The German Cooperative Banks. An Economic Overview

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Abstract Cooperative banking has a long and well established tradition in German speaking countries and in Germany in particular.

The cooperative financial network basis on the *Raiffeisenbanken* and *Volksbanken*, member owned financial intermediaries.

Although local banks in terms of operational territory at single level, the credit unions are able to offer their customers and members an extensive range of financial services due to the close cooperation with their specialized product institutes within the cooperative banking network, the so called *Finanzverbund*. In that sense the *Raiffeisenbanken* and *Volksbanken* might be viewed as *pocket* universal banks.

In this context, the present study—given a general background of the cooperative credit system within the overall German banking market—focuses on the institutional framework of the cooperative system, both on the entrepreneurship and associative level, considering its legal and economic relationship in order to highlight its specialness also in terms of potential replicability in other national experiences.

Summary: (1) Introduction; (2) The Background and Size of the German Cooperative Banking System; (3) The Institutional Framework: The Entrepreneurship and Associative Level; (4) Economic, Legal and Regulatory Relationships within the Cooperative Network; (5) Concluding Remarks;

1 Introduction

Cooperative banking has a long and well established tradition in German speaking countries and in Germany in particular.[1]

The cooperative financial network basis on the *Raiffeisenbanken* and *Volksbanken*, member owned financial intermediaries whose origins go back to the early promoters of the German cooperative banking concept, namely Friedrich

[1] The paper also relies on previous works of the author.

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Willhelm Raiffeisen and Franz Hermann Schulze-Delitzsch, respectively. The *Raiffeisenbanken* were traditionally characterized by a rural context while the *Volksbanken* were typically established in towns and suburban areas.

The cooperative banks and their comprehensive financial institutions, linked together in the *Finanzverbund*, define the "third pillar" of the German banking system beside the so called *Grossbanken* and commercial banks (i.e. the large universal intermediaries) and the savings banks' network (namely *Sparkassen* and *Landesbanken*, the latter the central banks of the former). Each pillar has peculiar ownership structures and market characteristics.

The cooperative banking system controls roughly 14 % (2013) of the German banking market as measured by the total business volume, compared to a percentage of 57 % dominated by commercial banks (including the big banks and the Deutsche Postbank AG), while 29 % of the market is managed by the saving institutions (Table 1).

Despite the relatively limited business share, *Raiffeisenbanken* and *Volksbanken* play a relevant role in the German banking system from a substantial perspective because of their focus on the small and medium businesses that largely depend on banking services due to the limited market access capability of this enterprise segment. Although local banks in terms of operational territory at single level, the credit unions are able to offer their customers and members an extensive range of financial services due to the close cooperation with their specialized product institutes within the cooperative banking network. In that sense the *Raiffeisenbanken* and *Volksbanken* might be viewed as *pocket* universal banks.

In this context, the present study—given a general background of the cooperative credit system within the overall German banking market—focuses on the institutional framework of the cooperative system, both on the entrepreneurship and associative level, considering its legal and economic relationship in order to highlight its specialness also in terms of potential replicability in other national experiences. More in detail, the study addresses (i) the regulatory peculiarities governing the network of the German credit cooperatives in order to highlight if there are legal provisions able to positively influence the competitiveness of the credit unions; (ii) the financial and governance linkages, between the local banks and their central entities, induced by the institutional ruling of the *Finanzverbund*.

This in order to highlight from an economic point of view the capability of the German mutual banks to act as an universal banking group, by preserving the statutory independence of the individual first level entities, and not as a mere aggregation of local financial intermediaries.

The relative competitive advantage of the German cooperative network seems to result from the mandatory membership with the regional federations for the primary cooperative banks. This legal requirement has historically enabled a strong coordination of the cooperative system and the implementation of inherent network strategies. However, the regulatory constraint does not impair the legal and operational independence of the single *Raiffeisenkassen* and *Volksbanken* that are not legally required to convey the banking business towards the central business institutions. In turn the freedom degree at operational stage incentivizes the central

Table 1 Assets and liabilities of German banks

	Number of reporting institutions	Balance sheet total	Cash & equivalents[a]	Lending to banks	Lending to non-banks	Debt securities & treasury bills	Shares & participating interests	Other assets[b,c]	Amounts owed to banks	Amounts owed to non-banks	Securitised liabilities	Other liabilities[c]	Provisions & others[d]	Subordinated liabilities	Capital[e]
Assets and liabilities of German banks															
Million Euros															
	All banks														
2000	2740	6,148,318	67,083	1,497,307	2,942,901	973,254	340,352	327,421	1,769,439	2,226,911	1,432,138	314,836	74,983	77,406	252,605
2005	2089	6,903,169	63,262	1,956,772	3,020,110	1,222,491	376,687	263,847	1,943,192	2,554,049	1,616,781	325,322	81,739	93,260	288,826
2011	1903	8,466,239	110,378	2,138,873	3,229,751	1,257,035	298,783	1,431,419	1,859,802	3,218,400	1,376,504	1,445,467	99,367	102,073	364,626
2013	1846	7,604,225	104,430	1,935,483	3,097,419	1,187,144	309,265	970,484	1,651,794	3,260,992	1,143,945	955,558	127,807	86,725	377,404
	Commercial and other banks (including the so called "Big Banks")[f]														
2000	369	3,210,690	31,023	799,372	1,544,785	438,425	200,184	196,901	887,638	958,199	940,254	204,000	53,123	38,141	129,335
2005	318	3,708,581	25,076	1,110,954	1,588,297	619,956	187,665	176,633	1,054,184	1,141,032	1,064,616	210,427	53,602	49,219	135,501
2011	344	4,938,284	61,768	1,446,125	1,572,845	603,564	122,543	1,131,439	1,067,702	1,531,141	936,403	1,102,789	63,908	58,458	177,883
2013	336	4,366,192	68,550	1,397,547	1,450,066	552,678	131,199	766,152	947,234	1,567,868	803,120	742,625	93,371	49,047	162,927
	Savings banks (Sparkassen & Landesbanken)														
2000	575	2,176,624	23,373	543,152	1,021,177	383,427	103,956	101,539	671,790	863,460	415,502	89,698	15,506	33,593	87,075
2005	475	2,379,000	25,277	677,883	1,048,040	428,509	136,752	62,539	675,977	959,818	490,834	83,983	20,409	37,829	110,150
2011	437	2,512,085	30,960	484,304	1,200,585	447,190	108,731	240,315	547,726	1,130,137	367,277	275,200	26,346	36,473	128,926
2013	430	2,203,390	22,991	354,187	1,152,650	417,494	106,801	149,267	470,363	1,101,206	274,958	155,983	25,197	29,772	145,911
	Credit cooperatives and Regional institutions of credit cooperatives (Raiffeisen- und Volksbanken; Zentralbanken)[g]														
2000	1796	761,004	12,687	154,783	376,939	151,402	36,212	28,981	210,011	405,252	76,382	21,138	6,354	5,672	36,195
2005	1296	815,588	12,909	167,935	383,773	174,026	52,270	24,675	213,031	453,199	61,331	30,912	7,728	6,212	43,175
2011	1122	1,015,870	17,650	208,444	456,321	206,281	67,509	59,665	244,374	557,122	72,824	67,478	9,113	7,142	57,817
2013	1080	1,034,643	12,889	183,749	494,703	216,972	71,265	55,065	234,197	591,918	65,867	56,950	9,239	7,906	68,566
Percentage values															
	Commercial and other banks (including the so called "Big Banks")[f]														
2000	369	*52.2 %*	*46.2 %*	*53.4 %*	*52.5 %*	*45.0 %*	*58.8 %*	*60.1 %*	*50.2 %*	*43.0 %*	*65.7 %*	*64.8 %*	*70.8 %*	*49.3 %*	*51.2 %*
2005	318	*53.7 %*	*39.6 %*	*56.8 %*	*52.6 %*	*50.7 %*	*49.8 %*	*66.9 %*	*54.3 %*	*44.7 %*	*65.8 %*	*64.7 %*	*65.6 %*	*52.8 %*	*46.9 %*

(continued)

Table 1 (continued)

	Number of reporting institutions	Balance sheet total	Cash & equivalents[a]	Lending to banks	Lending to non-banks	Debt securities & treasury bills	Shares & participating interests	Other assets[b,c]	Amounts owed to banks	Amounts owed to non-banks	Securitised liabilities	Other liabilities[c]	Provisions & others[d]	Subordinated liabilities	Capital[e]
Assets and liabilities of German banks															
2011	344	*58.3 %*	*56.0 %*	*67.6 %*	*48.7 %*	*48.0 %*	*41.0 %*	*79.0 %*	*57.4 %*	*47.6 %*	*68.0 %*	*76.3 %*	*64.3 %*	*57.3 %*	*48.8 %*
2013	336	*57.4 %*	*65.6 %*	*72.2 %*	*46.8 %*	*46.6 %*	*42.4 %*	*78.9 %*	*57.3 %*	*48.1 %*	*70.2 %*	*77.7 %*	*73.1 %*	*56.6 %*	*43.2 %*
	Savings banks (Sparkassen & Landesbanken)														
2000	575	*35.4 %*	*34.8 %*	*36.3 %*	*34.7 %*	*39.4 %*	*30.5 %*	*31.0 %*	*38.0 %*	*38.8 %*	*29.0 %*	*28.5 %*	*20.7 %*	*43.4 %*	*34.5 %*
2005	475	*34.5 %*	*40.0 %*	*34.6 %*	*34,7 %*	*35.1 %*	*36.3 %*	*23.7 %*	*34.8 %*	*37.6 %*	*30.4 %*	*25.8 %*	*25.0 %*	*40.6 %*	*38.1 %*
2011	437	*29.7 %*	*28.0 %*	*22.6 %*	*37.2 %*	*35.6 %*	*36.4 %*	*16.8 %*	*29.5 %*	*35.1 %*	*26.7 %*	*19.0 %*	*26.5 %*	*35.7 %*	*35.4 %*
2013	430	*29.0 %*	*22.0 %*	*18.3 %*	*37.2 %*	*35.2 %*	*34.5 %*	*15.4 %*	*28.5 %*	*33.8 %*	*24.0 %*	*16.3 %*	*19.7 %*	*34.3 %*	*38.7 %*
	Credit cooperatives and Regional institutions of credit cooperatives (Raiffeisen- und Volksbanken; Zentralbanken)														
2000	1796	*12.4 %*	*18.9 %*	*10.3 %*	*12.8 %*	*15.6 %*	*10.6 %*	*8.9 %*	*11.9 %*	*18.2 %*	*5.3 %*	*6.7 %*	*8.5 %*	*7.3 %*	*14.3 %*
2005	1296	*11.8 %*	*20.4 %*	*8.6 %*	*12.7 %*	*14.2 %*	*13.9 %*	*9.4 %*	*11.0 %*	*17.7 %*	*3.8 %*	*9.5 %*	*9.5 %*	*6.7 %*	*14.9 %*
2011	1122	*12.0 %*	*16.0 %*	*9.7 %*	*14.1 %*	*16.4 %*	*22.6 %*	*4.2 %*	*13.1 %*	*17.3 %*	*5.3 %*	*4.7 %*	*9.2 %*	*7.0 %*	*15.9 %*
2013	1080	*13.6 %*	*12.3 %*	*9.5 %*	*16.0 %*	*18.3 %*	*23.0 %*	*5.7 %*	*14.2 %*	*18.2 %*	*5.8 %*	*6.0 %*	*7.2 %*	*9.1 %*	*18.2 %*
Asset & Liabilities as Proportion (%) of relative balance sheet total															
	Commercial banks (including the so called "Big Banks")[f]														
2000	369	100 %	1 %	25 %	48 %	14 %	6 %	6 %	28 %	30 %	29 %	6 %	2 %	1 %	4 %
2005	318	100 %	1 %	30 %	43 %	17 %	5 %	5 %	28 %	31 %	29 %	6 %	1 %	1 %	4 %
2011	344	100 %	1 %	29 %	32 %	12 %	2 %	23 %	22 %	31 %	19 %	22 %	1 %	1 %	4 %
2013	336	100 %	2 %	32 %	33 %	13 %	3 %	18 %	22 %	36 %	18 %	17 %	2 %	1 %	4 %
	Savings banks (Sparkassen & Landesbanken)														
2000	575	100 %	1 %	25 %	47 %	18 %	5 %	5 %	31 %	40 %	19 %	4 %	1 %	2 %	4 %
2005	475	100 %	1 %	28 %	44 %	18 %	6 %	3 %	28 %	40 %	21 %	4 %	1 %	2 %	5 %
2011	437	100 %	1 %	19 %	48 %	18 %	4 %	10 %	22 %	45 %	15 %	11 %	1 %	1 %	5 %
2013	430	100 %	1 %	16 %	52 %	19 %	5 %	7 %	21 %	50 %	12 %	7 %	1 %	1 %	7 %
	Credit cooperatives and Regional institutions of credit cooperatives (Raiffeisen- und Volksbanken; Zentralbanken)														
2000	1796	100 %	2 %	20 %	50 %	20 %	5 %	4 %	28 %	53 %	10 %	3 %	1 %	1 %	5 %
2005	1296	100 %	2 %	21 %	47 %	21 %	6 %	3 %	26 %	56 %	8 %	4 %	1 %	1 %	5 %

2011	1122	100 %	2 %	21 %	45 %	20 %	7 %	6 %	24 %	55 %	7 %	7 %	1 %	1 %	6 %
2013	1080	100 %	1 %	18 %	48 %	21 %	7 %	5 %	23 %	57 %	6 %	6 %	1 %	1 %	7 %

Source: processed by the author from "Deutsche Bundesbank, Bankenstatistik", Statistisches Beiheft zum Monatsbericht, February 2014, February 2012, February 2006, February 2001

[a]Including balances with Central Banks

[b]Fiduciary assets & equalisation claims, fixed assets, others

[c]Including derivatives of the trading portfolio starting from 2010 due to reporting changes (Act Modernising Accounting Law)

[d]Provisions for liabilities and charges & general and country risk allowances

[e]Including participation rights

[f]Including Deutsche Postbank AG (starting from 2004) and subsidiaries of foreign banks

[g]Please note that the reported values are not netted out at consolidated level (i.e. large parts of the liabilities to banks reported by the regional institutions of credit cooperatives are to primary Volksbanken and Raiffeisen)

business entities to offer their services at competitive market condition. This market capability is testified by the high percentage of captive business outsourced by the primary banks towards the network institutions.

The study is organized as follows. Section 2 provides a general overview of the role of the cooperative sector within the German banking system in terms of size, structure and taxonomy. Section 3 highlights the (Sect. 3.1) entrepreneurship and (Sect. 3.2) associative organization in order to portray the institutional framework. Section 4 depicts the economic and legal relationships between first (i.e. *Raiffeisenkassen* and *Volksbanken*) and second level entities (i.e. the central product institutions). The conclusions are drawn in Sect. 5.

2 The Background and Size of the German Cooperative Banking System

The overall taxonomy and size upon business volume composition by category of banks is depicted in Table 1 that summarizes the overall structure of the domestic financial sector.

The *Raiffeisenbanken* and *Volksbanken*, together with their parent companies and central intermediaries, define a peculiar institutional segment of the German banking market because of their governance structure as well as of the regionally oriented business model largely focused on traditional banking products and on local retail customers (over 30 million in 2012[2]), most of them at the same time also cooperatives' members (17.7 million[3]). In that sense they significantly differ in nature both from the large commercial banks and the saving institutions despite their ability to potentially cover the entire set of financial intermediation services.

The strong members' and customers' relationship represents a resilient entry barrier enabling the cooperative sector to successfully stand up against potential competitors interested in their local business model largely oriented towards traditional banking. In that way, differently from other regionally oriented banking institutions with a less focused business model and client target—like the saving banks that experienced a significant market decline over the last decade—the *Volksbanken* and *Raiffeisenbanken* have been able to preserve and implement their market share of circa 14 % of the overall German banking business amounting to over 1,034 billion euros (Table 1). This despite the intense competition in certain financial service areas (like in the asset management sector) and in larger metropolitan areas where cooperative banks suffer from competition with the large commercial banks and the saving banks, respectively.

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[2] Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (2013b), *Zahlen und Fakten 2012*.

[3] Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (2014), *Entwicklung der Volksbanken und Raiffeisenbanken Ende 2013*.

In particular, credit cooperatives—consistently with their institutional nature described more in detail next—are largely devoted to traditional banking activities towards small and medium business as well as private retail clients located in rural areas and small towns. Their presence in large urban centers is generally weaker. Due to customary relationship activities, cooperative banks benefit from higher direct retail funding (57 % of the total liabilities—Table 1—equal to a market share of over 18 % of domestic deposits from non-banks) compared to commercial and savings banks (with 36 % and 50 % respectively [2013 data]) which rely more heavily on securitized liabilities (commercial banks 18 %; savings banks 12 % of total liabilities versus 6 % of market type debt of cooperative banks including their central institutions). At the same time interbank liabilities if netted out at consolidated level (i.e. large parts of the deposits from banks reported by the regional institutions of credit cooperatives are liabilities owed to primary *Volksbanken* and *Raiffeisenbanken*) amount to roughly 103 billion euros (2011),[4] making funding on the interbank market not strategically important to the sector.[5]

The strong direct funding capability at primary level enables the credit cooperatives to almost close the intermediation process. The lending activity, mainly towards non-banks [48 % of the total assets versus 33 % of the big banks and commercial banks (2013)], is therefore largely financed via retail deposits and—to a minor extent—interbank liabilities. The credit cooperatives' loan and (retail) funding activity is consequently more than proportional to the overall market share of the *Volksbanken* and *Raiffeisenbanken* as measured upon total assets and characterized by a relevant maturity transformation. Other things equal, the profit and loss accounts benefit from this conservative balance sheet in terms of net interest income and a lower exposure to the monetary market interests' volatility.

This evidence is depicted in Table 2 reporting the cost and income structure of the German banking industry. In the last decade, the significant business volumes with private retail clients and small and medium-sized firms of the cooperative banks lead to above average net interest margin. The net interests received ranged between 76.5 % (2000) and 78.2 % (2012) of the total operating income in respect to a contribution between 67.8 % (2005) and 71.50 % (2012) for the overall banking system.[6] More in detail, due to their business model and geographical focus—where financial competition is somehow lower—*Raiffeisenbanken* and *Volksbanken* enjoyed a higher interest income (2.21 % of the total assets in 2012; 2.46 % in 2005 and 2.45 % in 2000) than the commercial banks [0.85 % (2012); 1.27 % (2005); 1.17 (2000)], largely involved in wholesale activities, and, partly, in

[4] Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (2012b), *Konsolidierter Jahresabschluss 2011* and Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (2013c), *Konsolidierter Jahresabschluss 2012*.

[5] DZ Bank (2014), *2013 Annual Report, Group Management Report*, p. 57.

[6] Deutsche Bundesbank (2013b), *The Performance of German Credit Institutions in 2012*, Monthly Report.

Table 2 Cost and income items for major bank categories[a]

	Year	All banks	Big banks	(Primary) Savings banks	Credit cooperatives: Regional Institutions	Credit cooperatives: Primary credit cooperatives
Net interest margin (1)	2000	67.80 %	49.20 %	80.90 %	71.20 %	76.50 %
	2005	68.20 %	49.30 %	79.00 %	57.40 %	74.70 %
	2011	72.90 %	57.50 %	79.60 %	70.40 %	78.00 %
	2012	71.50 %	61.10 %	79.40 %	53.90 %	78.20 %
Net commission margin (2)	2000	24.80 %	35.40 %	19.00 %	19.50 %	21.40 %
	2005	21.50 %	25.60 %	19.40 %	19.90 %	20.40 %
	2011	23.00 %	31.90 %	20.70 %	20.00 %	19.50 %
	2012	21.70 %	28.30 %	20.90 %	14.00 %	19.60 %
Net results from trading portfolio/ financial operations	2000	5.70 %	16.50 %	0.60 %	8.60 %	0.10 %
	2005	8.80 %	27.30 %	0.60 %	22.40 %	0.30 %
	2011	3.70 %	13.80 %	−0.10 %	10.20 %	0.10 %
	2012	5.50 %	14.50 %	0.10 %	32.00 %	0.10 %
Other operating income and charges	2000	1.80 %	−1.10 %	−0.40 %	0.70 %	1.90 %
	2005	1.40 %	−2.10 %	1.00 %	0.40 %	4.70 %
	2011	0.40 %	−3.20 %	−0.20 %	−0.60 %	2.40 %
	2012	1.20 %	−3.90 %	−0.40 %	−0.10 %	2.10 %
Operating income		100.00 %	100.00 %	100.00 %	100.00 %	100.00 %
General administrative spending. *Of which:*	2000	−68.40 %	−79.00 %	−68.90 %	−51.80 %	−74.50 %
	2005	−61.00 %	−60.50 %	−66.00 %	−53.90 %	−70.00 %
	2011	−63.90 %	−72.50 %	−62.70 %	−57.70 %	−63.90 %
	2012	−64.20 %	−68.80 %	−65.70 %	−42.30 %	−65.80 %
Staff costs	2000	*−37.00 %*	*−42.30 %*	*−41.30 %*	*−24.30 %*	*−43.10 %*
	2005	*−33.60 %*	*−31.90 %*	*−40.80 %*	*−30.00 %*	*−42.00 %*
	2011	*−33.30 %*	*−33.40 %*	*−38.70 %*	*−30.10 %*	*−38.10 %*
	2012	*−34.00 %*	*−32.90 %*	*−41.20 %*	*−21.60 %*	*−39.20 %*
Other administrative spending	2000	*−31.40 %*	*−36.70 %*	*−27.60 %*	*−27.50 %*	*−31.50 %*
	2005	*−27.40 %*	*−28.60 %*	*−25.20 %*	*−23.80 %*	*−27.90 %*
	2011	*−30.60 %*	*−39.20 %*	*−24.00 %*	*−27.70 %*	*−25.80 %*
	2012	*−30.20 %*	*−35.90 %*	*−24.50 %*	*−20.60 %*	*−26.60 %*
Net income/ charges from asset valuation	2000	−14.00 %	−8.20 %	−15.90 %	−43.30 %	−14.50 %
	2005	−10.80 %	−4.30 %	−17.00 %	−10.00 %	−15.70 %
	2011	1.80 %	−5.70 %	24.80 %	63.80 %	−1.60 %
	2012	−3.30 %	−8.50 %	2.40 %	−5.30 %	1.20 %
Net other and extraordinary income/charges	2000	−0.50 %	−1.80 %	3.70 %	27.80 %	1.50 %
	2005	−2.50 %	2.50 %	0.00 %	−13.70 %	7.50 %
	2011	−13.60 %	−22.10 %	−6.10 %	−37.40 %	−1.20 %
	2012	−9.10 %	−8.50 %	−4.30 %	−29.10 %	0.00 %

(continued)

Table 2 (continued)

	Year	All banks	Big banks	(Primary) Savings banks	Credit cooperatives	
					Regional Institutions	Primary credit cooperatives
Profit before taxes	2000	17.00 %	11.00 %	18.90 %	32.70 %	12.40 %
	2005	25.70 %	37.70 %	17.00 %	22.50 %	21.80 %
	2011	24.30 %	−0.30 %	56.10 %	68.60 %	33.30 %
	2012	23.40 %	14.30 %	32.30 %	23.30 %	35.50 %
Taxes on income and earnings	2000	−5.90 %	1.50 %	−10.40 %	−10.40 %	−6.50 %
	2005	−7.50 %	−10.20 %	−7.90 %	−0.60 %	−7.60 %
	2011	−5.50 %	−1.70 %	−9.20 %	−5.20 %	−9.20 %
	2012	−6.70 %	−8.00 %	−9.10 %	15.80 %	−9.50 %
Profit after taxes	2000	11.10 %	12.60 %	8.50 %	22.30 %	5.90 %
	2005	18.20 %	27.50 %	9.10 %	21.90 %	14.20 %
	2011	18.80 %	−2.00 %	46.90 %	63.50 %	24.10 %
	2012	16.70 %	6.30 %	23.30 %	39.20 %	25.90 %
Return on equity pre−tax	2000	9.32	6.34	13.39	12.95	8.59
	2005	13.00	31.72	10.45	5.25	13.79
	2011	8.36	−0.12	27.35	10.27	16.39
	2012	7.81	6.65	12.99	4.94	15.73
Return on equity (ROE)	2000	6.07	7.23	6.02	8.84	4.09
	2005	9.19	23.12	5.60	5.12	9.00
	2011	6.49	−0.83	22.88	9.50	11.87
	2012	5.59	2.91	9.34	8.30	11.51
General administrative spending as % of (1) Net interest margin and (2) Net commission margin	2011	66.70 %	81.10 %	62.50 %	63.90 %	65.50 %
	2012	68,90 %	76.90 %	65.50 %	62.20 %	67.30 %

Note: primary credit cooperatives do not include building and loan associations
Source: processed by the author from Deutsche Bundesbank, The performance of German credit institutions, September 2013, 2012
[a]All values as percentage of operating income. 2000–2005–2011–2012

respect to the competing savings institutions, serving a similar clientele (2.12 %; 2.30 %; 2.33 %).[7]

In turn, the net commission incidence on operating earnings is somehow lower for the *Raiffeisenbanken* and *Volksbanken* than for commercial banks due to the type of customers served and the contained offering of highly specialized financial and asset management services. In the reported time windows (Table 2), the primary credit

[7] Deutsche Bundesbank (September 2013a), *Die Ertragslage der deutschen Kreditinstitute im Jahr 2012*, Monatsbericht.

cooperatives achieved a net commission margin of 19.6 % (2012), 20.4 % (2005) and 21.4 % (2000) of the operating earnings (equivalent to 0.56 %; 0.67 % and 0.69 % of the total assets, respectively[8]) where the commissions' incidence for the (large) commercial banks was equal to 28.3 % (2012), 25.6 % (2005) and 35.4 % (2000).

At the same time, the contribution to the operating income of financial operations and own portfolio trading activity is very limited and of marginal relevance (2012: 0.10 %; 2005: 0.30 %; 2000: 0.10 %) for the primary credit cooperatives, similarly to the savings institutions.

The strong focusing on traditional lending activity necessarily turns out—similarly to the savings banks—in relatively higher net charges from asset valuation via bad loans provisions compared to commercial banks whose operating income is largely generated by financial services and security trading. As shown in Table 2, net charges from asset valuation are typically above average for credit cooperatives as it is also for the savings institutions.

The strong territorial presence of the German cooperative banks that follows their orientation towards traditional banking activities, is attested by the wide branch network (2012: 11,778 offices equal to 32.5 % of the whole banking industry) and the high number of primary institutions (2012: 1,104 units) (see Table 3), reflecting the local nature of the *Raiffeisenbanken* and *Volksbanken* that had been historically established at rural and municipality level.

These circumstances generate two important effects in terms of cost-income structure and related efficiency.

At first stage, the nature of independent, local banks of the credit unions drives down the company size of the single cooperative institution measured by total assets (see Table 4): in 2012 credit cooperatives had an average balance sheet total of 661 million euros compared to 298 million of 2000 (+121.8 % on nominal values). 41 % of the *Raiffeisenbanken* and *Volksbanken* had a company size below 250 million euros, while almost one quarter (23 %) was concentrated between 250 and 500 million; the remaining 36 % might be viewed as "larger" credit cooperatives totaling more than 500 million euros of assets. The increase in size follows the dramatic reduction of the number of cooperative banks (−38.5 % over the period) pursuing a precise strategy that aims to reduce the relative incidence of fixed costs and to improve efficiency of the first level banks of the *Finanzverbund* consistently with the findings of scale economies.[9] At the same time, the merger process should limit competition and overlaps between primary institutions serving the same geographical area following the "one market—one bank" principle, providing—all other things been equal—higher revenues.[10]

[8] Idem.

[9] Lang G., Welzel P. (1996), *Efficiency and technical progress in banking. Empirical Results for a panel of German cooperative banks*, Journal of Banking and Finance, 20, 1003–1023.

[10] Krüger M., *Gestaltung der Zukunft kommt voran*, Bankinformation und Genossenschaftsforum, 6/2002.

Table 3 Number of German banks and their branches. Credit Cooperatives' distribution and average size

	All banks	Commercial banks and other credit institutions [including the "Big Banks" (Grossbanken)][a]	Savings banks (Sparkassen & Landesbanken)	Credit cooperatives and regional institutions of credit cooperatives		
					Regional institutions (Zentralbanken)	Credit cooperatives (Raiffeisen und Volksbanken)[b]
	Number of banks[a]					
2000	2912	539	575	1798	*3*	*1795*
2005	2344	574	475	1295	*2*	*1293*
2010	2093	511	439	1143	*2*	*1141*
2012	2053	515	432	1106	*2*	*1104*
	Branches					
2000	56,936	24,049	17,530	15,357	*25*	*15,332*
2005	44,100	16,837	14,530	12,733	*11*	*12,722*
2010	38,183	12,630	13,496	12,057	*11*	*12,046*
2012	36,283	11,400	13,094	11,789	*11*	*11,778*
2000	100 %	42.2 %	30.8 %	27.0 %	*0.0 %*	*26.9 %*
2005	100 %	38.2 %	32.9 %	28.9 %	*0.0 %*	*28.8 %*
2010	100 %	33.1 %	35.3 %	31.6 %	*0.0 %*	*31.5 %*
2012	100 %	31.4 %	36.1 %	32.5 %	*0.0 %*	*32.5 %*

Source: processed by the author from "Deutsche Bundesbank, Bankenstatistik, Statistisches Beiheft", Dezember 2006, Februar 2002 and "Deutsche Bundesbank, Banking Statistics, Statistical Supplement to the Monthly Report", February 2014

[a]Including Deutsche Postbank AG

[b]Including 3 banks affiliated to the BVR but not established as credit cooperatives

Table 4 Credit cooperatives only—distribution and average size (balance sheet total)

Number of banks per size class								
	2000	%	2005	%	2010	%	2012	%
Balance sheet total < 25 million euros	67	3.7	–	0.0	–	0.0	–	0.0
Balance sheet total between 25 > 50 million euros	217	12.1	120	9.3	66	5.8	53	4.8
Balance sheet total between 50 > 100 million euros	368	20.5	199	15.4	127	11.2	121	11.0
Balance sheet total between 100 > 250 million euros	559	31.2	364	28.1	307	27.0	277	25.1
Balance sheet total between 250 > 500 million euros	346	19.3	313	24.2	261	22.9	251	22.8
Balance sheet total between 500 million > 1 billion euros	151	8.4	189	14.6	211	18.5	222	20.1
Balance sheet total between 1 billion > 5 billion euros	79	4.4	101	7.8	152	13.4	163	14.8
Balance sheet total between 5 billion > 10 billion euros	3	0.2	6	0.5	12	1.1	13	1.2
Balance sheet total > 10 billion euros	2	0.1	2	0.2	2	0.2	2	0.2
	1.792	100.0	1.294	100.0	1.138	100.0	1.102	100.0
Average Size (based on balance sheet total)								
Average balance sheet total (million euros)	*298*		*457*		*620*		*661*	

Note: Excluding Regional/Central institutions of credit cooperatives and (no. 2) banks not established as credit cooperatives but belonging to the BVR
Source: processed by the author from "Deutsche Bundesbank, Bankenstatistik, Statistisches Beiheft", Februar 2013, Dezember 2006, Februar 2001 and "Deutsche Bundesbank, Banking Statistics, Statistical Supplement to the Monthly Report", March 2013

At the second stage, as maintaining bank offices is cost intensive, the widespread branch network and the limited company size of the *Raiffeisenbanken* and *Volksbanken* generate high administrative spending which, in turn, leads to a relative high cost/income ratio. Excluding their central institutions, cooperative banks have a cost/income ratio of almost 65.8 % in 2012 (70.0 % in 2005; 74.5 % in 2000—see Table 2), which is generally higher than the average efficiency ratio of the German banking system. More in detail, contrary to the mean systemic values, the largest component of the administrative expenditures is represented by staff costs (39.2 % of the operating income in 2012, equal to 59.6 % of the general administrative spending) while the other executive costs are below average. In that respect it is however worth mentioning that the cooperative banking sector has been able to achieve an almost steady cost reduction over the reported time period consistent with the expense saving strategy mentioned above and pursued both at associative and at entrepreneurship level.

Contrary to other European fiscal legislations, credit cooperatives de facto do not enjoy any tax benefit. This leads to median return on equity of roughly 9.1 % for the reported time window (11.51 %; 11.87 %; 9 %; 4.09 % respectively) and of 13.6 % at pre-tax (mean) level.

Beside possible efficiency gaps in respect to commercial banks (the latter characterized by a higher volatility and implied risk), ROE analysis must consider the fact that due to the cooperative nature of the *Raiffeisen* and *Volksbanken*, profits are driven to their shareholders not only in form of dividends but also in terms of better economic conditions (lower costs or higher earnings), compared to non-member clients, as well.

3 The Institutional Framework: The Associative and Entrepreneurship Level

The German cooperative banking system is basically a two-stage network consisting of an associative and entrepreneurship platform largely organized at local and national level. Both levels and platforms are characterized by a strong and continuous networking based on regulatory and economic relationships.

3.1 The Entrepreneurship Level

The German credit cooperatives are basically a double-level financial grid constituted by (i) the primary *Volksbanken* and *Raiffeisenbanken*, on the one side, and (ii) by their central institutions, on the other side. First and second level cooperative entities form a highly interrelated financial network, however not a banking group from a legal point of view, the so called *Finanzverbund*.

(i) The first level *Volksbanken* and *Raiffeisenbanken* are independent cooperative banks established locally in form of registered associations with legal personality (so called "*Eingetragene Kreditgenossenschaften*"). Members—individuals as well as legal entities forming a broad ownership base—are united voluntarily to meet their common economic and social needs through the jointly-owned and democratically controlled cooperative institution. In that sense, *Volksbanken* and *Raiffeisenbanken* are by definition local banks because of their territorial membership-basis to which their banking activity is largely devoted. Members participate through the acquisition of capital units (i.e. shares) authorized by the governing board of the cooperative union. Ownership is characterized by co-determination. Shares are normally entitled to one vote per unit regardless of the participation held (upon the "one member, one vote"-principle) but the by-law may entitle multiple voting rights to particular members.[11] The statutes might also cap the overall participation

[11] § 43, *Gesetz betreffend die Erwerbs- und Wirtschaftsgenossenschaften* (Genossenschaftsgesetz—GenG), 1.5.1889, last amendment 15.7.2013 (BGBI. I S. 2379).

that can be held by each member in order to ensure a widespread shareholder basis.

In the general case, shareholders' liability is limited to the initial capital contribution but might be increased—as enforced by several cooperative banks—by an additional amount capped to a maximum volume (*Haftsumme*) defined upon articles of association,[12.13]

Although sharing the same legal and operational framework, credit unions are traditionally divided in *Raiffeisenbanken* and *Volksbanken* reflecting the different historical background.[14] *Raiffeisenbanken* were originally founded in rural areas by farmers, while *Volksbanken* were established in towns and urban centers by (retail) business men. Beside the nominal indication, both categories act nowadays as one single network sharing the same central institutions at entrepreneurship level as well as regional and federal organizations at associative stage.

From a legal point of view, the credit cooperatives' banking business is subject to the federal banking law (*Kreditwesengesetz*) ruling the German banking system upon the European Union's financial services sectorial regulation, while the cooperative federal law (*Genossenschaftsgesetz*)[15] rules the corporate governance of the primary banks. The by-laws, enacted by each single credit union in accordance to the general regulatory framework of the *Genossenschaftsgesetz*, detail the rules for conduct of the cooperative's operation and management.

The governance structure consists of a board of managing directors, which is directly responsible for all business activities of the cooperative, a supervisory board and a general shareholders (or members) meeting. All members of the board of directors as well as of the supervisory committee must be member of the cooperative union. The shareholders assembly elects the supervisory board members, who in turn appoints the board of the managing directors, carries out the annual closing of the accounts and is responsible for the supervision of both the executive and the supervisory board as well as for extraordinary decisions exceeding the normal operations.[16]

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[12] § 6 and § 22a, idem.

[13] The additional capital contributions to which members are obliged (*Haftsummen*) are regarded as regulatory capital. This special regulation reflects the legal peculiarities of cooperative institutions [*Gesetzüber das Kreditwesen*] (Gesetz über das Kreditwesen (Kreditwesengesetz – KWG), 1961, Bek. v. 9. 9.1998, last amendment Art. 2 G v. 7.5.2013).

[14] Sparda-Banken (12 entities) and PSD-Banken (15) also belongtothecooperativecreditsector [Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (2013), *Jahresbericht 2012*, p. 116]. They were established as credit unions of specific categories of workers (like for example railway or post employees). Due to their limited number and relevance they are not going to be considered separately.

[15] Lang J., Weidmüller L, *Genossenschaftsgesetz. Mit Erläuterungen zum Umwandlungsgesetz. Kommentar*, Gruyter, 2005.

[16] Kramer J. W., *Co-operative Development and Corporate Governance Structures in German Cooperatives—Problems and Perspectives*, paper presented at the XIV International Economic History Congress, Helsinki, 2006.

It should also be noted that the federal cooperative law forces primary credit union to apply for mandatory membership in a co-operative auditing association (the so called *Prüfungsverband*) which, in turn, is in charge for the annual audit of the financial statements and the overall management and operational conduct of the associate cooperative banks. As described in detail next (Sect. 3.2.), this provision—that might appear of secondary relevance—is in fact a grounding element of the German cooperative to act as a cohesive financial network.

At operational level, credit cooperatives act as full financial intermediaries with de facto no legal limitations or regulatory burdens different from the general rules applying to commercial banks. As such, *Volksbanken* and *Raiffeisenbanken* are therefore supervised by the Federal Financial Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*—BAFIN). Yet cooperative banks perform locally; competitions between credit unions is therefore constrained—even if not at legal stage—by the so called *Regionalprinzip*, largely followed at *Verbund*-level, limiting their activities to a specific regional area.

Due to the fact that the cooperative banks are considered ordinary financial intermediaries from a regulatory perspective, German credit unions do not enjoy particular tax benefits.

(ii) The regional or central entities form the second stage of the cooperative network.[17] The key central institution is represented by the *Deutsche Zentral-Genossenschaftsbank* (DZ-Bank), the fourth largest German bank, functioning primarily as financial service provider for the local credit cooperatives' business needs.[18] In doing that DZ-Bank serves as parent holding company of several product entities, joint in the DZ-Bank group, acting as specialized service units organized in the four major business areas of corporate and private banking, capital markets and transaction banking.[19]

The DZ-Bank plays a key role within the German cooperative banking system by supporting the local *Raiffeisenbanken* and *Volksbanken* as subsidiary partner and by acting as commercial bank being a relevant institutional player in the German wholesale banking market also as interface between the

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[17] The entrepreneurship level of the cooperative sector is described more in detail in par. 2.2.

[18] At year end 2012 the total asset of the DZ Bank Gruppe amounted to 407 billion Euros [DZ Bank Gruppe (2013), *Zusammen geht mehr*, p. 8].

[19] The most important central units, among others, are: Union Investment Group (asset management); R + V Versicherung AG (insurances); Bausparkasse Schwäbisch Hall AG (building savings bank); DG HYP (commercial real estate finance); DZ Privatbank Gruppe (private banking); VR LEASING (leasing). Most affiliated companies of the DZ-Bank group hold leading market shares in the respective business areas: VR Leasing is considered the second largest leasing company in Germany. Union Investment and R + V Versicherung rank second in the respective business area while Bausparkasse Schwäbisch Hall is considered the largest German building society. The DZ-Bank as well as the majority of the parent companies are organized as joint-stock companies [DZ Bank Gruppe (2013), *Zusammen geht mehr*].

cooperative network and the (international) capital markets.[20] In that respect the interaction between the first and second entrepreneurship platform is twofold in the sense that DZ-Bank offers the primary banks access to the monetary markets and the broad range of *Allfinanz* products via the scale and scope economies achievable at aggregate level but at the same time the DZ-Bank group profits from the placing power of the local cooperative banks when offering investment services to her (larger) corporate or institutional clients.

In that sense it can be stated that the general responsibility for tapping the market in the respective market area lies with the individual cooperative banks. This means that the sales activities in the local market shall generally be performed under the direction of the single credit union while the central institutions and their parent companies are responsible, as product specialists, for offering services to cooperative banks at financially viable, competitive rates. The bidirectional relationship also implies that if the first level bank fails to work the market adequately, the financial network should be given the opportunity to work the corresponding market segments, subject to the prior consent of the respective local bank.[21]

The DZ-Bank serves as central institution for virtually all primary *Raiffeisenbanken* and *Volksbanken* (at present about 900 local banks, equal to more than four fifths of the total, are served by the summit institution[22]), with the only exception of the credit cooperatives of the federal districts (*Land*) of Rheinland and Westfalen operating under the umbrella of the *WGZ-Bank* (*Westdeutsche Genossenschafts-Zentralbank*), a regional second level cooperative institution owned by the same local banks served by the former.[23]

The lead cooperative institution emerged from the progressive merger of previous regional and supra-regional central banks (seven in 1985) originally established in almost every federal district (*Land*) which in turn controlled the cooperative central bank originally known as *Deutsche Genossenschaftsbank* (DG-Bank). The *Finazverbund* was therefore historically a three-tier platform replicating the political governance structure at federal level that interprets Germany as a union of *Länder*. Following the current debate, the merger process may in the near future be completed by involving also the WGZ-Bank in order to achieve better scale effects and remove potential operational overlaps and cost duplications, leading to a unique central bank.[24]

[20] DZ-Bank (2013), *DZ-Bank—Zusammen geht mehr*.

[21] Bundesverband der DeutschenVolksbanken und Raiffeisenbanken (2005), *By-Laws*, Preamble, Adopted by the BVR's Members' General Meeting on December 1, 2004.

[22] DZ Bank Gruppe (2014), *Zusammen geht mehr*.

[23] Even if incorporated in form of joint-stock corporations, the central institutions (DZ-Bank, WGZ-Bank) and their parent companies are considered as part of the cooperative sector due to their shareholders' structure and captive business volumes.

[24] *Genossenschaftsbanken, Ehre wem Ehre gebührt*, Zeitschrift für das gesamte Kreditwesen, 19/2004, p. 1034.

The DZ-Bank is controlled by the local credit unions. In that sense the governance structure of the German cooperative system may be viewed as a two-stage bottom up structure. The primary credit unions served by the central bank hold 82.3 % of the share capital either directly or indirectly through regional holding companies resulting from the above mentioned merger process of the previous existing regional central institutions which, in turn, participated in the share capital of the former *Deutsche Genossenschaftsbank* (DG-Bank).[25] For the same reason, WGZ-Bank holds—as the last remaining regional central institution serving a group of about 210 local cooperative banks not yet merged with the DZ-Bank—almost 7 % of the share capital of the latter superregional central bank, while the remaining capital is controlled by other non-credit cooperatives (6.9 %) and, for a minority stake, by the federal association of the German *Volksbanken and Raiffeisenbanken*, described next.

In respect to the governance structure it should be noted that the share capital composition does not directly reflect the shareholders' capability of addressing the DZ-Bank's governing bodies due to the fact that the bank's by-laws establish that nine members out of 20 constituting the so called supervisory board (which in turn appoints the board of managing directors) shall be elected by the shareholders, ten by the employees, while the *Bundesverband der Deutschen Volksbanken und Raiffeisenbanken* (BVR) is entitled to appoint a member of its executive committee as a member of the supervisory board of the bank. This regardless of the minority stake that the BVR holds of the DZ-Bank's share capital.

3.2 The Associative Level

The cooperative associations define the institutional representation and strategic organization of the cooperative financial network and of its members, acting as political and service centers for the cooperative banks and their affiliated companies. The associative organization is basically structured in five regional and one national (i.e. federal) federations denominated *Regionalverbände* and *Bundesverband deutscher Volksbanken und Raiffeisenbanken* (*BVR*), respectively.[26] In addition there are two superregional associations devoted to special

[25] The leading regional holding companies hold together about 76 % of the subscribed capital of the DZ-Bank [DZ-Bank, *Debt Issuance Programme Prospectus*, 15 May 2009].

[26] The geographic area of the *Regionalverbände* does not correspond to the one of the *Länder* due to historic reasons and repeated mergers that altered the original territorial distribution. At the same time, the BVR results from the merger in 1972 of the previous national associations of the *Raiffeisenbanken* and *Volksbanken* which were formerly independent federations of the two cooperative banking circuits (*Genossenschaftsverbände in der Bundesrepublik Deutschland*, in "Handwörterbuch des Genossenschaftswesens", 1980).

categories of credit unions, the Sparda-Banken and PSD-Bankengruppe, originally representing cooperative banks of specific categories of workers (i.e. the railway and post-office employees) and now partly evolved into specialized private- and direct-banking financial intermediaries, respectively.

The key point is given by the fact that first level *Raiffeisenbanken* and *Volksbanken* are obliged by law to become member of a co-operative auditing association (*Prüfungsverband* incorporated in the *Regionalverbände*) deputized to perform the annual audit of the financial statements as well as of the overall correctness of management of the associate cooperative banks,[27] [28]

The mandatory membership has relevant strategic and operational implications due to the fact that this constraint implicitly attributes to the associative organizations a governance capability of the cooperative systems that largely exceeds the mere ordinary audit task. In fact, profiting from the inspection services provided, the legal provision of the mandatory membership has de facto enabled the regional and national associative organizations to extend the range of services offered to the member banks in a captive context—but on a voluntary basis—and, in that way, to achieve a preeminent role in addressing and unifying the overall strategy and business activities of the cooperative banks enhancing the network's cohesion, at the same time.[29] In addition, as described above, the presence of national associations' representatives in the boards of the central business institutions enforces their coordination influence over the sector.[30]

Part of the services is provided to the affiliated primary banks for free, being their costs cross-subsidized by the audit services and membership-fees invoiced,

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27 §53, *Gesetz betreffend die Erwerbs- und Wirtschaftsgenossenschaften*, cit.

As mentioned, the *Volksbanken* and *Raiffeisenbanken* are also subject to the regulatory vigilance of the BaFin. In 2011 the supervisory authority conducted 105 special audits of institutions belonging to the cooperative sector, equal to 8.9 % of the total number of cooperative banks. The percentages of audited commercial banks and savings institutions were of 17.8 % and 14.0 %, respectively (2011 data). Please note that the significantly higher overall percentage of audits at commercial banks and savings bank compared with the cooperative sector reflects the greater systemic importance of the former institutions in accordance with a risk-weighted approach of the supervisory authority [Bundesanstalt für Finanzdienstleistungsaufsicht (2012), *Annual Report 2011*, pp. 160–161]

28 On the contrary, cooperative institutions are not obliged to become member of the national federation. Even if limited in numbers, there have been cases of primary banks refusing national membership but legally obliged to maintain regional association. Due to their legal form classification, these banks were entitled to carry the denomination of *Volksbanken* or *Raiffeisenbanken* but were restrained from using the credit cooperatives' logo belonging to the federal association.

29 In accordance to audit regulation (*Bilanzrechtsreformgesetz*—BilReG), cooperative associations have to separate their audit activities from their remaining operations (Jessen U., *Regelungen zur Unabhängigkeit der genossenschaftlichen Prüfungsverbände nach dem Bilanzrechtsreformgesetz*, Zeitschrift für das gesamte Genossenschaftswesen, 2005, Band 55, p.45; Esser I., Hillebrand K.P., Wlater K.F., *Unabhängigkeit der genossenschaftlichen Prüfungsverbände*, Zeitschrift für das gesamte Genossenschaftswesen, 2006, Band 56, pp. 26–58).

30 Backenköhler R., *Der moderne Genossenschaftsverband—Neue Wege für Dienstleistungen und Prüfung*, Newsletter des Instituts für Genossenschaftswesen der Universität Münster, n.2/2002.

while part of the services is billed separately on the basis of the effective facilities requested by the single bank.[31] In this respect, the legal tying therefore represents, on the one side, an extraordinary discipline for incentivizing the local banks to profit from the cooperative network's assistance due to the fact that buying the same services in the market from external suppliers would partly duplicate the costs (being the membership-fee invoiced anyway), and, on the other side, enables the regional associations to enhance the service quality due to the economies of scale and of specialization resulting from the captive business volume.

In that way the regional associations have been able to provide adequate services—like legal and tax support as well as counseling in general management issues (e.g. risk management and compliance) and staff training—to their members at viable rates.

The strong linkages between entrepreneurship and associative level especially at regional stage have also enabled a knowledge spillover within the cooperative banking sectors, allowing the primary banks to improve their competences both at commercial as well as at management stage by profiting from the know-how and professional competences of the regional associative service centers.[32] Evidence of this fact is the relative low performance volatility within the cooperative banking sector.[33]

In order to further strengthen and coordinate the assistance to the affiliated member banks and limit the competition of external service providers the *Finanzverbund* has implemented over the last years a market strategy, called *Bündelung der Kräfte*, involving both the associative and the entrepreneurship levels. The strategy requires a strengthening of the cooperation within the cooperative sector; in turn, given the autonomy of the single credit unions, this relies on the economic incentives and convenience of the local institutions to pursue the defined goals.[34]

The strategy defines a clear competence and job division between national and regional associations, where the BVR is in charge for the strategic action (considering the indications expressed by the local banks through their regional associations and the BVR's general meeting) while regional organizations assist the primary banks in the respective local area also via standardized information

[31] In addition to the ordinary membership-fees, *Volksbanken* and *Raiffeisenbanken* associated to the BVR are also levied contributions to a nationwide advertising fund operated by the federal association. The fund finances nationwide marketing campaigns for the cooperative brand as well as the development of marketing concepts and advertising tools for local, regional and nationwide use (BVR, *By-laws*, Section 12a).

[32] Göhlich T. (2012), *The Performance Effects of Mergers within the German Cooperative Banking Sector*, Grin Verlag.

[33] Kontalaimou A., Tsekouras K. (2010), *Are cooperatives the weakest link in European banking? A non-parametric metafrontier approach*, Journal of Banking and Finance, 34, 1946–1957.

[34] Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, *Bündelung der Kräfte: Ein Verbund—eine Strategie*, 1999, Band 1,2; DG Bank, *Die deutschen Genossenschaften. Statistik*, 1999.

processes and platforms, mainly at entrepreneurial stage.[35] For these reasons the BVR has implemented at central stage the so called "competence committees", also foreseen in the by-law of the association, in the areas of: market and product development; information technology; staff; legal services; management; payment systems.[36] The competence committees are in charge for the development of the corresponding business areas whose implementation in terms of service facilities and procedures is performed locally by the regional cooperative associations interfacing the local credit banks.

Those competence centers pursue economies of scale in developing at central stage the necessary know-how—especially in the risk management control and compliance procedures—otherwise non obtainable at economic and efficient conditions at local level; representatives of the *Raiffeisenbanken* and *Volksbanken* participate in the working groups established within each competence center in order to bring in the operational needs of the category and act as interlink between the associative and entrepreneurship circuit.[37]

4 Economic, Legal and Regulatory Relationships Within the Cooperative Network

The main peculiarity of the German cooperative banking system is a twofold classification perspective. From a legal point of view, the cooperative banks describe a collection of single bank entities preserving their individual independence and autonomy of the governing bodies. However, from an economic perspective, the German credit unions and their parent central institutions may be interpreted as an integrated but decentralized economic network characterized by a high degree of mutual support and subsidiarity, largely based on voluntary relationships intended to strengthen the captive activity and, in that way, to enhance the network's competitiveness in the overall market. The regional and national associations represent the unifying element ensuring the overall coordination of the entrepreneurship level following a bottom-up governance approach.

In that sense the cooperative network might be viewed as an cohesive economic banking group (also called *Finanzgruppe*) with a common risk profile. This progressive integration is attested by the publication (starting from 2003) of consolidated accounts and by the fact that the *Finanzgruppe* is also formally rated by the major credit scoring agencies (Fitch and Standard & Poor's) where the rating also

[35] Kubista B., Ein unternehmerischer Verband. Der BVR—ein Verbundunternehmen sui generis, Bankinformation, Januar 2012.

[36] BVR, *By-laws*, Section 26.

[37] Krüger M., *Neue Ära*, Bankinformation und Genossenschaftsforum, 12/2004.

explicitly recognizes the major peculiarities of the German cooperative banking sector in terms of mutual support and subsidiarity.[38]

The critical key elements peculiar to the *Finanzverband* able to ensuring the high cohesion might be identified in: (i) the provision of an exclusive safety net; (ii) the strong infra-sectorial cooperation between first and second level cooperative institutions characterized by a relevant separation between distribution and production *momentum* at market stage; (iii) the mutual interest of a strong cooperation in a voluntary context.

(i) *Safety net*. The exclusive protection scheme adopted by the German *Volksbanken* and *Raiffeisenbanken* differs from the traditional deposit insurance in the sense that it is conceptually intended to safeguard the solvency of the associate members and not only of the customers' deposits. This by ensuring that each banking institution meets its entire payment obligations in order to prevent any negative impact on confidence in the cooperative banks. In that sense the protection scheme, managed by the national association (BVR), exceeds—although fully in line with and integrated into—the deposit insurance schemes at foreseen by the European Union prudential regulation and may be viewed as a guarantee fund linked to a guarantee network.[39] As such, the protection scheme also aims at preserving the customer relationship and informational know-how on the asset side of the balance sheet by avoiding that (entrepreneur) debtors need to swap their liability with other financial intermediaries and repeat the information costs of the credit process.

Yearly levy contributions constituting the guarantee fund are charged to the credit cooperatives upon a (credit) classification system (also considering the risk-weighted assets) which is intended to enable early identification and correction of critical situations. Member banks with a good credit rating are rewarded with reduced contributions while banks with poorer ratings, showing a significantly higher probability of failure according to the classification result, are motivated through differentiated surcharges to improve their credit rating.[40]

In addition to capital contributions and based on the subsidiarity rule, member banks are also obliged to guarantee collectively for the obligations

[38] In 2011 Fitch Ratings and Standard &Poor's awarded the cooperative banking sector long-term ratings of AA and A+ respectively [Bundesanstalt für Finanzdienstleistungsaufsicht—Bafin (2012), *Jahresbericht 2011*, p. 161].

[39] Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, *Statute of the Protection Scheme*, § 1.

In future, starting from July, 2015, the deposit insurance scheme will be managed by the BVR Institutssicherung GmbH, a 100 %-owned subsidiary of the BVR, which meets the statutory deposit insurance scheme requirements harmonized across the European Union.

[40] Bundesverband der Deutschen Volksbanken und Raiffeisenbanken Banken, *Consolidated Accounts of the German Cooperative Banking Sector*, 2003, p. 4

of the protection scheme by providing guarantee bonds; these bonds form the so called guarantee volume.[41]

The BVR is also authorized to take preventive measures should it become convinced that the operating policy of an institute is not consistent with the solvency standard upon notification by the corresponding regional association in charge for the audit of the interested bank and might request ex ante restructuring plans in order to avoid the risk of potential crisis.

(ii) *Origination and distribution. Raiffeisenkassen* and *Volksbanken* are able to offer their customers (and their members in particular) the whole range of financial services following an *Allfinanz*-approach, typical of German intermediaries. However, in that respect it is necessary to distinguish between the (central) production and (local) distribution *momentum* of the banking services.

As already mentioned, “responsibility for tapping the market and revenue potential in the respective territorial area lies with the individual cooperative bank[42]”, exploiting the distribution power of its branches. The relationship management is therefore generally always allotted locally; this because of the strong personal acquaintance of the client (often also a union’s member) by the primary bank, consistently with the cooperative inception that relies on local needs.

However, the production chain differs in respect to the nature of the financial services, based on the macro-distinction between products of “asset broker” or “asset transformer”-type. When the primary bank acts as asset transformer (i.e. when offering loans, deposits and similar banking products implying a [credit and market] risk intermediation) the services are originated (and distributed) by the same institution. In the case of asset broker services (e.g. asset management and private banking products, insurances, security trading, etc.), but also for some specialized loan facilities like leasing and factoring, they are generally originated (i.e. produced) by the central cooperative institutions but distributed by the primary credit union preserving the customer relationship. In doing that, local banks might eventually be supported by product specialists of the second level entities (which, in turn, enhances the professional skills of the periphery). This because of the general limited average bank size of the local cooperatives that does not allow to provide the service directly due to the economies of scale and of specialization requested for those product range [Lang, Welzel (1996)]. At the same time, primary banks outsource other business services, like liquidity management, own security trading and data processing to the DZ-Bank or to cooperative service companies generally serving supra-regional areas.

[41] Bundesverband der Deutschen Volksbanken und Raiffeisenbanken, *Statute of the Protection Scheme*, § 5.

[42] Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (2013a), *By-laws*, Preamble.

This job division between central production and local distribution is intended to segment the market and strengthen the territorial presence of the local credit institutions helping them to serve the market efficiently and to fully exploit their distribution power by meeting the specific client's needs through the wide product range of the *Finanzverbund* without having to produce the whole product assortment themselves.[43]

(iii) *Mutual cooperation incentives*. Given the above mentioned job division, what are the incentives for the primary banks to buy the financial services from the central institutions and not to profit from service providers external to the cooperative sector? In that respect, the key elements in explaining the inherent cohesion of the cooperative banking system lies, on the one side, in the voluntariness of the outsourcing mechanism and, on the other side, on the governance schemes that link primary and secondary sector institutions.

In obedience to their legal independence, primary banks are not required to convey the "outsourced" banking business towards the central institutions. So the central institutions, namely the DZ-Bank Group and related entities, are incentivized to supply the financial services at competitive market rates otherwise facing competition from non-cooperative financial intermediaries.[44] The DZ-Bank Group has therefore to seek constantly for the potential captive cooperative market. Given the comparable product pricing, the primary credit unions will prefer to buy the services within the *Finanzverbund* which, in turn, strengthens the competitive capability of the central institutions to work efficiently by achieving adequate business volumes. In doing that the shareholder and governance structure of the central institutions favor the infrasectorial outsourcing process, due to the fact that the local *Raiffeisenbanken* and *Volksbanken* are at the same time clients and owner of the DZ-Bank Group, so participating—via property rights—in her economic performance which is boosted by the same network participants. In that sense the relationship between first and second level institutions might be viewed as self-referring.

In that context a key role is played by the pricing mechanisms of the services provided, pursuing a correct alignment of interest. Generally speaking, pricing policy basically follows a cost approach in the sense that the products or services are invoiced separately; in addition prices tends to decrease in parallel to higher business volumes also via bonus and commission retrocession, representing implicit performance attribution.

Moreover, in order to steadily adapt the product range and service quality to the needs of the primary banks, the central bank has established at regional level joint consulting committees (so called *Beiräte*) formed by

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[43] Kless M. (2012), *Benchmarking wirkt. Wie gute Banken permanent ein bisschen besser werden*, Bankinformation, 10.

[44] The DZ-Bank articles of association obliges the bank to serve reliably the cooperative banks.

representatives of the local *Raiffeisenbanken* and *Volksbanken* as well as of the DZ-Bank.[45] In addition, the DZ-Bank has recently established also the so called *Allfinanzbeirat*, which is in charge for new product developments based upon the financial and marketing needs manifested by the local banks.[46]

The central institutions seem to have historically been able to adequately serve the cooperative sector by capturing large shares of the business volumes generated by local banks. DZ-Bank estimates the amount of captive business volume (*Verbundquote*) in more than 90 %.[47]

The relevance of the governance structure is enhanced by the fact that the national association (BVR) is entitled to appoint one member (usually the chairman) of the supervisory board of the DZ-Bank which act as holding company of the central banking group. This enables a strong interlink between the associative and entrepreneurship level of the cooperative sector and facilitates the implementation of the *Verband*'s strategies; it also helps in mitigating possible frictions among shareholders, on the one side, and between local banks and the board of directors of the central bank itself, on the other side.

The above mentioned qualification of the *Finanzverbund* as banking group from a financial perspective but not in the formal sense might become a critical issue in the future considering the expected amendments in the overall prudential vigilance that might negatively impact on the regulatory burden.

In addition, below others, as indicated by the supervisory authorities, the so called *Haftssumme* (i.e. the additional capital contribution that might be requested to shareholders in addition to the initial capital payment) will no longer be regarded as regulatory capital. Moreover, credit cooperatives face the threat of a further negative effect on their own funds because they will be requested to deduct equity interests in their central institutions (mainly WGZ Bank and DZ Bank) from their liable capital.[48] In turn, this might limit the overall financing capacity of the central institutions by the primary credit cooperatives, leading potentially to a higher refinancing cost of the latter because recurring to market debt. These elements could potentially weaken the overall competitive capacity of the cooperative sector despite its past ability to recognize adequate capital provisions due to positive earnings trends.

In addition to the above mentioned critical issues, the cooperative sector might prospectively suffer from the new European (micro)vigilance framework (i.e. the Single Supervisory Mechanism). In this respect the BVR was in favor of a supra-national supervision provided that the central authority plays a subsidiary role in respect to the operational vigilance that should be maintained at national stage also

[45] DZ-Bank (2012a), *Jahresbericht2011*.

[46] DZ-Bank (2012b), *Nachhaltigskeitsbericht 2011*.

[47] DZ-Bank (2014), *Zusammen geht mehr*.

[48] Bundesanstalt für Finanzdienstleistungsaufsicht—Bafin (2012), *Jahresbericht 2011*.

in terms of inspections and interventions. This with the only exception of the so called systemically important financial institutions (banks and financial conglomerates) that will be supervised centrally due to their size and potential instability effects in the case of financial crisis.[49] In that respect the expectations of the BVR have been fulfilled only in part, due to the fact that the new system of vigilance clearly states that the European Central Bank (ECB) is responsible for the effective and consistent functioning of the supervisory mechanism, closely working with the domestic competent authorities that will be in charge of the execution of the banking supervision in the respective domestic market but under the overall oversight of the ECB. The ECB will directly supervise significant credit institutions (i.e. around 130 banking groups, representing almost 85 % of total banking assets in the euro area) but may decide at any time to take responsibility also for any less-significant credit institution. In that perspective, the German vigilance authority Bafin (*Bundesanstalt für Finanzdienstleistungsaufsicht*) will be responsible for the local credit cooperatives while the ECB will assume responsibility for the supervision of the DZ-Bank in consideration of its size and systemic importance. This inclusion imposes enhanced regulatory standards and comprehensive assessment in terms of risk assessments, asset quality review and stress tests that will request capital increases to be subscribed by the respective local banks.[50]

At the same time, the BVR used to be also strict against a pan-European safety net centralizing and mutualizing deposit insurance considering the German cooperative banks' guarantee scheme a better protection due to the supposed higher standards.[51] However, this indication seems defensive and does not consider the implied stabilization effects and positive externalities of a supranational mutual support able to better deal with local instabilities because of the implied size and inherent diversification effects.

5 Concluding Remarks

German credit unions are a cohesive financial network characterized by a strong interaction between associative and entrepreneurship stages and by intense economic transactions between local and central institutions.

In this respect the regional and central associations have been able to successfully address the strategic orientation of the cooperative banking sector also profiting from the legal provision of the mandatory membership of the primary

[49] Becker E., Baustelle Finanzarchitektur. 6. Europäische Bankenaufsichts- und Risikomanagementkonferenz beim BVR, Bankinformation, August 2012.

[50] DZ Bank (2014), *2013 Annual Report, Group Management Report*, p. 90.

[51] Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (2012a), *Gemeinsames Positionspapier zu einem einheitlichen Aufsichtsmechanismus für Kreditinstitute im Sinne der Gipfelerklärung der Mitglieder des Euro-Währungsgebiets vom 29. Juni 2012*.

banks in order to fulfill audit requirements. This regulatory constraint is largely compensated by a bottom-up governance structure which confers to the local banks a strong incentive to engage in the *Verband* and strengthens the sector's cohesion and mutual support.

Due to these peculiarities and their cooperative nature (and implied local activity) the German cooperative system has been able to maintain a favorable earnings situation by adequately serving the market and their members. In that sense they represent a peculiar banking sector which significantly differs from other financial intermediaries and from commercial banks, in particular.

At business level, the *Finanzverbund* has implemented a largely successful job separation between the first level cooperative banks and the central bank(s),by separating the distribution and relationship management—mainly attributed to the local cooperative banks—and the production momentum which is largely delegated to the central institutions, namely the DZ-Bank and her parent product companies. This organizational structure helps levering the variable revenue and lowering the fixed cost component of primary banks in order to strengthen their profitability and allow to offer their clients the whole range of financial products regardless of their individual (limited) size.

However, in obedience to their legal independence, primary banks are not obliged to convey the outsourced banking business towards the central entities. This incentives the second level institutions to supply the financial services at competitive market rates otherwise facing competition from non-cooperative intermediaries.

The fact that local credit unions are at the same time the main clients as well as the controlling shareholders of the DZ-Bank Group implies that—given comparable economic market conditions—the primary banks will prefer to buy the services within the cooperative network because sharing the implied added-value and central earnings. In turn, this self-reference approach strengthens the competitive capability of the central institutions to work efficiently by achieving adequate business volumes.

This has historically proved to be the case. At present, beside legal considerations, the German cooperative sector may be viewed as an integrated banking group as testified by the consolidated financial statements and the rating attributions.

Prospective regulations at supranational stage might force the cooperative sector to further strengthen the economic and associative partnership in order to be recognized as a banking group also at regulatory level. The challenge will be to preserve the independence of the local banks by ensuring a uniform group orientation.

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