Panu Kalmi*

ETHICS, BANKING AND OWNERSHIP

1. WHAT MAKES BANKS ETHICAL?

At the very least, one could think that ethics in banking implies that the bank will not cheat its customers, banking authorities, or other market participants. Further, an elementary notion of banking ethics would recognize that banks would not engage in illegal activities, such as money-laundering, or would not accept deposits based on criminal activities or finance terrorist actions. A broader definition of ethical conduct in banking would perhaps include such items as good customer service, proximity to customers, financial inclusion, (non-predatory) lending to marginalized borrowers, transparency of operations, support of the communities where the bank is embedded, and avoidance of excessive risk. The list could go on, and some elements may be even somewhat contradictory: for instance, lending to marginalized borrowers is inherently risky.

In the next section, I present a simple model of risk shifting that illuminates the conflict between depositors and shareholders and presents shareholder incentives to gamble "with other peoples' money". Customer ownership through cooperative or savings bank structure solves this problem neatly. However, I point out that these structures have problems of their own. Then I move on to look at some empirical analysis on these issues, both systematic and anecdotal. Towards the end of the paper, I shift the focus to the benefits of organizational diversity in banking, on how banks in different ownership structures may foster that diversity, and also why ownership may not be a sufficient condition for diversity.

---

* Panu Kalmi is a Professor at University of Vaasa, Finland.

2. THE PROBLEM OF RISK SHIFTING

In the absence of a generally accepted measure of ethical conduct in banking, it is difficult to rank banks according to their ethical behavior, or to explore the trade-offs in behaving ethically. One possible and quite general starting point for the analysis of banking ethics would be the problem of risk shifting (John et al., 1991). The essence of risk shifting is that shareholders have a preference for excessively risky investments, and due to limited liability, they do not take into account the potential profits and losses symmetrically. Imagine the following situation. There are two projects, both of which require an initial investment of 110 euros at time T1. This is received from debt-holders, who invest 100 euros, and shareholders, who invest 10 euros. The investment is done at time T1, and the value of the project (V) will be realized at time T2. The debt-holders are promised a 5% interest (i.e. 5 euros) on their deposits at time T2. All the revenues in excess of what is promised to debt-holders accrue to the shareholders. However, it is also possible that V turns out to be less than 105. In this case, shareholders get nothing, and the value of the project is distributed to the debt-holders, who may either receive a positive interest (if V>100) or suffer a loss on their principal. In sum, the payoffs are

i) If V<=105, debt-holders' pay-off will be V-100 and shareholders' pay-off will be -10.
ii) If V>105, debt-holders' pay-off will be 5 and shareholder's pay-off will be V-10.

Now assume that the pay-off structures of the two projects are as follows. Project A has V=116 at time T2 for certainty. Project B has two possible outcomes: Either V=130 with a probability of 50%, or V=90 also with a probability of 50%. Thus, the expected value from project B is 110, and it is easy to see that from the social point of view project A is better. However, things look different from the point of view of shareholders. (Assume that both debt-holders and shareholders are risk neutral). When we calculate the returns from project A and B for debt-holders and shareholders, we find that

i) The return of project A to debt-holders is 5 (5%) and its return to shareholders is 1 (10%).
ii) The expected return of project A to debt-holders is -2.5 (-2.5%) and its expected return to shareholders is 2.5 (25%).

Thus, because of the asymmetric effect of profits and losses to shareholders (due to limited liability) shareholders would prefer the project with lower expected value at time T2. Assuming that equity investors can decide on which project to invest, this leads to suboptimal project choice.

So far this example has not been specific to banking, but it represents any investment partially based on debt, partially on equity. Another general result from

the model is that when the proportion of equity of total investment is increased, shareholders' interests become more aligned with the highest-value project A. Further, we have not asked why any debt-holders in their right mind would agree to invest in a project that has a negative expected value for them. Either they would increase their required interest rate in response of higher riskiness of project B, or require shareholders to put more equity (or both). All this would make project B relatively more costly from the point of view of shareholders, and make them more likely to choose project A.

However, once we substitute "depositors" for debt-holders, the issue becomes more relevant. In modern banking, due to deposit insurance (currently at the level of 100.000 euros in the euro area), depositors have little reason to worry about the riskiness of their deposit investment, at least as long as they think the deposit insurance is credible. Leaving deposit insurance aside for a moment, let me point a solution to the problem, which may appear somewhat trivial. What if depositors and shareholders are not two groups, but actually the same people? Clearly, in this case, the depositor-shareholders will choose project A, that has a combined pay-off of 6, rather than B, which is a break-even for the investors. In other words, the agency conflict between depositors and owners disappears in the situation where the parties are the same, and no-one has an incentive to gamble with "other peoples' money".

The main examples of customer-owned banks in the real world are cooperative and savings banks.[1] They have significant market shares in many European countries. Taken all cooperative and savings banks groups together, they have around or above 50% in deposits or loans in countries such as France, Germany and Austria and, until recently, in Spain.[2] Cooperative banks are genuine customer-owned banks in the sense that control and residual returns belong to the same party. In cooperatives, customer-members provide equity capital to the cooperative. Even though the ownership of shares may vary across members, each member has one vote only. The criteria for dividing the surplus may differ: in some cooperatives, it depends on profitability, in others, on patronage (use of services). Savings banks, in turn, are non-profits that have no formal owners; in some cases though (as in Germany), public authorities (often municipalities) have control rights. Savings banks are operated to the benefit of their customers, but not by their customers. The boards of savings banks are typically self-perpetuating (each board appoints it successor). Continental European cooperative banks especially, but to some

1 In the UK, the preferred term is mutuals (instead of cooperatives), and the real-life examples are building societies and (the much smaller) credit unions. The UK is considered to be birth-place of Trustee Savings Banks, but these have virtually disappeared.

2 Due to the massive failure of some large Spanish savings banks, the whole sector has now been transformed into joint-stock companies.

extent also savings banks, are organized in networks, where local level banks own regional or national banks, which, either directly or through subsidiaries, may conduct operations such as corporate banking, wholesale banking, investment banking etc.

Even though the ownership structure of cooperative and savings banks solves the agency conflict between depositors and shareholders, some other problems remain pertinent. In the literature of cooperative financial institutions, two further agency problems identified in the literature are those between borrowers and depositors, and the one between members and managers (Cuevas and Fischer, 2006).[3] To start with the first problem, the preferences of the members may differ by the type of their relationship to the bank, whether they are net depositors or net borrowers. Apart from differences in the preferences regarding the pricing of deposits and loans, depositors may also favor a more conservative lending policy.

However, in real life, the agency conflict between members and management is likely to be much more serious. Managerial agency problems arise when there is asymmetric information and managers can take actions that benefit them personally at the expense of owners (members). This may range from "quiet life" to excessive consumption of perks or outright looting of assets. In financial cooperatives, the monitoring of managers is made difficult by the fact that all members have only a small ownership interest and a very small fraction of voting rights, and often little or no experience of banking sector. However, the ownership structure also guards against transfer of assets from the cooperative to other entities, and prevents self-dealing by the managers. Most local-level cooperatives in Europe have a relatively conservative and modest ethos, which constrains the consumption of perks. Usually the cooperative centrals also monitor the local level managers. Thus, perhaps the most common form of managerial misbehavior is then a suboptimal level of effort.

When it comes to the savings banks, they could suffer from even more pronounced agency problems than cooperative banks. Where cooperative banks have weak owners, savings banks are characterized by a complete absence of owners. However, as Hansmann (1996) has pointed out, the absence of strong owner interest also protects from expropriation of other shareholders, of which the previously mentioned risk-shifting is an example.

[3] In continental European – style cooperative banks there could also be a third source of agency conflict, seldom discussed in the literature: between members and non-members. However, the scope of this problem is limited by the fact that non-members can typically easily acquire membership and membership is typically not closed.

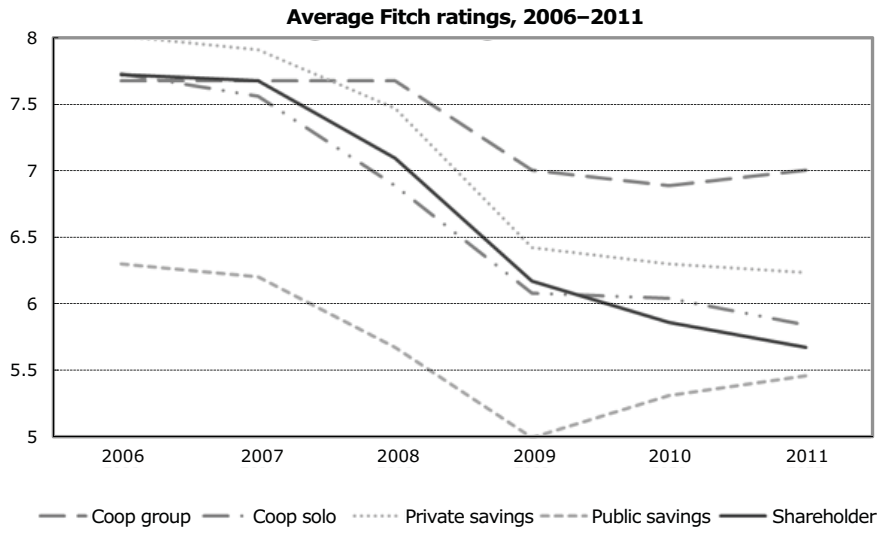
3. WHAT DOES THE EVIDENCE SAY?

There may be case study evidence both supporting the relative stability or instability of stakeholder banks. The fate of Spanish savings banks is certainly evidence against stakeholder banks, although compared to the failures of some core capitalist banking sectors (e.g. US investment banks), the shortcomings of European stakeholder banks may appear small. As the banking sector has become much more fragile, we need statistical data to perform comparisons across types of ownership. This is made difficult by the fact that because of the interventions by fiscal authorities and central banks, very few banks in Europe were actually allowed to fail. However, there is some evidence on which to build. Already before the crisis, Hesse and Cihak (2007) argued – on the basis of distance-to-default z-scores – that stakeholder banks, and especially cooperative banks, were more stable than shareholder banks. From the crisis period, a series of papers by Ferri, Kalmi and Kerola explores the performance of stakeholder banks vis-à-vis shareholder banks, using several levels of disaggregation of ownership. Ferri, Kalmi and Kerola (2014a) investigate the performance of banks under different ownership structure in three dimensions of performance – profitability, loan quality and cost efficiency. For the pre-crisis period, they find that the profitability of shareholder banks was superior to stakeholder banks, but the latter had better loan quality. In cost efficiency, there were no notable differences between shareholder and stakeholder banks in general. However, in the crisis period, the profitability of stakeholder banks improved vis-à-vis shareholder banks, so that there were no significant differences in the levels of profitability during the crisis period. The situation regarding loan quality and cost efficiency remained similar to the pre-crisis situation. There was also some heterogeneity concerning different types of stakeholder banks: for instance, even though stakeholder banks in general did not have higher levels of cost efficiency than shareholder banks, tightly integrated cooperative banks actually did have better cost efficiency than shareholder banks. Private savings banks were in the pre-crisis period very similar to shareholder banks, but their performance deteriorated in the post-crisis period, reflecting the problems of Spanish savings banks.

In another paper, Ferri, Kalmi and Kerola (2014b) study the development of bank ratings using data from two major rating agencies – Fitch and Moody's. Figure 1 reproduces the changes in the Fitch Individual Rating. This particular rating measures the ability of banks to survive without any outside support (notably, from the government). Banks are divided into five groups according to their ownership: cooperative groups, individual cooperatives, private savings banks, public savings banks, and shareholder banks. The ratings are translated into a numerical scale so that higher numerical values indicate better ratings (smaller likelihood of default). As can be seen from the figure, all banks except public savings banks (that have lower individual ratings) start from rather similar levels of ratings, but cooperative

groups are much more stable than other banks. Ferri, Kalmi and Kerola further investigate this in a regression analysis framework, which have the change in ratings between the end of 2006 and the end of 2011 as the dependent variable, and as explanatory variables they use ownership and add controls for country-specific and time effects, initial rating, changes in sovereign ratings, and various bank-specific control variables. They find that the ratings of cooperative groups deteriorate less, and this result is statistically significant. When they repeat their analysis for Moody's, they find that even though the results are not inconsistent, they are not statistically significant. In further analysis they find that Fitch and Moody's give to rate banks in different ownership structures systematically different ratings.

Figure 1. The performance of shareholder banks and various types of stakeholder banks



Source: Ferri, Kalmi and Kerola (2014b).

In a third paper on this topic, Ferri, Kalmi and Kerola (2014c) analyze the sensitivity of banks in different ownership structures to monetary policy changes. First of all, they find that stakeholder banks have much lower volatility of lending than shareholder banks. They also find that stakeholder banks are less sensitive in their credit supply to changes in interest rates than shareholder banks – in fact, the results indicate that the elasticity of credit supply of stakeholder banks to interest rate is around zero. This is consistent with the relationship banking story, where stakeholder banks build long-term commitments with their customers.

These results mentioned above are consistent with arguments that stakeholder banks build long-term relationships with their clients and they take less risk than

shareholder banks. They also seem to suggest that ownership matters and there are many differences across the balance sheets of these banks. More recently, there have been developed arguments that for the functioning of banking markets as a whole and systemic stability, it is important to have banks with different ownership structures (Bülbül et al., 2013; Michie and Oughton, 2013). However, the benefits from diversity also depend on banks having different objectives, not only different ownership structures. Drawing on evidence especially from France (the country with the highest share of cooperative banks), De Serres et al. (2011) argue that cooperative banks suffer from isomorphic pressures: regulations, rating agencies and perhaps managerial preferences move them closer to shareholder banks in their behavior. If stakeholder banks start to behave more and more like shareholder banks, important benefits from diversity will be lost.

The year 2013 was a rather black year for financial cooperatives. Despite the relatively good performance discussed earlier, cooperatives had not been invincible during the crisis: for various reasons, including bad investments abroad, the Austrian Volksbank group had become nearly bankrupt and had to be rescued by the Austrian state already in 2011. However, in 2013 there were several adverse developments for cooperative banks. Credit Agricole, the largest bank in the euro area, had to withdraw from its Greece subsidiary Emporiki, accruing losses in hundreds of millions of Euros. The sale to the Greek Alpha Bank, with a price of €1, was announced in the Fall of 2012 but completed in 2013. Moreover, Credit Agricole, which in the early period of the crisis experienced huge losses from subprime-related securities, is under suspicion of manipulating the Libor rate. Unlike some other large banks, Credit Agricole has not admitted any wrongdoing. If it is found guilty, it is likely to receive a larger fine than those parties (e.g. Deutsche Bank, RBS) that pleaded guilty. For them, the fine was €1.7 Bn.

Later in the fall, the British Co-operative Bank, which is not a traditional cooperative bank owned by its customers but instead owned by the British Cooperative Wholesale Society (CWS), needed to access a £1.5 Bn recapitalization, due to the losses it had encountered after the merger with another cooperative financial institution, the Britannia Building Society, in 2009. Further developments revealed gross incompetence of some leading board members, and did not lack farcical elements. This was embarrassing for a bank that at one point had strongly branded itself as an ethical alternative to mainstream banks. Finally, in late fall 2013 the Dutch Rabobank, which had been seen in many ways as an exemplary cooperative bank, was fined €1 Bn for rigging the Libor rates.

All of the three banks – Credit Agricole, Rabobank and the Co-operative Bank – have had to access external equity to improve their capital ratios. In the Co-operative Bank, the original shareholder (CWS) no longer holds majority control. Having to access external funding further erodes the cooperative character of these banks and reduces their distinctiveness compared to shareholder banks.

Cooperative banks may have more to lose from engaging in dubious practices than many large conventional banks, because cooperatives are perceived as more trustworthy and the loss of trust is difficult to make up. The alleged excuse of Rabobank traders manipulating the interest rates – "there are bigger crooks in the market than us" – may be right, but if one is perceived not to be a crook and benefits from it, the cost of the reputational loss may be large for these "saints".

4. ARE COOPERATIVES DOOMED TO DEGENERATE?

Cooperative degeneration is a term originally attributed to the late 19th century British Fabian Socialist Beatrice Potter (later Webb; see Jones, 1976). Originally the term was applied to worker cooperatives that transformed into capitalist enterprises and there is now rather large literature discussing and disputing the phenomenon (see e.g. Estrin and Jones, 1992). As far as I know, it has not been used in connection with financial cooperatives before. However, one could speculate that the current level of hybridization (i.e. combination of listed subsidiaries with cooperative ownership) of cooperatives is just one step away from a transformation to full investor ownership.[4] In fact, there have not been full demutualizations (conversions into investor ownership) of continental European-type cooperative banks. The US savings & loans sector and the UK building societies remain examples where a large part of the sector (though not the entire sector) was demutualized.

It is clear that there are many different kinds of cooperative banks. A large majority of these banks have been completely exemplary in their conduct. The large risks lay in the fact that the central units, living in rather separate worlds compared to the local banks, start to take huge risks. This has been apparent in the internationalization experiences of cooperative banks and in derivatives trading, all areas where cooperative banks have experienced huge losses. The problem is that the managers of the cooperative groups tend to regard the investment and international banking operations of these banks as indispensable. In this regard, the cooperative banks may in the long term benefit from the recommendations of the Liikanen Committee (2012) regarding the separation of "retail banking" and "investment banking" activities. These safeguards might actually prevent the core banking business of cooperative banks, the local levels, from failing due to crisis arising from riskier activities. However, the practice of cooperative banks has

[4] Finnish cooperative banking group OP-Pohjola forms a rather interesting exception in this regard. In February 2014, they announced that the group would buy out outside investors from its listed subsidiary Pohjola Bank. At the time of the writing (March 2014) it is yet unclear whether this plan will materialize. In any case, it represents a move against the current.

moved into another direction, with the introduction of joint liability of operations. Therefore, perhaps not surprisingly, the European Association of Co-operative Banks has opposed the proposed measures of the Liikanen report (EACB, 2012).

The cooperative banking sector is also influenced by the "too big to fail" (TBTF) syndrome. While local cooperatives are practically always small enough to be allowed to fail (and usually are taken care of by the group), entire groups are so large that they must be saved, as has been seen in the Austrian Volksbank case. In fact, the TBTF syndrome might mean that it is ultimately more advantageous for cooperative banks to organize in tighter federations, which also enables faster growth than retaining the local orientation. From the point of view of the regulators, it is also easier to regulate one large single entity rather than a multitude of small organizations.

Whatever the development of existing cooperative banks, in the long-term the financial cooperative sector cannot remain viable without the entry of new cooperative banks. In the traditional cooperative banking sector, there typically is a process of consolidation via mergers, and new entry is non-existent. However, in the past few decades new types of banking organizations have emerged, namely the social banks (alternatively called ethical banks).[5] Many, though not all, banks in this sector have been organized as cooperatives. Prominent examples of such banks include Banca Populare Etica in Italy or Credit Coopératif in France (the latter is an older bank, dating from the late 19th century). The social banks differ from the traditional cooperative sector in several ways: for instance, they lend to marginalized borrowers (financially excluded, immigrants, social enterprises etc.) and they are less based in specific localities than traditional cooperatives. After October 2008, when in general very few banks have been established, there have emerged new cooperative banks in countries where they have been largely absent, namely in Belgium (NewB) and in Israel (Ofek). Both of these cooperatives are still at a budding stage.

5. CONCLUSIONS

The great crisis that started in 2007–2008 has taught an important lesson related to the importance of banking diversity. In order to maintain systemic stability, it is not enough to have well-diversified banks doing more or less the same thing – what is needed is banks with different business models doing different things (Haldane, 2010). Stakeholder banks – cooperative and savings banks – have a valuable role in maintaining that diversity. However, if there is homogenization of banking practices – caused by "one size fits all" regulations or managerial

[5] See Cornée and Szafarz (2014).

emulation of "best practices" – the diversity does not increase. In a time when customer trust towards banks is at an all time low, customers are moving from shareholder banks to cooperative financial institution en masse (witness the success of Bank Transfer Day in the U.S. in November 2011). In other words, there is a social need and customer demand for banks that are different, but there are many pressures towards undesirable homogenization, many of them originating from bank regulations. These include the capitalization rules originating from Basel accords and the role of rating agencies in calculating capitalization, and the large disproportionalities in regulatory burden (Ferri and Kalmi, 2014), all of which favor large banks at the expense of smaller banks.

It is not always clear that smaller means more ethical, and in the absence of generally accepted measurement of ethical characteristics in banking, it is hard to enforce regulation favoring "more ethical" organizations. However, a regulation fully recognizing the value of diversity of banking organizations would go a long way to ensuring also a more stable and perhaps a more ethical banking sector.

Abstract

The paper analyses the notion of banking ethics and presents a simple model of risk shifting that illuminates the conflict between depositors and shareholders and presents shareholder incentives to gamble "with other peoples' money". Customer ownership through cooperative or savings bank structure solves this problem, however, these structures have problems of their own. Finally, it stresses the benefits of organizational diversity in banking, on how banks in different ownership structures may foster that diversity, and also why ownership may not be a sufficient condition for diversity.

Key words: Bank ownership, bank diversity

References

Bülbül, D., Schmidt, R.H. and Schüwer, U., (2013): "Caisses d'epargne et banques cooperatives en Europe". *Revue d'Economie Financiere*, 111: 159–187.

Cornée, S. and Szafarz, A. (2014): "Vive la Différence: Social Banks and Reciprocity in the Credit Market". *Journal of Business Ethics*, forthcoming.

Cuevas, C.E. and Fischer, K.P. (2006): "Cooperative financial institutions – issues in governance, regulation, and supervision". *World Bank Working Paper* No. 82.

De Serres, A., Jaeger, M. and Ory, J.-N. (2011): "Have Co-operative Banks Lost Their Soul? The Me-Too Effect of Regulation". Working paper, University of Lorraine.

EACB (2012): *Consultation to the Consultation by the High Level Expert Group on Reforming the Structure of the European Banking Sector*. Brussels: European Association of Co-operative Banks.

Estrin, S. and Jones, D.C. (1992): "The Viability of Employee-owned Firms: Evidence from France". *Industrial and Labor Relations Review* 45(2): 323–338.

Ferri, G. and Kalmi, P. (2014): *Only Up: Regulatory Burden and Its Effects on Credit Unions*. Filene Institute Research Report, forthcoming.

Ferri, G., Kalmi, P. and Kerola, E. (2014a): "Organizational Structure and Performance in European Banks: A Post-Crisis Reassessment". Working paper, LUMSA University, University of Vaasa and Aalto University.

Ferri, G., Kalmi, P. and Kerola, E. (2014b): "Organizational Structure and Exposure to Crisis in European Banks: Evidence From Rating Changes". *Journal of Entrepreneurial and Organizational Diversity*, forthcoming.

Ferri, G., Kalmi, P. and Kerola, E. (2014c): "Does Bank Ownership Affect Lending Behavior? Evidence from the Euro Area". *Journal of Banking and Finance* (forthcoming).

Haldane, A. (2010): *The $100 Billion Question*. Bank of England.

Hansmann, H. (1996): *The Ownership of Enterprise*. Cambridge MA: Belknap Press.

Hesse, H. and Ĉihák, M. (2007): "Cooperative Banks and Financial Stability". *IMF Working Paper* WP/07/2.

Jones, D.C. (1976): "British Economic Thought on Associations of Labourers, 1848–1974". *Annals of Public and Cooperative Economics*, 47: 5–36.

Liikanen Committee (2012): High Level Expert Group on Reforming the Structure of the European Banking Sector. Brussels.

Michie, J. and Oughton, C. (2013): "Measuring Diversity in Financial Services Markets: A Diversity Index". SOAS, University of London: Centre for Financial and Management Studies Discussion Paper No. 113.