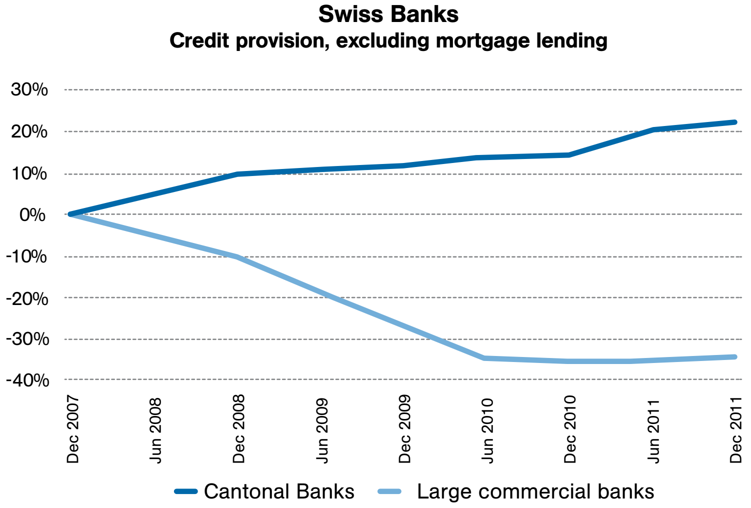


Source: Swiss National Bank[46]

Stable credit provision

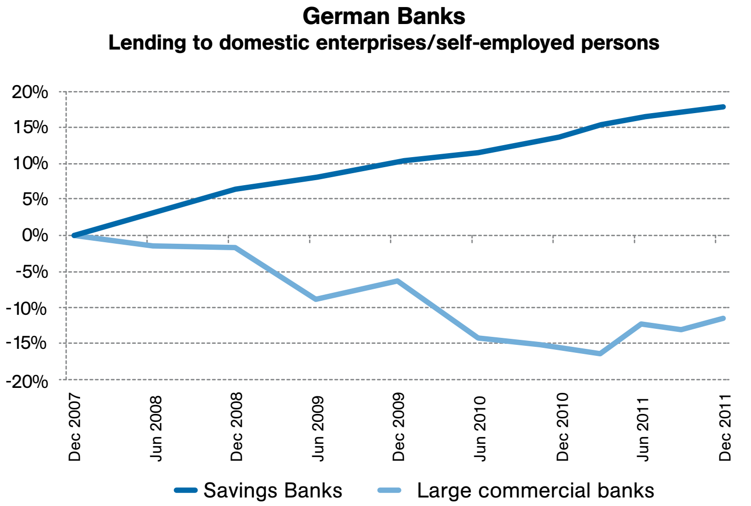
Since the financial crisis, Swiss Cantonal banks have increased their stock of lending, excluding mortgages, by 23 per cent compared with a contraction of 34 per cent by UBS and Credit Suisse (Figure 5). Similarly, German Sparkassen increased total outstanding loans to domestic enterprises and self-employed persons by 18 per cent whilst the large German commercial banks decreased by 12 per cent (Figure 6).

Figure 5 – Credit provision by Swiss Banks



Source: Swiss National Bank, Monthly Bulletin of Banking Statistics TABLE 3A

Figure 6 – Credit provision by German Banks



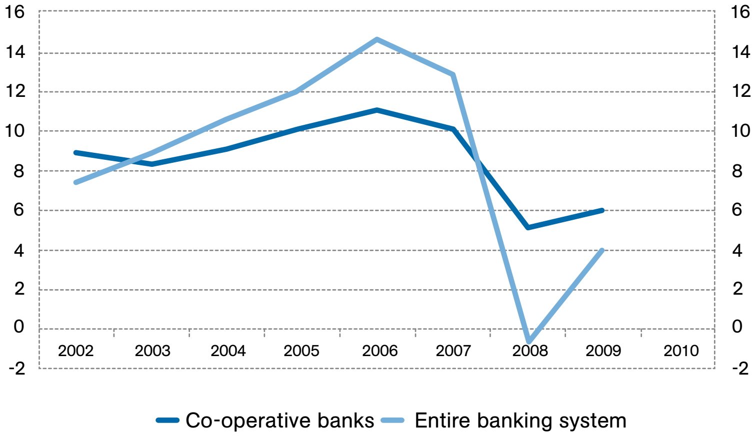
Source: Deutsche Bundesbank, The performance of German credit institutions

In 2008, Canadian and US credit unions both expanded lending by 7 per cent,[47] while US commercial banks cut back by 7 per cent.[48] US credit union loans to small businesses increased by 30 per cent between 2007 and 2009, and by 40 per cent in 2010.[49] In 2009 European cooperatives in total increased their lending to non-financial firms by 3.5 per cent compared with a decrease of 1 per cent in lending from all other banks combined.[50]

Stable returns

The return on equity (ROE) and return on assets (ROA) of cooperative banks were both lower but more stable than commercial banks,[51] with the latter's ROE fluctuating nearly twice as much as cooperative banks (Figure 7).

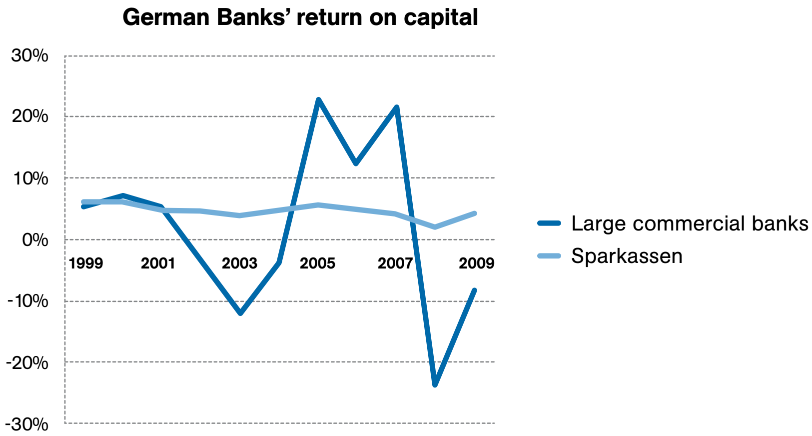
Figure 7 – Cooperative banks vs. commercial bank Return on Equity



Average Return on Equity for cooperative banks in Austria, Finland, France, Germany, Italy, The Netherlands, Spain, and Switzerland, vs. the return on equity for the entire banking systems in these countries. Source: 'The value of European Cooperative banks for the future financial system.'[52]

Savings banks have been found to be better at managing income fluctuations than commercial banks.[53] The German Sparkassen achieved both a higher average return on capital between 1999 and 2009 than commercial banks (4.7 per cent vs. 2.2 per cent), and a standard deviation nearly thirteen times lower (see Figure 8)

Figure 8 – German commercial and savings banks' return on capital



Source: Bundesbank[54]

Similarly, credit unions suffered fewer bad debts than commercial banks. For example, 5.4 per cent of American commercial banks' loans were delinquent in 2009 compared to 1.8 per cent for credit unions.[55] Overall, credit unions' loans appear to be 25 per cent less affected by economic downturns than commercial banks.[56]

There are exceptions, particularly where property markets have crashed. Credit unions in Florida and California ran into significant difficulties, as did credit unions in Ireland[57] where the majority of their loans were mortgages.[58]

4. Criticism of Stakeholder Banks

From the 1970s until the financial crisis, stakeholder banks came under sustained criticism on the basis of economic theories that favoured privatisation and financial deregulation. This led to the dismantling of the stakeholder banking sector in some countries such as the UK. How valid are these criticisms?

4.1 Political interference and lack of accountability

Public savings banks have been argued to be inherently corruptible. In Spain, local authority representation on the boards of Cajas was capped at 50 per cent due to concerns about political influence. This is a genuine and important concern and the two tier board structure is designed to ensure that members of the Supervisory Board cannot interfere with the day to day running of the bank or direct a bank for political purposes. In Germany regional supervisors carefully monitor the activities of the Sparkassen for any evidence of politically motivated investments and to ensure that they are abiding by business principles to meet their social mission. Few problems have arisen in Germany or Switzerland, which suggests that, as long as governance is properly designed, any dangers inherent in public interest ownership can be overcome.

Concerns about accountability also arise regarding the central institutions in cooperative and credit union networks. These are owned and controlled by local members, but as they have broadened their scope of activities, taken on an increasingly important role within the network, and hired staff with high levels of financial expertise, they also began to exert an element of centralised coordination and control over the network. Many, such as Rabobank, even have an explicit and formalised supervisory role over their network of local members.

Cooperative banks' central institutions and the US credit union 'corporates' did engage in similar risky activities as large commercial banks and thus also fell into trouble during the financial crisis. For example, Rabobank suffered heavy losses in trading and markets.[59] This highlights again the need to ensure that governance is weighted in favour of customers and other local stakeholders to keep stakeholder banks focused on their dual social and financial mission.

4.2 Capital raising and allocation

A feature of the stakeholder model is the inability to raise large amounts of capital quickly by issuing shares on a stock market. This was one of the main arguments for the demutualisation of many of the largest UK building societies in the 1990s, and in many other countries this prompted a move towards central institutions becoming 'semi-cooperatives' with an element of shareholder ownership.

However, access to capital markets need not be a constraint if the strategy of the bank is simply to grow its activities in line with its retained capital. Furthermore, it should mean that stakeholder banks are more cautious with how they deploy their capital because capital losses are harder to replace, as is reflected in their more prudent levels of capital. It does nevertheless represent a significant barrier to growth in countries where the stakeholder banking sector is small.

Stakeholder banks are not incentivised to seek the optimum use of their capital, which has been described as "capital in dead hands"[60] because stakeholders do not own it. However, it has become apparent since the financial crisis that a significant proportion of the capital invested by commercial banks went into unsustainable activities and unproductive sectors. The 'dead' capital held by stakeholder banks was instead, on average, invested in more sustainable, albeit less lucrative, products and services.

4.3 Inefficiency and poor quality management

Stakeholder ownership structures have been argued to tolerate inefficiency. Management are not subject to market discipline, because external parties cannot take over stakeholder banks and remove underperforming management. Without a sole focus on profit maximisation, they have no single, easily measurable target to judge performance. Finally, cooperative and mutual structures make it difficult to coordinate a large number of members with equal votes to hold directors to account. However, the regulation and scrutiny of management that cooperatives are subject to in many countries also helps to maintain quality of management.[61]

There are three notable cases of failures within the stakeholder banking sector: US credit union corporates, German Landesbanken and Spanish Cajas.

Failures within US credit union 'corporates'

US credit unions can belong to any corporate, so corporates compete to offer the highest returns on funds they hold on behalf of members. Corporates started to invest in mortgage-backed securities to boost returns; by 2007 they amounted to 37 per cent of their investments. By the end of 2008, US corporates had lost $33 billion on such products and five corporates, holding 75 per cent of all corporates' assets, had to be bailed out by the regulator, central bank, and Treasury department. Had the losses been covered by credit unions' deposits at the corporates, it is estimated that nearly one third of all US credit unions would have collapsed.[62]

The difficulties faced by US corporates during the financial crisis serve as a warning of the dangers of creating a centralised infrastructure that operates on the basis of competition. Canadian centrals do not compete with each other and have stayed focused on providing liquidity services, whereas American corporates became preoccupied with generating profits.

German Landesbanken

In Germany, Landesbanken made such heavy losses in the financial crisis that the Sparkassen were not able to bail them out without assistance from the federal government. BayernLB received €10 billion in state aid[63] and, with LBBW and HSH Nordbank, is undergoing extensive restructuring to return to core activities. Sachsen LB merged with another Landesbank, and West LB will be broken up completely. Why did the Landesbanken get into trouble?

During the period of financial market liberalisation prior to the financial crisis, Landesbanken were pressured into boosting profits and competing with the 25 per cent returns on equity posted by commercial banks. German commercial banks complained to the European Commission in the 1990s about the explicit state guarantees that Sparkassen and Landesbanken enjoyed, and these were removed in 2005.[64] This had a big impact on the Landesbanken who, unlike the depositor-funded Sparkassen, relied on wholesale money markets where they benefited from lower funding costs as a result of state backing.

There was a rush to take advantage of cheap state backed borrowing to expand internationally and to chase higher profits by investing in complicated, high-yielding financial products, such as mortgage-backed derivatives which later turned out to be worthless.[65] The Landesbanken became victims of the ambitions of their managers and political pressure to enter the territory of commercial banks.

It is important to note that the local savings banks, the Sparkassen, suffered few losses and required no government bailout.

Spanish Cajas

Prior to 1989, cajas were restricted to serving their local area with a limited range of retail banking activities. Policies aimed, once again, at improving efficiency and competition led to these restrictions being removed. This prompted a transformation in the nature of Spanish savings banks.

- Mergers and acquisitions reduced the number of cajas from 76 to 54 over the next twenty years.[66]
- Between 1991 and 2007, their market share of deposits increased from 45 per cent to 57 per cent, and of loans from 33 per cent to 49 per cent.[67]
- They significantly increased their exposure to residential and commercial property construction and mortgages.[68]
- Cajas changed their funding model from primarily customer deposits to wholesale money markets.
- They started to compete with one another nationally and try to outgrow their rivals.

Spanish property prices tripled in the ten years prior to 2007. In 2004 and 2005, half a million new properties were built per year. By the end of 2008, nearly 30 per cent of these were lying empty.[69] Developers and construction companies went bust and the cajas suffered ruinous losses on their loans. In a bid to prop up the sector, seven savings banks were merged in 2010 to form a new entity called Bankia, which was floated on the stock market to raise fresh capital. The bank still had to turn to the Spanish government for €19 billion in May 2012, which prompted them to request an EU bailout.[70]

The catastrophic failure of the Spanish cajas is cited as a failure of the local savings banks model. However, it is arguable that it proves the folly of deregulating such institutions and encouraging them to behave like commercial banks.

4.4 Distortion of competition

The European Commission pushed for the privatisation of public savings banks on the grounds that, because they could not legally be privatised, they undermined core EU principles of competition and the free movement of capital.[71] There was also much pressure from the academic community for the Sparkassen to be privatised.[72] State guarantees were removed from savings banks in Germany in 2005 and Austria in 2003.[73] However, the financial crisis has revealed the existence of implicit state subsidies for banks, whatever their ownership structure, that are considered 'too-big-to-fail' (TBTF). The implicit guarantee that governments will rescue such banks translates into lower borrowing costs, which puts smaller banks at a disadvantage and creates perverse incentives for banks to seek higher but riskier returns. In 2010, the four largest British commercial banks enjoyed a combined £45 billion TBTF subsidy.[74]

In fact, the financial crisis revealed the benefits of small stakeholder banks collaborating in networks. The German Sparkassen have a mutual guarantee system to protect customer deposits. If one Sparkassen gets into trouble the others will support it.

More broadly, evidence suggests that a diverse range of financial institutions in an economy can improve real competition, with an empirical study of Austria, Belgium, Germany, Italy, and Spain finding that the presence of savings banks helped enhance customer choice.[75]

5. Conclusions

Stakeholder banks create social and economic value and complement commercial banks by serving different markets. Banking policy should explicitly recognise their value and seek to preserve established stakeholder banking sectors, and develop them in economies with no significant stakeholder banks.

In section 3, we set out several benefits of stakeholder banks, namely that they:

- seek to maximise stakeholder value rather than just shareholder value, which can provide better deals for customers, as well as enabling provision of longer-term finance;
- have a social mission which may include provision to otherwise financially excluded communities, and investment in the community;
- promote local economic development by consistent support for SMEs, preventing capital drain from rural areas and regions, and maintaining access to bank branches even in remote areas, and
- contribute to financial stability by avoiding riskier activities, maintaining higher levels of capital, generating lower but more stable returns on capital, and increasing credit provision in the aftermath of the financial crisis.

It should be noted that we have not specifically examined the advantages and disadvantages of commercial banks, as we have taken it as a given that these will continue to be a significant, or even majority, component of the global banking system. Commercial banks are better suited than stakeholder banks to many activities, from investment banking to serving national and global corporations. However, there is clear evidence that they are less well suited than stakeholder banks to other equally important tasks. We conclude that a healthy and stable banking system requires both.

5.1 Success factors and dangers for stakeholder banks

Why have stakeholder banks prospered in some countries and not others? Where stakeholder banks have failed, what were the causes?

Local independence within collaborative networks

Stakeholder banks are most successful when they retain their local focus and governance, while working together in networks with shared central service institutions. These can achieve economies of scale, access to more specialist services and to national payment systems, and allow pooling of liquidity and risk. They have played an important part in the success of cooperative banks in Europe, German and Swiss savings banks and credit unions in US and Canada. The CDFI movement in the US also benefitted greatly from the establishment of the central CDFI Fund and formation of a coalition to lobby the federal government.

In recognition of this, legislation to facilitate central institutions for credit unions has been proposed in Ireland[76] and for mutuals in Australia.[77] In the UK some steps have been taken to, for example, gain access to post office branches, but this falls short of the central liquidity services and product development expertise available to US and Canadian credit unions. Furthermore, UK credit unions individually are unable to afford the IT investments needed to gain access to the payments system,[78] which acts as a barrier to expanding their customer base.

Risk of losing local focus

It is important to maintain the right balance between strong central institutions and local governance and control. There are risks of stakeholder banks losing their local focus. In Germany the number of Sparkassen decreased by 15 per cent, from 519 to 438 between 2002 and 2008.[79] This risk is heightened by the removal of geographical restrictions. This happened not only in Spain, but also in Austria where restrictions were removed in 1979, and savings banks subsequently expanded into Eastern Europe.

Credit unions are increasingly merging to achieve economies of scale to cope with rising technology and regulatory costs. Between 2005 and 2010, the number of US credit unions decreased by 16 per cent even as membership increased by 7 per cent to 90.5 million.[80] Despite Canadian credit union assets increasing by nearly 400 per cent between 1991 and 2010, the number of credit unions has decreased from 1133 to 386.[81]

The search for greater scale was one of the factors in the huge reduction in Building Society mutuals in the UK from 1723 to 49 over the 100 years to 2010. Building societies did not remain local and independent, preferring to grow into national companies through mergers.

In Canada, USA, and UK the common bond rules are being relaxed, with some questioning their continued relevance. However, it is the sense of common bond and strong social solidarity that makes credit unions distinctive. Legislation is reinforcing these trends; federal regulation which would allow credit unions in Canada to open branches nationally is anticipated from 2014–15.

Favourable regulation – The US regulatory structure for CDFIs

The Community Reinvestment Act (CRA) was passed in 1977 and has been the major force driving the growth of the CDFI sector. The Fair Lending Act of 1968 and the Equal Credit Opportunity Act of 1974 had been passed in the wake of the civil rights movement to tackle racial discrimination in financial services. However, the Home Mortgage Disclosure Act of 1975, which compels banks to disclose their mortgage lending by geographical area, revealed the ongoing discrimination as banks refused to serve entire low-income and minority neighbourhoods on the basis of their perceived higher risk, a practice known as 'redlining'.[82] Building on these previous acts the CRA places a legal obligation on banks to serve the needs of all communities in the area in which they are chartered as is consistent with 'safe and sound operation'.

However, it was not until the Clinton Administration strengthened the CRA by establishing a standardised examination and rating system for banks' CRA related performance, and strengthened sanctions available to regulators, that the act really gained traction.[83] The Clinton Administration also established the CDFI Fund in 1994, part of the US Treasury Department, to accredit CDFIs and help capitalise them through grants and investment that has to be matched by the private sector. The CRA has encouraged trillions of dollars in community development and small business lending since its inception.[84]

Unfavourable regulation and deregulation

From the 1970s onwards building societies in the UK were criticised for being inefficient institutions, and economic policies favoured privatisation and deregulation of markets. Changes in legislation in 1986 permitted members to cash-in on the historical cumulative capital of the building society, and during the 1990s approximately 70 per cent of building societies' assets were privatised[85] including all but one of the larger institutions. In recent years, policies based on similar theories of efficient markets have played a significant role in European cooperative banks moving towards increasingly less cooperative structures.[86]

Stakeholder banks can also suffer from regulation that is designed for commercial banks. For example, new European regulations for bail-in bonds (debt that converts into equity if a financial institution gets into trouble) were drafted without consideration of the very different set of rights held by members in cooperative banks. Furthermore, capital adequacy requirements that demand proportionately more capital for SME lending will hit cooperative banks harder.

Deposit insurance schemes have provided added pressure for small credit unions to merge as the fee structure favours larger institutions. A further downside to this is that regulators became more interested in preventing failures than in seeing new credit unions enter the market. For example, today it is very rare to see a new credit union chartered in the US.

Communication and advertising

Credit unions and CDFIs face additional challenges. First, they are relatively unknown to the general public. For example, Central 1 Credit Union in Canada reported that one of the key issues is the cost of media time, especially in larger cities. In London, 62 per cent of low-income people in need of a loan but unable to get one from a bank have not even heard of credit unions.[87] Secondly, in the case of credit unions, in order to attract the more affluent customer that can help achieve overall financial sustainability, they need to convince people that they are not a ‘poor man’s bank’.

5.2 Policy recommendations

If policy makers are convinced by the argument for preserving and promoting a vibrant stakeholder banking sector, there are a number of policy principles that should inform banking regulation.

- Stakeholder banks should be legally protected from privatisation, as is the case in Germany, but was not the case in the UK where the Trustee Savings Banks and mutuals sector have disappeared and the capital accumulated of hundreds of years sold to the stock market.

- Restrictions on geographical areas of operation should not be removed, and should perhaps be strengthened where strong central service organisations exist to provide specialist expertise and economies of scale to smaller independent local institutions.

- Restrictions on which products can be provided should be as light as possible for basic retail banking products. Particularly in the case of credit unions and CDFIs, the ability to offer a full portfolio of retail financial services from current accounts to mortgages and SME lending is crucial to achieving financial stability and attracting more affluent customers to cross-subsidise financial inclusion and education work.

- Facilitating the establishment of networks and central institutions which are tightly defined in their scope and governance to prevent them following the failed example of the Landesbanken and US credit union corporates in straying too far into commercial and investment banking territory. Credit Union Central of Canada’s view is that government grants are more usefully directed at creating central infrastructure than supporting individual credit unions.

- Provision of patient low-cost capital to allow the sector to grow is vital to build or rebuild stakeholder banks, because their ownership structures prevent them raising new equity capital from capital markets.

In summary

The purpose of this paper is not to argue that any given type of bank is inherently better than any other. The aim was merely to highlight that different types of banks all have different strengths and weaknesses, target different customers and markets, are comfortable taking on different types and levels of risk, and that all different business and ownership models should be valued, respected, and protected. A healthy range of financial players makes for a strong and vibrant economy.

It is our hope that this research will broaden the debate on banking reform, and encourage people to look outside of the institutions already present in their own country, to learn from other countries, and, in many cases, to look back and learn from their own histories.

Our findings and policy recommendations should hopefully be useful for countries looking to restructure their financial systems to be more stable and socially just in the aftermath of the financial crisis, for developing countries that are still in the process of growing their banking sector, and for EU regulators in considering how European banking reform can contribute to global financial stability. We believe that financial stability is a global public good, and that diversity of banking institutions, including a healthy stakeholder banking sector, is a key component in achieving this goal.

Appendix – List of organisations interviewed

Association of British Credit Unions Ltd (ABCUL)

Association of Enterprise Opportunity

Association of German Public Banks (VÖB)

Bristol Credit Union

Building Societies Association

CD Venture Capital Alliance

CDFI Coalition

Central 1 Credit Union

Community Development Bankers Association

Confederación Española de Cajas de Ahorros (CECA)

Consumer Federation of America

Co-operatives UK

Credit Union Central of Canada

Cultura Bank

European Association of Cooperative Banks

European Savings Banks Group

German Savings Banks Association (DSGV)

Glasgow Credit Union

Global Alliance for Banking on Values

Independent Community Bankers of America

National Association of Community Economic Development Associations

National Association of Credit Union Service Organizations

National Community Investment Fund

National Community Reinvestment Coalition

National Development Council

National Federation of CDCUs

Opportunity Finance Network

Rabobank

The Co-operative Bank

Ulster Federation of Credit Unions

University of Manitoba

Woodstock Institute

World Council of Credit Unions

Yorkshire Building Society

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