Financial Services

THE OUTLOOK FOR CO-OPERATIVE BANKING IN EUROPE 2012

BANKING ON VALUES, BUILDING ON AGILITY

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FOREWORD FROM THE EACB

We would like to thank Oliver Wyman for their renewed interest taken in the European Co-operative Banking sector. This report is a follow-up of the 2008 survey "Co-operative Bank: Customer Champion" and it is a timely contribution to explain the specificities and the challenges of the Co-operative Banks. Indeed Co-operative Banking groups represent a significant, and in some countries, majority part of the banking industry. The Co-operative Banking model has performed reasonably well since the crisis and offers some positive lessons for the markets. However, Co-operative Banks have to face key challenges. We welcome this report that analyses the present and looks at future opportunities and possible evolution for our sector. We believe that the Co-operative model as a distinctive model of banks contributes significantly to the stability of the financial systems and the recovery of the economy.

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EXECUTIVE SUMMARY

This report examines the role and contribution of Co-operative Banks to the financial sector and wider economy. 2012 is the UN 'Year of the Co-operative' and falls at a time when confidence in the financial system and in particular banks is at a low point. As such it is timely to consider the strengths and challenges associated with a different banking model.

We last examined the sector in detail in the 2008 report, "Co-operative Bank: Customer Champion." The world has changed and many of the concerns and recommendations raised prior to the crisis are no longer relevant. However some topics (e.g. governance) remain key areas for Co-operative Bank development and will be examined further in this report.

One topic that remains highly relevant is the role of 'customer champion' – customer centricity remains one of the defining characteristics of Co-operative Banks as is particularly relevant at a time when customer trust in Financial Institutions remains low. The issue of how to define the Co-operative Banking space remains as challenging in 2012 as it was in 2008. Co-operative Banks vary dramatically in terms of size, business mix and governance model, but have two main unifying features:

- Ownership by their members/customers
- Their shared commitment to 'Co-operative values'

Co-operative Banks account for ~20% market share of EU bank deposits and loans so are a major feature of the sector. Although significant in total size, differences in Co-operative models and varying concentrations of Co-operative Banks by country combines to give the sector a varied appearance. Understanding of Co-operative Banks has improved somewhat in the last five years but the scale of the Co-operative Bank presence in Europe and the nature of the Co-operative ownership is still not always recognised and Co-operatives may have been seen as a non-standard model in a largely shareholder (including government) owned system.

It is always challenging to isolate performance arising from a particular feature such as ownership given the many firm, country and market factors impacting upon institutions' performance. Co-operative Banks as a whole have performed relatively well during and since the crisis and received much lower levels of government support than their market share would have suggested. They have also seen, on average, stronger revenue growth than large Shareholder Banks and have sustained lending levels, posting modest asset growth in contrast with deleveraging at many Shareholder Banks. One of the concerns about Co-operatives in the past has been the lack of emphasis on cost efficiency that shareholders impose on management. Co-operative Banks have to compete effectively with other bank models and cost efficiency is key to their long term success. However, since the crisis, this gap has closed as the cost/income and RoE levels of Shareholder and Co-operative Banks have converged – albeit at a reduced level for all institutions.

Given this performance, we see several advantages to the Co-operative model that are useful steers for the wider banking community:

- **Capital and Risk Taking:** Co-operative Banks contribute to overall system stability by accessing an additional source of capital via members in addition to the investor base and capital pools accessed by Shareholder Banks. As such, the Co-operative model helps increase the total level of capital available to financial services institutions. Also, there is a natural conservatism created by distributed, independent governance and limited access to 3rd party capital. This has tended to mean that Co-operatives steered away from riskier activities and practices; for example, operating at relatively high levels of tier1 capital.
- **Customer focus and client proximity:** There is an innate focus on customers created by customer ownership which reinforces this risk profile. This has an impact on business behaviours, putting customer centricity and value at the heart of decision taking and reducing appetite for non-core add-ons to bank strategy. The value Co-operatives gain from customer centricity is particularly relevant to competitors given the overall loss of trust in Financial Institutions post crisis.
- **Business mix:** Conservative and customer focused values means that Co-operative Banks have a natural bias towards 'real economy' business activity and their local markets. This focus, combined with the tendency to take a long term view of relationships with local businesses and municipalities is reflected in the fact that Co-operative Banks have continued to provide financing throughout the crisis. Although the largest Co-operative Banks have developed across multiple business lines and geographies most Co-operatives remain heavily rooted in domestic retail and commercial banking. This focus has helped with risk management and avoided the concerns over implicit subsidy being examined in the Liikanen review for many of them.

Nevertheless, the particular structure of Co-operatives also creates challenges for them and for their supervisors. In particular:

- **Governance and membership:** The role of members in governance is at the core of the Co-operative Bank model. Co-operative Banks are proud of their governance structures and indeed there are many potential advantages to the Co-operative governance approach, for example, improved local decision-taking, local accountability and risk management insights. Member ownership means that decision-taking dynamics between member banks and the central Co-operative group are different from between a Shareholder Bank and its subsidiaries. To an outside observer, Co-operatives appear to have relatively complex governance structures given their fragmentation of ownership, decision-rights, mutual guarantees and multi-level boards, requiring specific decision-making processes that differ from Shareholder Banks structures. This multi-level decentralised governance structure may raise challenges in terms of management complexity. Regulatory focus on Financial Services governance standards has intensified since the crisis and many banks' Boards have invested heavily in improving governance with a particular focus on risk. Co-operatives need to respond to this trend and focus on strengthening board oversight and capabilities at all levels within the decentralised co-operative model.

- **Financial Resource Management and allocation:** Co-operatives often have more complex financial structures given the localisation of capital and liquidity albeit under a mutual guarantee structure. This requires an increased focus on financial resource management. Co-operative Banks need to ensure that they have oversight on local risk-taking and specific solutions to capital and liquidity management within the group to ensure adequate coverage is available. Funding agility can also be a challenge. Co-operatives, unless they access wholesale markets, may have less ability to raise short-term capital quickly in response to a crisis even though they can rely on member capital in continuous mode.
- **Regulation** is the major challenge facing all Financial Services institutions at present and Co-operative Banks are no exception. The regulatory agenda is being built to fit a 'standard' large Shareholder Bank model. Co-operative Banks face an additional challenge of communication as well as more lengthly implementation processes. There are clear areas (e.g. the treatment of member bank capital under Basel 3, the regulatory push for increased governance and risk centralisation and compensation regulations on share-based payments) where improved regulatory dialogue is needed to ensure that the specificities of the Co-operative Bank model are actively considered.

Co-operative Banks broadly align well with the priority areas of regulatory development but there are some points where the Co-operative model faces specific regulatory challenges:

- **Resilience:** Co-operative Banks have traditionally had high levels of Tier 1 capital. In the aftermath of the crisis, however, large Shareholder Banks have increased capital more swiftly than Co-operative Banks (in some cases, with government support.) The picture on liquidity positioning is more nuanced; Co-operative Banks' high levels of deposit funding have also supported liquidity levels, but competition for deposit funding from Shareholder Banks is increasing. Moreover, Co-operative Banks' relatively high average loan/deposit ratios also mean that liquidity management will remain a priority.
- **Resolvability:** There has been a heavy emphasis on resolvability as a result of the crisis and Co-operatives need to apply the same discipline as other banks to ensure that they do not pose a systemic risk or have recourse to the tax-payer. This topic is potentially challenging. In principle, Co-operative Banks should be no harder to resolve than any other large financial institutions and efforts will need to be made by Co-operative Banks at all levels of their group structures. Yet their governance structures do not fit naturally with some of the currently proposed international tools (e.g. central 'bail-in' mechanisms and potential retail ring-fencing solutions do not consider Co-operative characteristics.)

- **Sector reshaping:** Co-operative Banks' values position them broadly in-line with regulators' goals on consumer and investor protection. Other areas of sector reshaping (e.g. OTC market structure changes and compensation rules) have caused Co-operative Banks some specific challenges but do not pose major threats given their lower reliance on CIB business lines. Proposals on the reshaping of the supervisory landscape may also have implications for Co-operative Banks in the future.

Overall, Co-operative Banks appear well-positioned in the face of industry changes. In order to address their key challenges, we see several priorities:

1. **Re-emphasising Co-operative values.** These values have proven their importance in underpinning business decision-taking during and since the crisis and remain the foundation for a stable, customer-centric business. They are particularly powerful at a time when customer trust in Financial Services institutions overall remains low. Co-operatives banks appear to have suffered less than other institutions from this loss of customer trust and Co-operative values remain an important differentiator but this difference risks being eroded as Shareholder Banks also up their game in responding to customer protection regulations and refocusing on core customers. To maintain their advantage, Co-operative Banks need to:
    - Transmit the message of Co-operative values and Co-operative Bank differentiation more effectively to regulators, investors and customers.
    - Deliver on values to customers with a focus on high service standards and appropriate products to core clients (i.e. with no product bias via traditional product sales targets but focusing on client need.)

    Customers and members need to be able to notice the 'cooperative difference.' They need to be able to see that Co-operative Banks and all Co-operative employees engage with them in a distinctly different way from other Financial Services institutions. In order to achieve this, Co-operative Banks as institutions need to make a renewed connection with local societies and members and all Co-operative Bank employees need to be imbued with a renewed sense of values and trained in the customer attitudes and competencies that align with the Co-operative principles.
2. **Re-assessing governance structures** and where necessary, implementing gradual changes in line with overall industry trends. This study does not recommend the convergence on a single Co-operative governance model and is not trying to suggest that Co-operatives should replicate Shareholder Bank governance structures. There is value in diversity and the long history of different Co-operative models developing within different local cultures does not advocate sudden change. Nevertheless, we do see a number of areas for potential evaluation and development. The aim of all these recommendations is to allow the development of the international principles of good governance whilst maintaining the strengths of Co-operative governance model:

- Review and tightening of overall governance standards. Several Co-operative Banks have reviewed and developed their Group governance standards since the crisis
- Specific focus on the governance of risk and financial resources in line with regulatory trends
- Ongoing work to support and strengthen the Boards of member banks in line with the principles of enhanced governance standards required by Regulators at Group level

3. **Re-assessing operating models**. Customer proximity remains a key part of the co-operative model – valuable for building customer engagement and for providing in-depth local knowledge to support risk management. In order to have a positive impact on local communities, Co-operative Banks need to have local presence and as such, their distribution model is fundamentally different from Shareholder Banks. High branch networks are part of the reason why Co-operatives have historically operated at less cost efficient levels relative to Shareholder Banks – this commitment to local presence is part of the Co-operative difference and additional costs from high branch coverage come with the Co-operative model. However, as profitability pressures on all banks increase, the cost burden of industry and regulatory changes is likely to put increased pressure on smaller Co-operative entities. This may potentially be addressed through:
   - Continued gradual rationalisation of branch networks in light of channel proliferation. This needs to be managed carefully in order to deliver cost savings whilst finding the right solution for changing customer demands and remaining true to the core principles of customer proximity and community engagement outlined above
   - Further consolidation of smaller Co-operative entities within larger groups (e.g. the merger of Friesland Bank with Rabobank in response to cost and capital pressures)
   - Continuation of the trend for increased centralisation of non-customer facing shared services within the Co-operative group, whilst still maintaining the local decision taking and proximity to the customer

I. INTRODUCTION: PURPOSE OF THIS REPORT AND MARKET CONTEXT

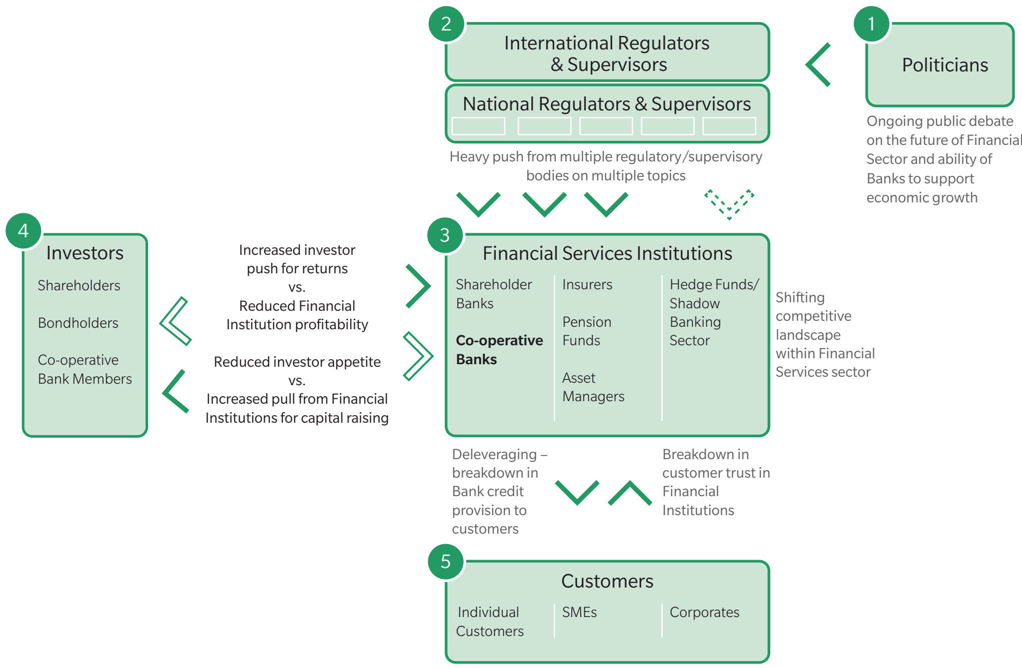
The Financial Services industry is continuing to work through a period of deep transformation. The changes underway impact all industry participants – Financial Services institutions of all types, regulators/supervisors, politicians, investors and customers are all reassessing their place in relation to the evolving Financial Services landscape.

The aim of this report is to focus on the positioning of co-operative banks within the changing Financial Services industry and regulatory environment. We will:

- Review progress and assess how the co-operative banks have fared since the financial crisis
- Assess what lessons the Co-operative banking model offers to the industry
- Assess where the main pressure points are for the Co-operative model
- Outline a vision for the future and assess what is needed to allow Co-operative banks to continue to play an effective role in the financial system and support stability and economic growth

The Financial Industry is facing a complex set of interlinked industry stresses in the aftermath of the crisis. The dynamics between politicians, regulators/supervisors, financial institutions, investors and customers have changed and the relationships between each of the participants are under pressure.

EXHIBIT 1: KEY POINTS OF STRESS BETWEEN MAJOR STAKEHOLDERS IN THE FINANCIAL SERVICES LANDSCAPE



1. Political pressure on the financial sector remains intense and continues to drive further regulatory change as politicians are – both directly and indirectly – heavily invested in the future of the Financial Services sector. Co-operative banks have, for the most part, been subject to less public political scrutiny and public opprobrium than large Shareholder Banks. In many cases, politicians profess sympathy with the values of the Co-operative bank sector but this has not led to active support or differentiated legislation.
2. The regulatory landscape is changing swiftly as multiple local and international regulators and supervisors seek to address a range of issues in parallel. Given the amount of work underway in different locations by different bodies, there is a very real risk of inconsistencies across geographies increasing the implementation challenge facing both Shareholder and Co-operative banks. Politicians and regulators are struggling to find a unified vision for the kind of financial sector they want and to take this as a coherent starting point for further regulation – without this, they risk curing stability by killing the patient; risk creating highly regulated and shadow sectors; and risk creating geographic arbitrage.
3. Competitive dynamics are changing the landscape within the Financial Services segment as banks face the risk of increasing disintermediation from non-banks and the shadow bank sector. Amongst the banks themselves, competitive positions continue to fluctuate as institutions that have recovered from the crisis respond to the challenging macro-

economic and regulatory environment as well as individual bank scandals. It is unclear as yet which institutions will 'win', but Co-operative Banks are a uniquely important feature of the European Financial Services Landscape and relatively well-positioned to grow.

4. Reduced revenues, high running and regulatory implementation costs and capital increases have all combined to reduce Bank Returns on Equity dramatically. Financial Institutions are less attractive prospects to Investors at the very time when they most need to raise Capital. This is a structural change – ROE for both Shareholder and Co-operative Banks is unlikely to return to pre-crisis levels.
5. Customer relationships with Banks have been shaken by the crisis and this lack of trust is exacerbated by Banks' continued need to deleverage – Banks are withdrawing credit availability to retail, commercial/SME and corporate clients, at the same time as customers are in need of sustained credit availability in the face of economic pressures. Co-operative Banks, with their publicly stated customer focus and commitments to local credit provision appear to be less impacted by this trend

All taken together, the stage is clearly set for a radical transformation of the Financial Services sector and with it a re-assessment of the position of Co-operative Banks.

II. DEFINING THE CO-OPERATIVE BANK UNIVERSE

Co-operative banks have two main distinctive unifying features which also serve as a source of differentiation against competition:

1. **Ownership by their members:** Co-operative Banks are private institutions – they are not owned by shareholders or by the state. Instead, they are owned by their members who are also the customers. Member ownership means that in contrast with Shareholder Banks' focus on market capitalisation, Co-operative Banks focus more explicitly on provision of good products and services along with profit distribution to members. Hence Co-operative Banks prioritise customer satisfaction and earnings stability, i.e. 'membership value' over shareholder value.
2. **Shared commitment to 'Co-operative values'** Following from member ownership, Co-operatives have a commitment to customer-centric values. Co-operatives have strong local roots and exist in closer proximity to their customers, have a greater interest in financing the local economy and are also consistent supporters of the local communities that they serve. They actively support the sustainable development of their regions by reploughing a portion of profits back into the community (in some cases, engaging with the local members to select the projects that should receive the cooperative dividend).

EXHIBIT 2: DEFINITION OF SIX KEY CO-OPERATIVE VALUES BY THE EUROPEAN ASSOCIATION OF CO-OPERATIVE BANKS

1. Trust: The keystone of Co-operative Banking	Trust is the key of the relationship between a bank and its customers. For Co-operative Banks, this means that their operations are set to serve the customers' interests. This is possible because profits maximization isn't the primary goal.
2. Governance: Members control their bank	Customers and members of Co-operative Banks are represented in the bank's governance structure through participation on boards, membership councils, etc. This ensures the members' interests are the top priority. By becoming a member, customers can influence the banks' policies. At a local level, they provide advice about branch services and sponsorship activities. At a national level, membership is ensured by local member banks or regional banks in certain countries, such as France and Germany. These institutions collectively own the Co-operative. Diversity brought through member ownership entails a consensus-driven approach and prevents a strong focus on only one stakeholder.
3. Resilience: Solid adapting to changing circumstances	Co-operative Banks have a lower risk appetite and a long-term orientation. They can also maintain higher capital reserves. Thanks to their local roots, Co-operative Banks anticipate and adapt to local circumstances. Co-operative institutions can adapt to changing circumstances and re-invent themselves more so than other banks.
4. Proximity: Closest to the customers	Local Co-operative Banks usually have a good physical proximity, thanks to their dense networks of branches. They are part of the community, understanding their customers and speaking their language. Proximity is further reinforced through the participation in numerous social networks and by actively supporting the local communities.
5. Social commitment: Supporting and operating nearby	As local contributors, Co-operative Banks are part of the economic and social environment of their customers. They naturally take initiatives, aiming to improve the clients' environment and provide financial services. A proportion of the banks earnings are reserved to promote economic initiatives and include local society. A good economic and social climate benefits the customers and so the bank. Social commitment therefore means investing in the customer. In doing so, Co-operative Banks have a tradition of fostering the development of local communities. Most Co-operative Banks' projects are small-scale local initiatives, taken by members. Co-operative Banks support them through financial funding, as well as access to their networks and unpaid services of employees. They support programs ranging from microfinance to financial education of groups experiencing long-term unemployment.
6. Solidarity: Emphasising the common good of society	Co-operative Banks have traditionally promoted entrepreneurship at the individual level, consequently impacting the common good of society. Moreover, Co-operative Banks play a key role in local and regional development by reinvesting capital at the local level. The mutual guarantee systems among Co-operative Banks provide another form of solidarity at two levels. Firstly, capital is made available for other people and companies that have an economic need; the local constituents have the opportunity to support each other. Secondly, Co-operative Banking systems provide mutual guarantees in case of default

Despite similar Co-operative values, however, there is **no single Co-operative Bank model.** Different models have emerged in response to different cultural and business environments and the result is a complex and diverse set of institutions within the European Co-operative Banking sector.

Co-operative Bank models differ across three main dimensions:

1. **Size:** A huge range of institutions of different sizes are covered (see appendix for details on the range EACB member bank sizes by assets.) The contrast is most apparent when comparing the opposite ends of the Co-operative universe:
   - Credit Agricole: A group comprising 39 Co-operative banks with over 11,600 branches[1], 160,000 employees and total assets of ~€1.9TN
   - The Co-operative Bank in the UK: a single entity with 342[2] branches, 8,528 employees and total assets of ~€56BN
2. **Business mix and geographical coverage:** The 'core' business of Co-operative banks is retail and SME/Commercial Banking within a domestic market. However, many Co-operatives have diversified by business (e.g. wholesale banking, bancassurance and asset management) and internationally.
3. **Structure and governance model:** A range of governance structures exists with varying degrees of centralization. We see three broad groupings:
   - Centralised model where member banks have delegated significant supervisory and decision taking power to the central entity (e.g. Rabobank and – highly centralised albeit under a different legal structure – the UK's Co-operative Bank)
   - Region-centric model where the member banks have delegated supervisory authority, strategic influence and guidance to the central entity but the member banks remain the essential decision-taking level (e.g. BPCE, Credit Agricole, Credit Mutuel)
   - Network model where a central entity provides support and has an advisory role, but the decision making power sits heavily with the member banks (e.g. BCC Federcasse and the Volksbanken Raiffeisenbanken Co-operative financial network in Germany)

Within these models there are many further variations as institutions seek to manage the delicate balance between the strengths of centralisation and the benefits of local autonomy. The main areas of variation and potential development are:

- **Risk governance:** In more centralised models, delegated authority from member banks allows the centre to build a risk management model similar to a Shareholder Bank, with a greater degree of central risk appetite setting and control oversight. In contrast, in highly networked models the centre takes an advisory role on risk but risk taking is managed – and overseen by supervisors – at the local member bank level
- **Capital management and allocation:** To manage the increasingly complex organisation structures, Co-operative Banks have developed cross-guarantee systems and institutional protection schemes. The benefit of systems preventing imminent risks or correcting existing financial tensions at member institutions (as at the Co-operative financial network in Germany, Rabobank in Netherlands and Op-Pohjola in Finland) is that capital can sit at any level. This has evolved from a model where local banks are the Shareholders and decide how much capital to allocate to the central entity

1 Total branches for Crédit Agricole SA
2 Data excludes recent acquisition of Lloyds branches

- **Listed entities:** Some Co-operative groups contain listed entities (e.g. the Natixis Investment Banking business in BCPE or CASA in Credit Agricole Group.) This brings advantages in the ability to raise shareholder capital for 'non-core' businesses but also brings potential challenges as management need to balance shareholder and member priorities and consider carefully how best to reflect co-operate values in the listed entity
- **Capital and funding structure:** Co-operatives have moved from solely relying on their Members for capital to accessing the capital markets in some cases, with stronger ratings than Shareholder Bank peers. This is attractive as an additional funding source given the challenge in increasing capital levels solely by retaining member dividends. The extent to which banks depend on capital markets for funding depends largely on the size and level of centralisation of the institution

For the purposes of the analysis in this report, we have taken a sample of EACB members to represent Co-operative Banks (please see appendix for details.) This represents a significant portion of Co-operative Banks in Europe but does not include all institutions that may fall within a broader definition of non-Shareholder Banks (e.g. the Cajas in Spain or the Building Societies in the UK).

III. PROGRESS AND LESSONS LEARNED

A. PROGRESS

The transforming landscape means that most of the issues identified in our previous report from 2008 have changed, are now less relevant or are already being addressed. Governance and challenges around membership engagement remain key topics throughout this report.

On aggregate, the analysis of our sample bank sets (see appendix) shows that Co-operative Banks have performed relatively well in the aftermath of the crisis. They have maintained market share, survived with limited government support and generated solid financial results.

Co-operative Banks are proud of the resilience that their models displayed during the Financial Crisis of 2008-9. Co-operatives were responsible for approximately 8%[3] of the total direct losses and write downs of the European banking sector during the credit crisis – a relatively small percentage given their overall market share of around 20%.

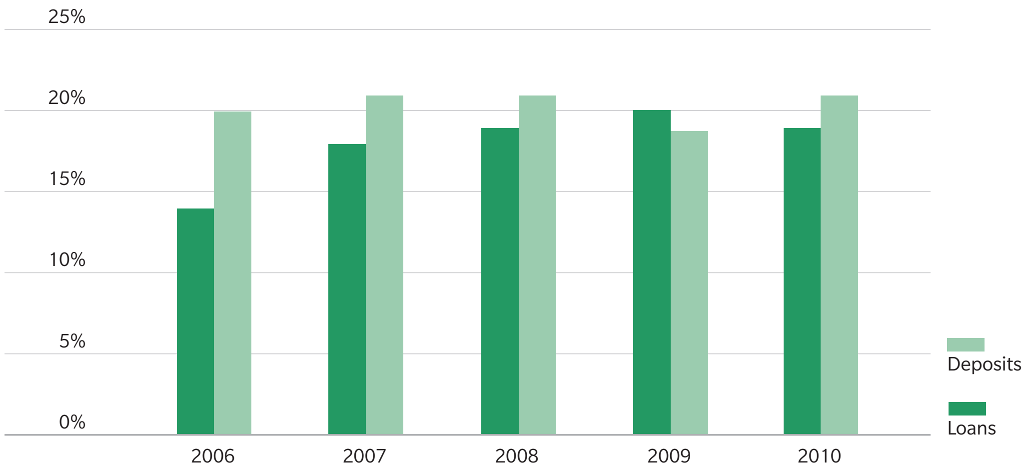
Co-operative Banks maintained a significant proportion of market share of both loans and deposits through the crisis. Whilst the market share of deposits remained steady at around 20%, their share of loans increased from 14% in 2006 to 19% in 2010 (demonstrating the continued role co-operatives have played in financing throughout the current period of economic volatility).

3 "Morality and Integrity in Cooperative banking", J.M Groeneveld (2011)

EXHIBIT 3: ISSUES AND PROGRESS FROM PREVIOUS REPORT, "CO-OPERATIVE BANK, CUSTOMER CHAMPION" (2008)

ACTION POINTS FROM THE 2008 REPORT	ISSUE TODAY?	COMMENTS
Execution – Ensure Co-operatives at least match industry norms on growth and efficiency with minimal dispersion amongst individual banks	Relative performance improved but ongoing challenges – financial pressure across the industry	Co-operative Banks have demonstrated above average revenue growth and improved cost efficiency levels relative to Shareholder Bank competitors. • Co-operative Banks have demonstrated higher revenue growth rate than Shareholder Bank peers • The cost efficiency gap – previously noted as an issue – has also closed as cost-income ratios of Co-operatives and Shareholder Banks have converged (albeit with reduced average profitability across the industry) The challenge now will be sustaining revenue growth in the face of adverse macroeconomic conditions and maintaining cost efficiency levels.
Membership – Expand beyond self-imposed boundaries to offer membership widely and to all vulnerable and financially excluded customer groups	Still a goal	Co-operative banks have continued to focus on both broadening their member/customer base and strengthening member engagement. • The client base of Co-operative Banks has broadened – the members/clients ratio for EU27 EACB Co-operatives fell from 33% in 2006 to 28% in 2010 • The issue of member engagement levels is an ongoing area of focus. Co-operatives face a demographic challenge as they seek to engage with younger member groups. They have been trying to increase member participation by growing the platforms through which members can participate in the decision-making process; The majority of Co-operative Banks participating in our questionnaire also offer members exclusive products and non-banking offers • So far, Co-operative Banks have seen some but limited results – over half the Co-operative Banks participating in our questionnaire said they had seen no change in member engagement levels since the crisis in 2009. It therefore remains a topic for ongoing efforts
Capitalisation – Ensure discipline in managing the capital base and capital levels	Capital levels stable – different challenges on capital management	The nature of the capitalisation challenges facing Co-operative Banks has fundamentally shifted since the 2008 report – high capital levels are no longer a concern. Instead, pressure is on to i) increase capital levels and ii) manage capital resources more effectively. • Levels of capital are not an immediate concern – Co-operatives have traditionally had higher levels of Tier 1 capital than other banks, although intensive capital raising efforts by Shareholder Banks since the crisis has changed this picture • The reliance of member capital has provided mixed benefits for Co-operatives since the crisis. On the one hand, reliance on member capital makes it hard for Co-operatives to raise capital quickly (as has been done by the Shareholder Banks.) However, although member capital can take longer to raise it is a stable source of capital at a time when investor appetite for Banks' capital raising efforts is low. Co-operative Banks also contribute to overall system stability by accessing an additional source of capital via members in addition to the investor base and capital pools accessed by Shareholder Banks Looking forward, this issue for all banks – including Co-operatives – is less around capital levels and more about effective capital management.
Governance – Define common approaches as a target operating model for Co-operatives that reinforce the performance and regulatory comfort with the Co-operative model	Remains a key area of regulator and bank focus	A range of Co-operative Bank governance models have evolved appropriate to individual models/market environments. To an external observer, Co-operative governance models – with multiple board levels and different ownership structures – appear relatively complex and this decentralised governance approach offers both potential advantages (proximity of risk assessment) as well as a significant management challenge. Regardless of historical/structural differences all banks – including Co-operatives – need to respond to increasing global regulatory focus on governance standards (with a specific emphasis on risk) The challenge looking forwards will be how best to relate the specificities of different Co-operative governance models with regulatory expectations and evolving international governance principles.
Expansion – Create methods for exporting the Co-operative model to new markets and banks	No longer a priority	Co-operative Banks have not been engaged in extensive international expansion in the past five years, however, we do not consider it key in light of more pertinent issues.

EXHIBIT 4: CO-OPERATIVE MARKET SHARE OF LOANS AND DEPOSITS



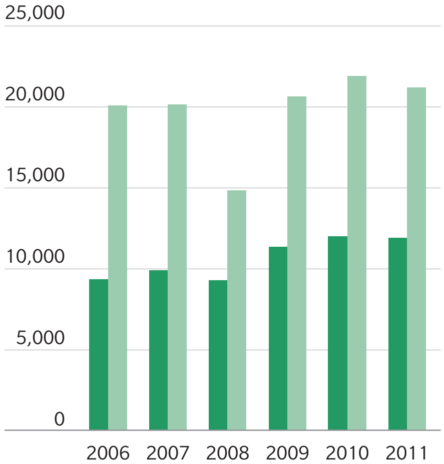
Source: EACB

On average, Co-operatives Banks have seen relatively stable revenue growth. For our sample, Co-operatives have averaged slightly higher revenue growth since 2009 (around 3% for Co-operatives compared with Shareholder Banks at around 2%.)

This revenue profile is attributable in part to business mix – Co-operative Banks have on average suffered less from the reductions in Corporate and Investment Banking revenues – and in part to Co-operative Banks' higher levels of asset growth since 2009. Most Co-operative and Shareholder Banks deleveraged in the immediate aftermath of the crisis with Shareholder Banks cutting assets hardest. However, Co-operative Banks have on average returned to lending to their core retail and SME or commercial clients, resulting in a notable increase in total asset growth versus Shareholder Banks in 2011.

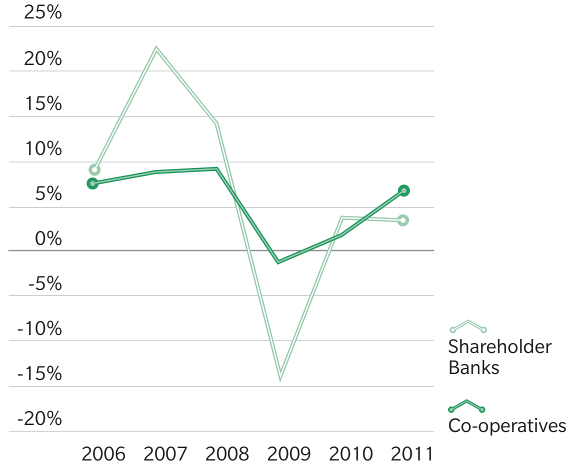
EXHIBIT 5: REVENUES AND TOTAL ASSET GROWTH FOR CO-OPERATIVE AND SHAREHOLDER BANKS

AVERAGE GROSS REVENUES (€MM), 2006-2011



	CAGR 2007-09	CAGR 2009-11
Co-operatives	7.1%	2.4%
Shareholder Banks	1.2%	1.3%

AVERAGE GROWTH IN TOTAL ASSETS, 2006-2011

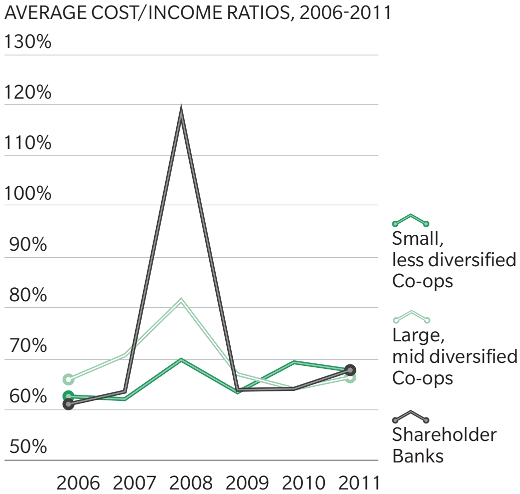


Note: Total Assets growth analysis conducted on a weighted average basis
Source: Bankscope, Oliver Wyman analysis

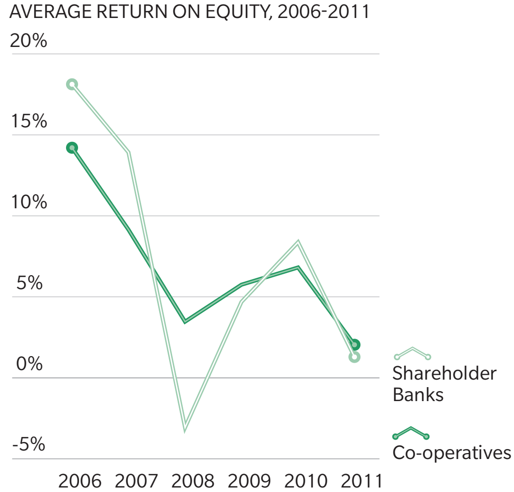
In the past, Co-operative Banks were traditionally less profitable than their Shareholder Bank competitors but this picture is changing. Profitability levels – in terms of both Cost/ Income levels and RoE – have converged since the crisis albeit at lower profitability levels for all banks.

EXHIBIT 6: COST/INCOME AND ROE LEVELS FOR CO-OPERATIVE AND SHAREHOLDER BANKS

AVERAGE COST/INCOME RATIOS, 2006-2011



AVERAGE RETURN ON EQUITY, 2006-2011



Source: Bankscope, Oliver Wyman analysis

Returns for all bank types have plummeted since the crisis and although cost management programmes aimed at improving RoE are underway at many large financial institutions these have yet to have a significant impact on average results. Although Co-operative Banks' RoE have also collapsed the picture has been slightly less extreme for them as they have, on average, faced less extreme capital increases and suffered less from loss of wholesale revenues than the large Shareholder Banks in our sample. The challenge for Co-operative Banks going forward will be to maintain this convergence in profitability levels. Co-operative Banks' ideological commitment to widespread physical branch networks means that they have traditionally had a heavier fixed cost base, but even this picture has been evolving as Co-operatives saw a gradual reduction in branch networks (-1% per annum 2009-11) compared with ongoing branch reduction by Shareholder Banks (-5% 2009-11).

B. LESSONS FROM THE CO-OPERATIVE MODEL

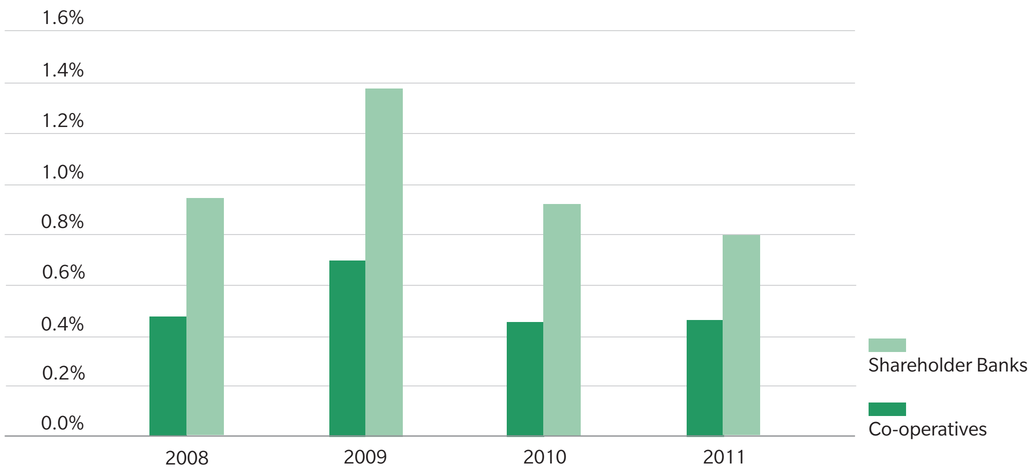
Given their relatively strong performance since our 2008 review, we see three main areas where the Co-operative banking model offers interesting positive lessons and points of comparison for the Financial Services industry.

I. CAPITAL AND RISK TAKING

Co-operative banks are in a unique position both in their ability to access member capital and in the impact that this capital source has on business decision taking.

There is a natural conservatism created by distributed, independent governance and limited access to third party capital. That has tended to mean that Co-operatives steered away from riskier activities and practices, for example operating at relatively high levels of tier 1 capital. This capital source feeds through to a naturally conservative attitude to risk taking. This can be seen through relatively stable loan impairments at Co-operative Banks throughout the crisis.

EXHIBIT 7: LOAN IMPAIRMENT/CUSTOMER LOANS FOR CO-OPERATIVE AND SHAREHOLDER BANKS



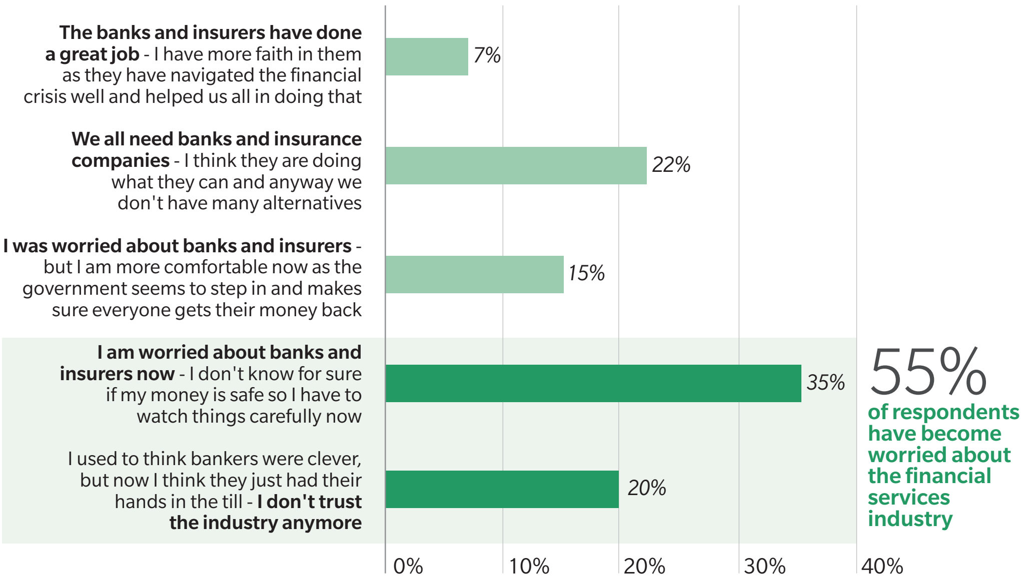
Source: Company annual reports, Oliver Wyman analysis

Co-operative banks also contribute to overall system stability by accessing a source of capital via member ownership that is not accessible to Shareholder Banks. As such, they help increase the overall capital pool available to the financial system.

II. CUSTOMER FOCUS AND CLIENT PROXIMITY

Some of the key differentiators of Co-operative Banks are their engagement with local regions and the real economy and the emphasis they place on member/customer value and service standards as part of their core values. This customer focus and customer proximity are increasingly important in the current market environment as customer dynamics are changing and customer trust in financial institutions has been significantly eroded since the crisis.

EXHIBIT 8: OLIVER WYMAN RETAIL BANK CUSTOMER SURVEY 2011: "SINCE THE FINANCIAL CRISIS, HOW HAS YOUR ATTITUDE CHANGED TO FINANCE?" (% OF RESPONDENTS)

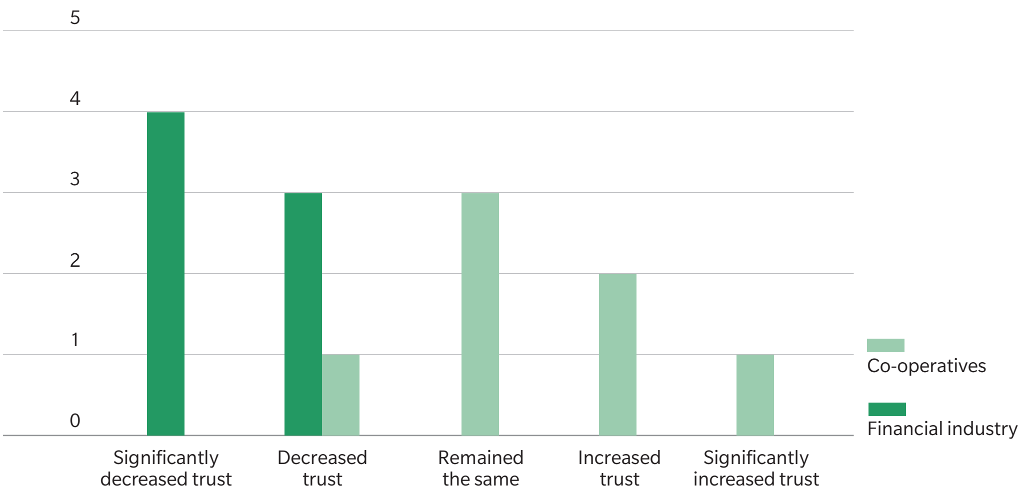


Source: Oliver Wyman analysis. Survey results for 1123 respondents across seven countries in December 2011

Reduced trust in banks leads to different buying behaviours between different customer groups. The more sophisticated and confident retail and commercial clients are moving away from the bank advisory model and are increasingly confident in taking their own financial decisions.

In contrast, other customers – the majority of retail and SME clients – will be increasingly dependent on banks to play an advocacy role. Co-operative Banks have suffered less than other financial institutions from this loss of trust; however, they are precariously privileged in this regard. Customers' expectations for Co-operative Banks need to be carefully preserved.

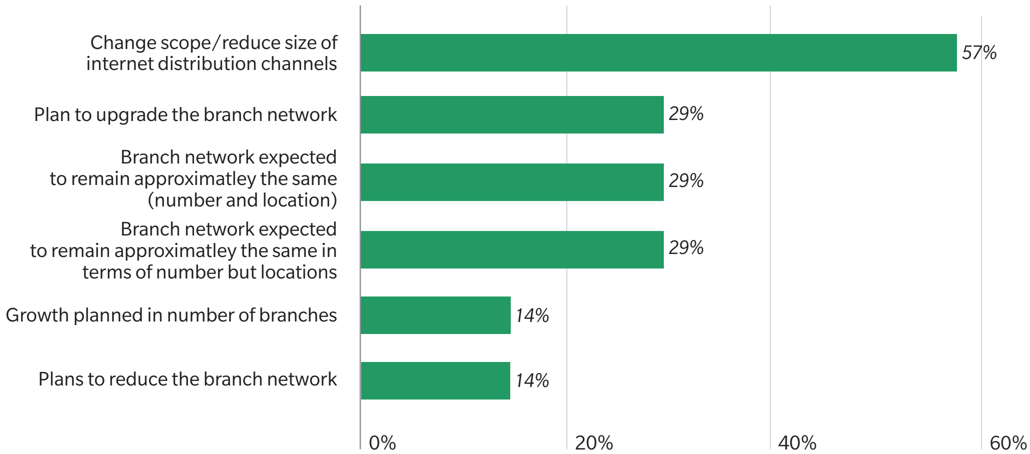
EXHIBIT 9: SURVEY OF CO-OPERATIVE BANKS PARTICIPATING IN THIS STUDY 2012: "WHAT IMPACT HAS THE FINANCIAL CRISIS HAD ON CUSTOMER TRUST IN A) THE FINANCIAL INDUSTRY OVERALL AND B) CO-OPERATIVE BANKS?"
(NUMBER OF RESPONSES)



Source: Oliver Wyman

Client proximity has previously been a key driver of Co-operative Bank success in maintaining customer loyalty and understanding local customer dynamics and risk profiles. However, the pace of technological change is accelerating and new models for customer interaction with banks outside the traditional branch model are gaining momentum. Moreover, Shareholder Banks have increased focus on their retail clients over the last years as part of their deposit gathering strategy, thus narrowing some of the differentiation vs. Co-operative banks. Co-operative banks remain committed to supporting wide branch networks as a key part of financial services industry infrastructure but in parallel need to invest in new online and e/mobile payment channels.

EXHIBIT 10: SURVEY OF CO-OPERATIVE BANKS PARTICIPATING IN THIS STUDY 2012: "HOW WOULD YOU DESCRIBE YOUR INSTITUTION'S BRANCH NETWORK STRATEGY OVER THE NEXT FIVE YEARS?" (% OF RESPONDENTS)



Source: Oliver Wyman

III. BUSINESS MIX

There has been an industry-wide shift in financial services towards business line and product simplification, with all banks refocusing scarce capital and resources on core activities. In practice this means:

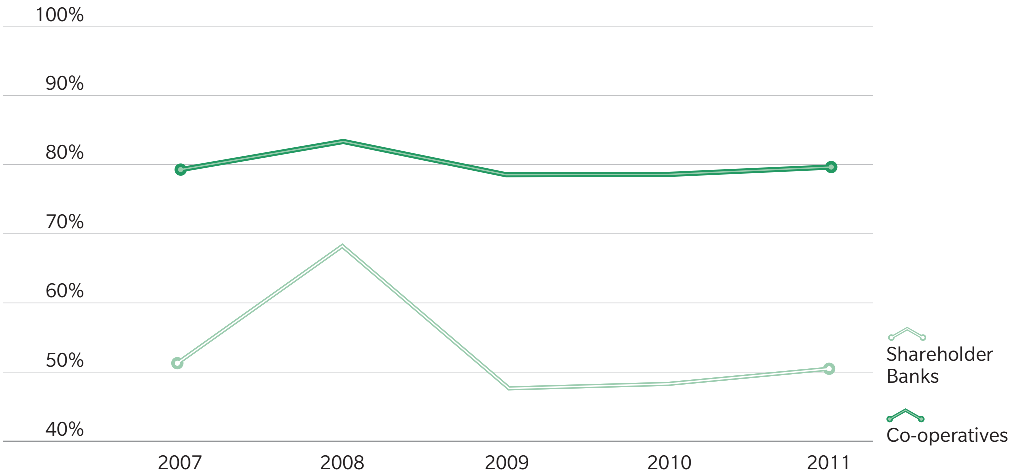
- Increased concentration of main wholesale products and activities amongst a smaller number of leading Investment Banks as second or third tier players exit
- Renewed resources and strategic focus from many banks on their core retail, commercial and corporate banking client franchises with a particular emphasis on deposit gathering in response to liquidity regulations

These industry shifts in business focus mirror traditional Co-operative Bank behaviours and strategy. Co-operative Banks typically take a long-term view of relationships with local businesses and municipalities. This innate focus on customers means that Co-operative Banks have historically demonstrated two key behaviours that other banks are starting to emulate, namely:

- A reduced appetite for non-core add-ons
- A bias towards 'real economy' activity

Although the largest Co-operative Banks have developed across multiple business lines and geographies most Co-operatives remain heavily rooted in domestic retail and commercial banking. This focus has helped with risk management and avoided the concerns over implicit subsidy addressed by the Vickers review in the UK and under assessment in the Liikanen report for the European Commission.

EXHIBIT 11: AVERAGE RETAIL REVENUES AS % TOTAL REVENUES 2007-11



Source: Company annual reports, Oliver Wyman analysis

This industry wide shift has several implications for Co-operative Banks:

- Refocus within the Co-operative Banks on core business lines i.e. domestic retail and commercial and SME banking. Some Co-operative Banks have been observed divesting non-core activities (e.g. Rabobank's sale of Robeco) as capital flows back to the member banks to support core customer lending activities
- Potential for increased intensity of competition from Shareholder Banks refocusing on their retail and commercial franchises. In particular, competition for customer deposits is already intensifying, driven largely in response to liquidity regulations

C. CHALLENGES FROM THE MARKET FOR CO-OPERATIVES

The idiosyncrasies of the Co-operative model mean that Co-operatives face a number of specific challenges:

I. GOVERNANCE AND MEMBERSHIP

The role of members in governance is at the core of the Co-operative Bank model. Member engagement remains a key focus for Co-operative Banks and many institutions have made significant efforts since the crisis.

Co-operative Banks are proud of their governance structures, they see them as a defining feature of the Co-operative model and a driver of success during the crisis. Indeed, there are potential advantages to the decentralised Co-operative governance approach, for example, improved local decision-taking, high-levels of local decision accountability and local risk management insights.

However, member ownership means that decision-taking dynamics between member banks and the central Co-operative group are different from between a Shareholder Bank and its subsidiaries. To an outside observer, Co-operatives appear to have relatively complex governance structures given their fragmentation of ownership, decision-rights, mutual guarantees and multi-level boards. This multi-level decentralised governance structure raises potential challenges in terms of management complexity. The model can work but it requires more effort.

Examples of the challenges observed in managing this decentralised governance model include:

- Ensuring consistent shared governance principles (in line with developing international governance principles) across all member banks. Several Co-operative Banks participating in this study have addressed this point since the crisis by reviewing and resetting governance principles
- Striking the right balance between central and local decision taking
- Balancing local and central risk governance (e.g. risk appetite)
- Supporting large numbers of member bank boards with recruitment and training. In particular, supporting members in playing an independent governance role while still remaining members (and by definition, personally invested in the institution rather than independent in the same way as the independent Non-Executive Directors of a Shareholder Bank)
- Managing reporting flows between member banks to the central entity

These management challenges around governance are linked to the regulatory challenge – the regulatory focus on Financial Services governance standards has intensified since the crisis. Regulators expect increasingly strong and centralised levels of governance oversight and are setting increasingly high expectations on the levels of independence and financial expertise that should exist within bank boards. Co-operative Banks need to focus on supporting members and strengthening board oversight and capabilities at all levels within the decentralised Co-operative model. The challenge looking forwards will be how best to relate the specificities of different Co-operative governance models with regulatory expectations and evolving international governance principles while still maintaining the benefits of the decentralised Co-operative governance and local accountability.

2. FINANCIAL RESOURCE MANAGEMENT AND ALLOCATION

Co-operatives often have more complex financial structures given the localisation of capital and liquidity albeit under a mutual guarantee structure. The implications of such structures raise critical issues under the current financial and regulatory environment:

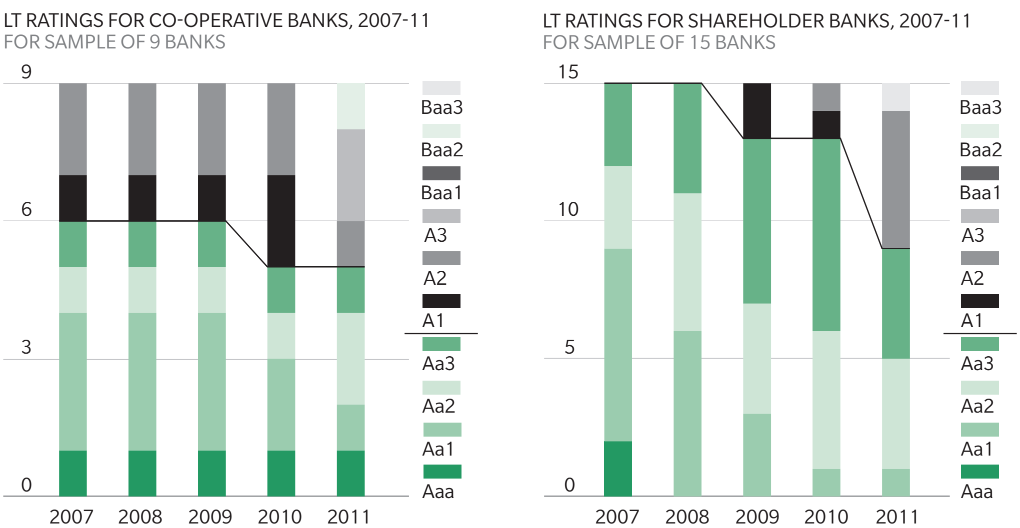
- Intra-group allocation across legal entities is more constrained
- Resource optimisation at group level may not converge with the best interests of individual banks

That requires a tight control over local risk-taking and specific solutions to capital and liquidity management within the group to ensure adequate coverage is available.

Capital and funding agility can also be a challenge. Co-operatives, unless they access the wholesale markets may have less ability to raise short-term debt or capital quickly in response a crisis due to the reliance on member capital. It is notable that large Shareholder Banks (including many institutions classified as SIFIs and so subject to higher capital requirements) have seen significant increases in tier 1 capital (see exhibit 11.) It is clear from discussions with the Co-operative Banks participating in this study that raising capital from member banks requires a more gradual timeframe and, in some cases, has become harder since the crisis as member banks are increasingly under pressure to deploy capital resources in funding local lending during the downturn. In response to these pressures, Co-operative Banks groups are increasingly seeking to ensure that their member banks aim to fund the majority (around 70%) of their local credit portfolio with local deposits.

In terms of wholesale funding, however, Co-operative Banks have shown greater ratings stability since the crisis. Although the Co-operative data set has lower overall ratings than the large Shareholder Banks, Co-operative Bank ratings have proved more stable since the crisis with fewer institutions experiencing downgrades.

EXHIBIT 12: COMPARISON OF CO-OPERATIVE VS. SHAREHOLDER BANKS' EXTERNAL RATINGS



Source: Moody's LT Deposit Rating

III. REGULATORY POSITIONING

Regulation is the greatest challenge facing banks of all types today. However, in addition to the implementation challenge faced by all banks, Co-operative Banks also face an additional challenge in terms of communication with regulators. A strong sense prevails amongst the Co-operative Banking participants in this study that regulation is currently following a "one model fits all" approach that does not acknowledge, and is not always appropriate, for the different characteristics of the Co-operative Banking model.

EXHIBIT 13: REPRESENTATIVE COMMENTS FROM DISCUSSIONS WITH CO-OPERATIVE BANKS

"Regulation needs to respect diversity of models – this is not happening at the moment"

"It is an uphill battle to ensure that the specificities of Co-operative Banks are considered [in regulation]"

"Biodiversity in the Banking market is a point of strength but this is not in the mind of regulators"

"I do not think, in general, that the regulator understands mutuals. They don't see that we've come out of the crisis better than other banks and I don't think they care"

"There is fragility in our discussions with regulators"

The challenge for regulators is not easy. As demonstrated earlier in this report, there is no such thing as a single standard Co-operative model. Getting to grips with the complex institution-specific structures of all the major Co-operative Banks is not a simple task and it appears that countries with high levels of Co-operative Bank representation there is a better understanding of Co-operative concerns. The challenge is more noticeable in the case of international regulators and there are tangible examples where this lack of understanding has led to problems, for example, the footnote clarification of Co-operative member funds as eligible Tier 1 capital in Basel 3.

In spite of this challenging starting point for regulatory engagement, with a few exceptions, Co-operative Banks align reasonably well with Regulators' priorities for industry change.

EXHIBIT 14: OVERVIEW OF REGULATORY AREAS OF FOCUS AND CO-OPERATIVE BANK POSITIONING

REGULATORY PRIORITIES	KEY AREAS OF REGULATION	CO-OPERATIVE BANK READINESS?
a. Resilience • Reducing Banks' probability of failure • Increasing Banks' ability to maintain lending to support economic growth	• Solvency and Liquidity regulations (Basel 2.5/3) • Enhanced supervision of SIFIs • Enhanced governance requirements (incl. Risk) • OTC market structure changes (clearing, reporting, short-selling restrictions)	• Solid Tier 1 capital levels; relatively high loan/deposit levels due to lending commitments • Few Co-operatives classified as SIFIs • Regulatory drive for governance enhancement and governance principles on need to be applied within context of the decentralised Co-operative governance model • OTC impact on CIB activities for large Co-operatives
b. Resolvability • Removing implicit guarantees • Reducing the cost to taxpayers in the event of Bank Failure	• Recovery and resolution plans • Structural changes (e.g. UK retail ring-fencing)	• Most pressing issue for Co-operative SIFIs • Not necessarily more difficult for Co-operatives – their decentralised legal entities may be an advantage but regulator approaches and proposals on bail-in tools are a potential challenge • EU-wide ring-fencing would be difficult
c. Sector reshaping • Protection for customers and investors • Increasing competition • Changing the structure / approach to Bank supervision	• Consumer protection (retail structured products, product standardisation/transparency) • Investor protection (duty of care for investor segments) • Compensation regulations • Securitisation rules • Proposals for international bank supervision	• Consumer and investor protection in line with core Co-operative values • Focus of compensation regulations on non-cash instruments a challenge for some Co-operatives • Limited securitisation impact • Potential impact of supervisory centralisation on Co-operative Banks

High levels of Co-operative Bank readiness and alignment with regulatory trends

Low levels of Co-operative Bank readiness and alignment with regulatory trends

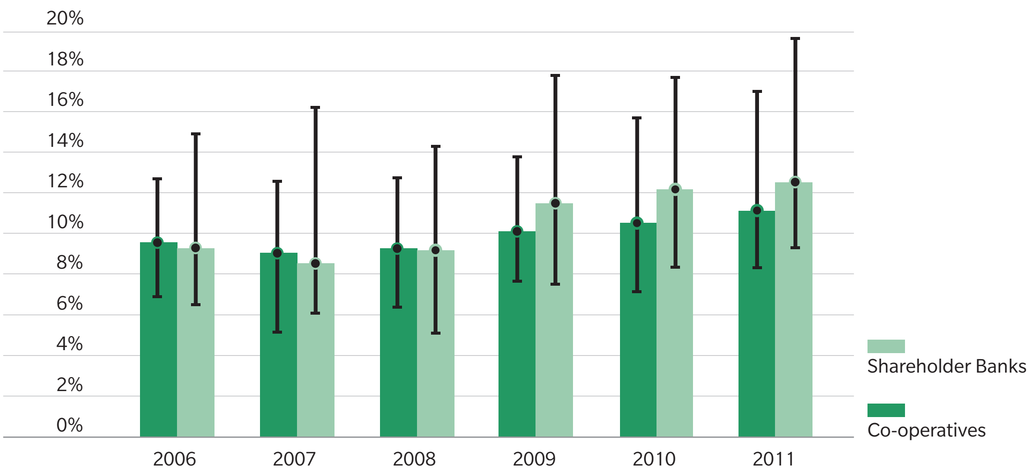
I. RESILIENCE

Regulators have initially focused on increasing bank resilience i.e. reducing the 'probability of default' and increasing the likelihood that banks will be able to continue to support the economy in the face of any future crises.

On average, Co-operative Banks have historically operated at higher Tier 1 capital ratios than Shareholder Banks. However, post-2008, Shareholder Banks have been under intensive pressure to strengthen their balance sheets and have aggressively increased capital to reach an average Tier-1 ratio of 12.2% in 2011 compared to the average of 10.7% for Co-operatives.[4]

4 Most Shareholder Banks in the data set are classified as SIFI institutions and hence have higher capital requirements. Only two Co-operatives in this dataset are classified as SIFIs – Credit Agricole and BPCE

EXHIBIT 15: AVERAGE TIER 1 CAPITAL RATIOS FOR CO-OPERATIVE VS. SHAREHOLDER BANKS 2006-1111

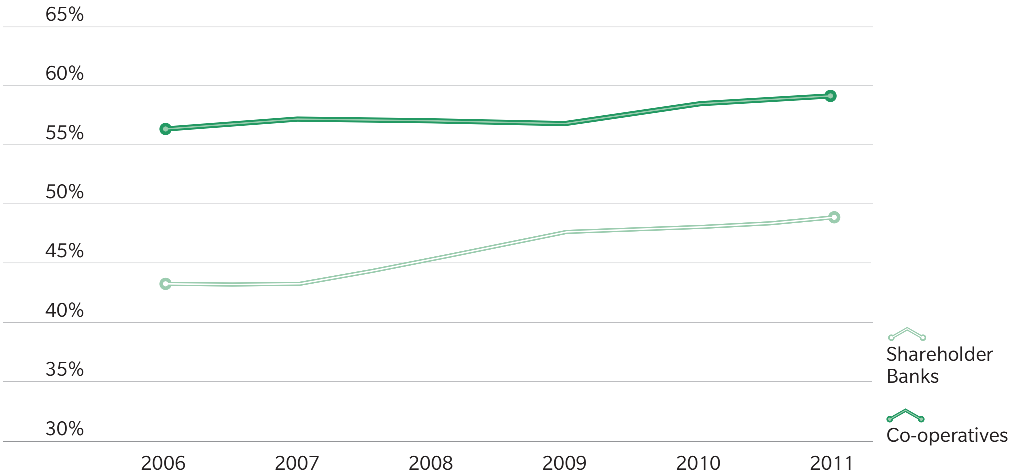


Source: Bankscope, Oliver Wyman analysis. Bars represent the range of results in our data sample

Co-operative Banks have been under less pressure to increase capital levels at the same rate as large Shareholder Banks. This is due to both their stronger initial starting point and their different business mix. This is fortunate given that for Co-operative Banks not active in the wholesale funding markets, capital-raising at such aggressive speed is not usually possible given the need to wait and agree on the level of profits that can be retained with Member Banks.

Co-operative Banks have historically had high levels of deposit funding which aids compliance with new liquidity ratios. However, competition for deposits from competitors is intensifying. Many Co-operative Banks feel that they benefitted from a 'flight to safety' effect at the height of the crisis, however, the proportion of funding from deposits has increased more for Shareholder Banks as they are driven by regulatory and funding pressures to expand their deposit base.

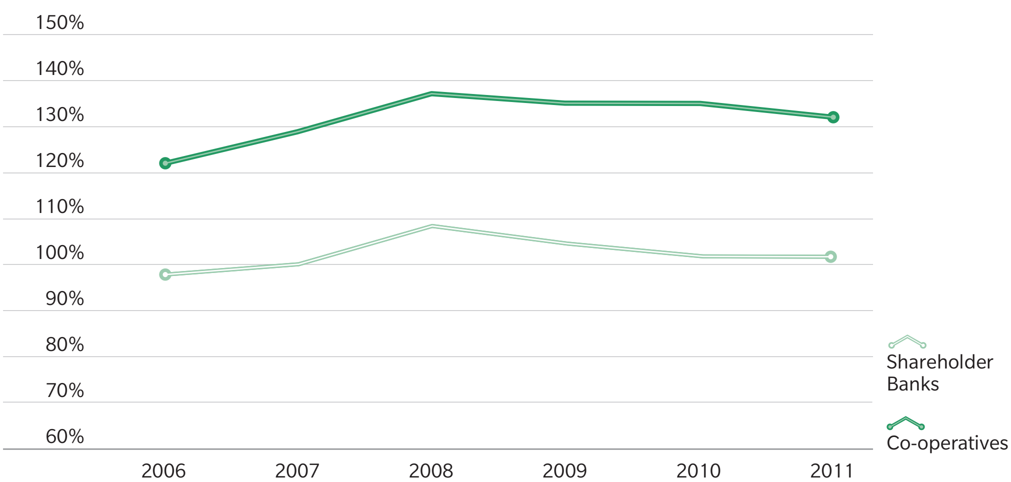
EXHIBIT 16: AVERAGE CUSTOMER DEPOSITS/TOTAL FUNDING RATIO, 2006-2011



Source: Bankscope, Oliver Wyman analysis

Moreover, Co-operative Banks' continued commitment to customer lending has resulted in relatively high average loan/deposit ratios compared with Shareholder Banks.

EXHIBIT 17: WEIGHTED AVERAGE LOAN/DEPOSIT RATIOS FOR CO-OPERATIVE BANKS VS. SHAREHOLDER BANKS (2006-11)



Source: Bankscope, Oliver Wyman analysis

Overall, therefore, although the core capital and liquidity ratios are sound, the complexity of governance models means that Co-operative Banks will have to satisfy regulators not solely on capital and liquidity levels but also on governance effectiveness in managing financial assets and risk. Intra-group protection schemes are a key factor in ensuring the overall resilience of Co-operative Banking groups:

EXHIBIT 18.PROTECTION SCHEMES – GENERAL APPROACH, ROLE, AND CASE STUDY OF THE GERMAN CO-OPERATIVE FINANCIAL NETWORK

What are protection schemes?	• Many Co-operative Banks have a protection scheme in place which takes advantage of the member banks' personal responsibility and joins them together to safeguard against problems in times of difficulty • In order for the mutual responsibility of the protection facility to work, a sense of solidarity must exist between the member banks. This is in line with the principles and values of the Co-operative model – member banks in a Co-operative group typically serve different regions/segments and so do not compete • Protection schemes are usually administered by the central body which acts as the overseer
What are their main roles?	• The exact structure and the scope of support covered by the protection scheme varies between institutions but key roles that the protection scheme may cover are to – Insure deposits placed with the banks, either partly or fully as stipulated by EU-directive and national legislation – Protect confidence in Co-operative Banks and the Co-operative Banking sector through trust of clients and members – Maintain the solvency of all member banks, and the stability of the Co-operative Group as a whole (e.g. assisting member banks when they are confronted by losses in their loan portfolio) – Support member banks through economic difficulties and assist in the prevention of any future problems from arising – Support member banks' capital position and growth ambitions (e.g. providing additional capital for expansion)
How does it work in the case of the German Co-operative financial network (BVR)?	• The protection facility at BVR, founded in 1934, is one of the oldest protection schemes in the world. It's central focus is on crisis prevention is the key focus • The protection scheme operates at the Co-operative Bank level and explicitly addresses any concerns over potential 'moral hazard' (i.e. the concern that the knowledge of deposit guarantees might lead to undesirable risk-taking behaviour by member banks.) All customers are treated equally (regardless of which member bank they belong to) and member bank behaviours and profitability are monitored to allow intervention and, if necessary, forced mergers of imbalanced or unprofitable member banks with a healthy institution • The protection scheme covers all deposits by safeguarding the deposit taking bank • The 'guarantee fund' is financed by member banks' contributions, which are fixed per annum on a risk-oriented-model and based on the regulatory risk weighted assets • The minimum contribution rate amounts to 0.04% of the 'loans to customers' balance sheet item, and can rise to a cap of 0.2%. The protection facility defines the contribution rate based on each bank's credit rating, which quantifies the banks' situations and their likelihood of drawing upon the protection scheme's funds. • Preventive measures taken by the protection scheme of the BVR also provide the basis for the identification of risks and tensions on member bank's level at an early stage

II. RESOLVABILITY

Resolvability without taxpayer funds in the event of failure i.e. reducing the 'loss given default' is the key new area of international regulatory focus post-crisis.

A mixed picture emerges for Co-operatives on this topic. This issue is most pressing for SIFIs and the largest most centralised Co-operatives will largely be able to follow emerging international standards for Recovery and Resolution Planning. Their central structures mean that bail-in tools – a key component of international regulatory thinking on resolution – will be able to be applied at the central entity level and then cascaded to member banks. In-spite of the apparent complexity of their membership structures and governance models, there is no reason why resolving these institutions should be harder than resolving any other major Shareholder Bank. Indeed, institutions with decentralised legal entity structures may find that this is an advantage in being able to explain clearly to regulators how individual legal entities could be resolved in the event of failure.

More of a challenge arises with Co-operatives operating under a network structure. In this case, it will not be possible to apply the central bail-in tools proposed by regulators. Co-operative Banks can point to historical successes in rescuing and resolving troubled member banks but in spite of this track record they may struggle to demonstrate to regulators that they would be able to absorb multiple member bank failures in the context of another crisis.

The introduction of the Vickers' proposal for a retail ringfence in the UK could have major implications for European Co-operatives if a similar model were to be introduced across the continent following the Liikanen review. In the UK, the Co-operative bank will be largely unaffected due to non-participation in wholesale activities, yet this is not true across the Co-operative universe. Some large European Co-operative banks with wholesale activities that are centrally owned by the member banks would find this ownership structure difficult in the event of retail ring-fencing. This is not an immediate threat but bears watching. It would force either an exit from these business lines or, potentially, changes to the current structure and increase in the use of separate listed legal entities for housing non-core activities. Potential ring-fencing solutions have to take into account their characteristics and their essential contributions.

III. SECTOR RESHAPING

New regulations following the financial crisis include a focus on consumer and investor protection which affects Co-operative and Shareholder Banks alike. However, the additional regulatory burden feels heavier for small Co-operatives when regulations are not based on the principal of proportionality. Furthermore, as Co-operatives already prioritise customer interests, prescriptive consumer protection regulation maybe viewed as unnecessary red tape.

Regulations include, but are not limited to: EU directive on credit agreements relating to residential property (aimed at increasing transparency in the mortgage market for consumers), MiFiD II (aimed at strengthening investor protection), single Euro payments area (harmonised rules for processing cross-border payments), unfair commercial practices directive (aimed at protecting consumers from misleading advertising), credit agreements for consumers (aimed at increasing information rights of customers), packaged retail investment products (aimed at increasing transparency of packaged products for investors), deposit guarantee schemes directive (aimed at protecting consumers from bank failure) and Investor compensation schemes directive (aimed at protecting investors from fraud, malpractice and operational error).

Compensation regulations have provided an area of regulatory challenge for some Co-operative Banks. The Compensation standards proposed by the FSB and implemented by local regulators were designed to target Shareholder institutions with large wholesale banking activities. However, some Co-operative Banks – even those with modest bonus payments and limited CIB activities – have also been affected and several of the key regulatory requirements focus on deferred bonus payments in non-cash instruments. As Co-operatives without listed entities do not have shares, this approach is not applicable. Instead they have had to engage with regulators and manufacture alternative non-cash payment instruments.

Changes to the overall supervisory structure of the Financial Services sector are also now pending. It still is uncertain where these changes will land but there will potentially be an impact on Co-operative Banks – both in terms of how they engage with the new international regulator and in terms of how Co-operative groups engage with and oversee their own member banks.

IV. FUTURE PRIORITIES AND OUTLOOK

The outlook for the Co-operative Bank model is broadly positive – Co-operative Banks have come through the crisis relatively well and are positioned in line with several key trends for the future. However, in order to ensure the sustainability of the model, Co-operative Banks do need to address some significant and model-specific future challenges:

External challenges – common to all banks

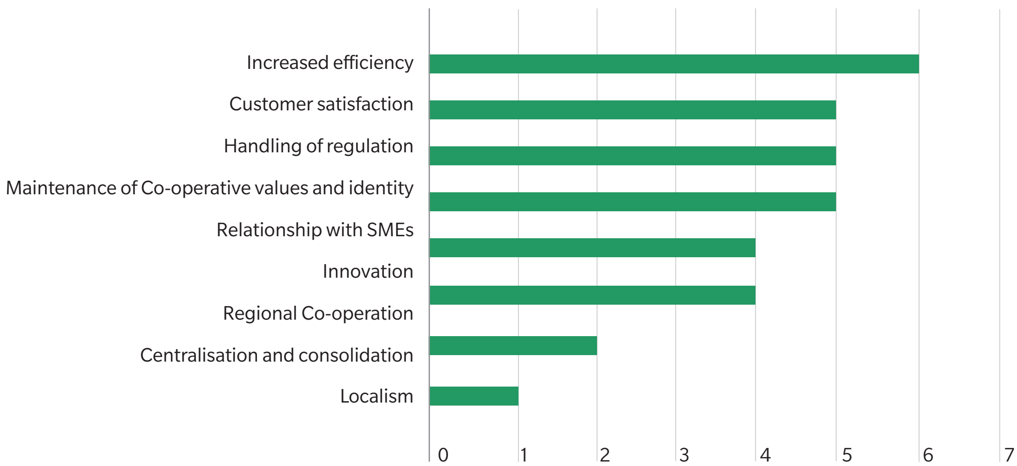
1. **Regulatory pressures:** both practical challenges in terms of the implementation of existing regulation, and communication challenges in engaging with Regulators on the specificities of the Co-operative Banking model to help inform future regulatory plans.
2. **Cost-pressures:** particularly on smaller Co-operative Banks and individual banks within Co-operative network models.
3. **Changing customer behaviours:** This may need further investment at some Co-operative institutions where development of non-branch channels has lagged Shareholder Bank competitors.
4. **Shifting industry and competitive landscape:** Co-operative Banks appear relatively well positioned but the financial services landscape remains in flux.

Internal challenges – specific to the Co-operative model

1. **Remain distinctive and differentiated:** Co-operatives have differentiated themselves by their natural predisposition to protect customer interests, stemming from their unique member ownership structure. However, with highly prescriptive consumer protection regulation now being applied across all of retail banking, Co-operatives will struggle to remain distinctive. They need to engage ever more closely with members and local societies and focus on ensuring that all employees are having the cooperative mindset and deliver the 'cooperative difference' in all customer interactions.
2. **Governance:** The challenge looking forwards will be how best to relate the specificities of different Co-operative governance models with regulatory expectations and evolving international governance principles. To outside observers (including regulators). Co-operatives have relatively complex governance structures compared with Shareholder Banks given their fragmentation of ownership, decision-rights, mutual guarantees and multi-level boards. Many banks have invested heavily in improved Board governance as a result of the crisis, with a particular focus on risk. Co-operative Banks also need to continue work on addressing the management challenges associated with their decentralised governance structures and ensuring that good governance principles and practices are embedded at all levels within their specific structures.

3. **Financial Resource Management and allocation:** Co-operatives often have more complex financial structures given the localisation of capital and liquidity albeit under a mutual guarantee structure. That requires tight control over local risk-taking and specific solutions to capital and liquidity management within the group to ensure adequate coverage is available.
4. **Capital and funding agility:** Co-operatives, unless they have access to wholesale funding, have less ability to raise short-term capital quickly in response to a crisis due to the reliance on member capital

EXHIBIT 19: KEY SUCCESS FACTORS IDENTIFIED BY CO-OPERATIVE BANKS PARTICIPATING IN THIS STUDY – 2012 SURVEY



Source: Oliver Wyman

However, in order to do more than just survive these challenges – in order to thrive and position themselves for future successful growth – Co-operatives need to focus on a number of key areas:

I. RE-EMPHASISING CO-OPERATIVE VALUES

The Co-operatives Banks participating in this study remain proud of Co-operative values and committed to the principles of Co-operative Banking. These standards offer a strong compass for navigating uncertain market conditions and, hopefully, avoiding the reputational scandals that have beset other bank competitors.

EXHIBIT 20: REPRESENTATIVE COMMENTS FROM DISCUSSIONS WITH CO-OPERATIVE BANKS

"Co-operative Banks exist for the purpose, for serving members, individuals and SMEs"

"In the end, banking is all about trust"

"Customer advocacy/putting the customer first remains a key point"

"High levels of pride in the Co-operative model and high commitment to Co-operative values"

We see two priorities:

- Ensuring that the **message of Co-operative values** and what these values mean for their business is transmitted more effectively to regulators, investors and customers. This is the key differentiator of Co-operative Banks and has the potential to be a significant competitive advantage but has so far been underutilised – Co-operatives could afford to emphasise their differences from Shareholder Banks more.
- Delivering on values through **high service standards and appropriate products** to core clients. It has hard for Co-operatives to distinguish themselves from Shareholder Bank competitors based on product innovation in their core retail and SME space. Instead the focus needs to be on:
  - Continuing to ensure the appropriateness of all product sales. This is in-line with core Co-operative values and is particularly key given the emphasis on customer protection and the risk of mis-selling scandals (e.g. PPI in the UK)
  - Delivering the highest standards of customer service through all channels (branch/phone/e-banking)

II. RE-ASSESSING GOVERNANCE MODELS.

Governance improvements are a key area for development at many financial institutions post crisis and the time is ripe for Co-operative Banks to re-assess their governance structures and where necessary, implement gradual changes.

This study does not recommend the convergence on a single Co-operative governance model and is not trying to suggest that Co-operatives should move towards Shareholder Bank governance structures. There is value in diversity and the long history of different Co-operative models developing within different local cultures does not advocate sudden change. However, we see a number of areas for potential evaluation and development. The aim of all these recommendations is to maintain the strengths of Co-operative governance structures while ensuring that developing international principles of good governance are reflected at all levels within the Co-operative model:

- Review and tightening of overall governance standards and – as has already begun at some institutions – a revision of formal governance and membership rules. This may also include a reconsideration of the positioning and oversight of non-core subsidiaries and changes to the management of Listed entities within the Co-operative strucutre
- Specific focus on tightening of risk governance in line with regulatory pressures
- Ongoing work to support and strengthen the Boards of member banks in line with the principles of and enhanced governance standards required by regulators at Group level. Key areas to consider include:
  - Continued information and training support for all members participating in governance bodies at all levels. The materials and information provided needs to reflect evolving international governance principles
  - Developing reporting flows between governance bodies at local and central levels in line with regulatory expectations

III. REASSESSING OPERATING MODELS

Co-operatives have historically operated with higher embedded cost levels on average than Shareholder Banks and cost management pressures will continue and need to be addressed. As profitability pressures on all banks increase, the cost burden of industry and regulatory changes is likely to put increased pressure on smaller Co-operative entities. This may potentially be addressed through:

- Continued gradual rationalisation of branch networks in light of channel proliferation whilst still remaining true to the principle of customer access. This needs to be done without losing the physical link to local customers and the ability to engage and make a positive impact on local communities
- Further consolidation of smaller Co-operative entities within larger groups (e.g. the merger of Friesland Bank with Rabobank in response to cost and capital pressures)
- Continuation of the trend for increased centralisation of non-customer facing shared services within the Co-operative group, whilst still maintaining the local decision taking and proximity to the customer

APPENDIX I.

A. SOURCES AND FURTHER INFORMATION

This report was compiled through a combination of three major sources:

- Research and analysis of 3rd party sources conducted by the Oliver Wyman project team
- A questionnaire distributed to a sample Co-operative Banks and covering a range of topics including strategy, membership, governance, risk, values overall outlook. Results for the questionnaire shown in this report are based on detailed responses from seven Co-operative Banks
- A series of senior level interviews with the Co-operative Banks participating in this study. We also recevied feedback on key messages from a task force of Co-operative Bank representatives

The following data sources were used:

1. Bankscope
2. Annual Reports/Registration Documents/Financial Reports
3. EACB
4. Bank of England
5. European Banking Federation
6. Dealogic
7. Bloomberg
8. Moody's LT Deposit ratings
9. Bank of Italy
10. Oxford Economics

The following papers/reports have been reviewed in the preparation of this report:

1. "Co-operative Bank, Customer Champion", Oliver Wyman (2008)
2. Groeneveld, J.M. (2011), 'Morality and Integrity in Cooperative Banking', Ethical Perspectives, Vol. 18, No. 4, pp. 515-540.
3. "Morality and Integrity in Cooperative banking" J.M Groenveld, Rabobank (June 2011)
4. "Performance of European cooperative banks in the recent financial and economic crisis" N.Smolders, I.Koetsier and B. de Vries, Rabobank Economic Research Department (February 2012)
5. "Mutual Guarantee Schemes: Importance and Outlook", Opinion Paper of IW Köln / Universitiy Cologne by T.Hartmann-Wendels and M. Jager-Ambrozewicz (2010)
6. "Bundesverband der Deutschen Volksbanken und Raiffeisenbanken – National Association of German Cooperative Banks"

B. DATASET

We took a sample dataset for comparison between Co-operative and Shareholder Banks.

We note that there are limitations in this approach – in some countries (e.g. UK) the Shareholder Banks are significantly larger than the Co-operative Banks in the dataset. As such, country level analyses are of limited value however at an aggregate level the data does allow us to get a snapshot view of average patterns across the two groups of Banks.

EXHIBIT 21: TABLE OF CO-OPERATIVE AND SHAREHOLDER BANKS INCLUDED IN THE ANALYSIS

COUNTRY	CO-OPERATIVE BANKS	SHAREHOLDER BANKS
Austria	Raifeisen Zentralbank Osterreich AG	Erste Group Bank UniCredit Bank (Austria)
Finland	OP-Pohjola Group	Nordea Bank (Finland)
France	Crédit Agricole Group BPCE Group Credit Mutuel Group	BNP Paribas Société Générale
Germany	Volksbanken Raiffeisenbanken Co-operative financial network	Deutsche Bank Commerzbank UniCredit Bank (AG)
Italy	Banco Popolare Unione di Banche Italiane Scpa – UBI Banca Federazione Italiana delle Banche di Credito Cooperativo	UniCredit Intesa Sanpaolo Banca Monte dei Paschi di Siena Gruppo
Netherlands	Rabobank Nederland Group	ING Group
Switzerland	Raiffeisen Schweiz Genossenschaft-Raiffeisen Suisse société coopérative	UBS Credit Suisse Group
UK	The Co-operative Bank	HSBC Holdings Barclays Royal Bank of Scotland Group

EXHIBIT 22: EACB EUROPEAN CO-OPERATIVES' KEY STATISTICS, 2010[5]

FULL MEMBER ORGANISATIONS	ECONOMIC INDICATORS			PROFITABILITY INDICATORS			CAPITAL SOLIDITY INDICATORS					OTHER INDICATORS					MARKET SHARE	
									Long term rating									
	Total assets (EUROmio)	Total deposits (EUROmio)	Total loans (EUROmio)	ROA (%)	ROE (%)	Cost/ Income (%)	Tier 1 capital ratio (%)	Total capital ratio (%)	S&P	Moodys	Fitch	Nb employees	Nb clients	Regional/ Local banks	Banking Outlets	Nb members	Market share deposits (%)	Market share Credits (%)
Austria																		
Österreichische Raiffeisenbanken	255,220	149,742	162,777	0,6	10,5	65,7	7,80	11,4	A	A1	A	25,828	3,600,000	551	1,738	1,720,000	29,3	25,5
Österreichischer Genossenschaftsverband	65,167	29,588	45,021	0,3	5,1	62,5	11,4	17,0	n.a.	A	n.a.	12,980	1,500,000	80	1,042	701,643	7,2	7,3
Bulgaria																		
Central Co-operative Bank	1,168	990	610	1,10	8,56	73,4	13,5	13,5	n.a.	n.a.	n.a.	2,203	1,220,811	30	266	6,953	4,10	2,26
Cyprus																		
Co-operative Central Bank	19,936	13,513	12,515	0,67	13,4	54,5	10,1	5,0	n.a.	n.a.	n.a.	2,865	746,734	111	426	633,620	19,34	20,35
Denmark																		
Sammenslutningen Danske Andelskasser	2,037	1,333	1,283	(-)1,22	(-)12,1	128,0	11,9	12,1	n.a.	n.a.	n.a.	623	125,000	16	51	63,000	0,62	0,51
Finland																		
OP-Pohjola Group	83,969	39,205	56,834	0,50	6,80	59,0	12,8	12,8	AA-	Aa2	AA-	12,504	4,133	213	554	1,300,000	32,5	33,0
France																		
Crédit Agricole	1,730,846	811,800	882,035	n.a.	n.a.	60,9	10,3	11,7	AA-	Aa1	AA-	161,276	54,000,000	39 [a]	11,500 [a]	6,500,000 (a)	n.a	n.a
Crédit Mutuel	591,309	228,412	323,065	0,50	11,88	60,8	11,5	4,67	A+	Aa3	AA-	75,805	29,200,000	18 [f]	5,875	7,200,000	14,2	17.0
BPCE [b]	349,000	167,900	122,700	0,30	5,80	78,5	9,1	11,1	AA-	Aa3	A+	40,855	7,800,000	20	2,938	3,300,000	6,7	7,6
Germany																		
BVR/DZ Bank	1,020,313	619,985	583,326	0,80	13,0	63,3	8,9	13,7	A+	n.a.	A+	187,296	30,000,000	1,138	13,474	16,689,000	19,4	16,9
Greece																		
Association of Cooperative Banks of Greece	4,500	3,400	3,500	0,72	5,56	n.a	17,5	9,89	n.a.	n.a.	n.a.	1,307	430,686	16	191	212,488	1,0	1,0
Hungary																		
National Federation of Savings Co-operatives	5,075	4,240	2,070	0.65	8,56	68,8	17,1	20,8	n.a.	n.a.	n.a.	7,101	1,100,000	112	1,520	120,506	8,58	2,77
Italy																		
Assoc. Nazionale fra le Banche Popolari	481,472	425,375	378,391	0,70	5,10	57,6	7,90	11,2	n.a.	n.a.	n.a.	84,500	9,593,158	100	9,514	1,212,739	26,9	24,7
FEDERCASSE	179,960	151,037	135,300	0,20	1,70	74,2	14,1	15,2	n.a.	n.a.	n.a.	32,000	5,700,000	415	4,375	1,010,805	7,3	7,2
Lithuania																		
Association of Lithuanian credit unions [a]	315	259	173	(-) 3,33	(-) 0,36	1,10	18,3	19,2	n.a.	n.a.	n.a.	478	102,403	61	167	101,501	2,0	1,0
Luxembourg																		
Banque Raiffeisen	5,868	4,695	3,746	0,28	8,0	71,2	7,90	9,67	n.a.	n.a.	n.a.	511	124,501	13	49	7,514	11,0	11,0
Netherlands																		
Rabobank Nederland	652,536	298,761	436,292	0,42	8,60	64,5	15,7	5,20	AAA	Aaa	AA+	58,714	10,000,000	141	911	1,801,000	40,0	29.0
Poland																		
Krajowy Zwiazek Banków Spóldzielczych	17,625	13,400	9,900	1,14	12,1	69,2	9,80	13,6	n.a.	n.a.	n.a.	32,131	7,500,000	576	4,395	2,500,000	8,90	5,70
Portugal																		
Crédito Agrícola	13,213	9,989	8,606	0,3	3,6	67,2	12,6	13,4	n.a.	n.a.	n.a.	4,314	1,181,291	86	691	391,782	4,50	3,10
Romania																		
Creditcoop	185	116	120	0,69	3,16	97,12	36,4	21,8	n.a.	n.a.	n.a.	2,171	1,086,070	48	784	679,569	n.a	n.a
Slovenia																		
Dezelna Banka Slovenije d.d. [a]	911	625	643	0.05 [e]	0.53 [e]	76,8	11.8	13,4	n.a.	n.a.	n.a.	405	86,000	n.a.	88	302	2,67	1,64
Spain																		
Unión Nacional de Cooperativas de Crédito [a]	119,455	98,222	95,589	0,37	4,60	52,8	n.a.	n.a.	n.a.	n.a.	n.a.	20,722	10,819,586	80	5,079	2,223,603	6,62	5,26
Sweden																		
Landshypotek [a]	4,648	n.a	4,123	n.a	n.a	n.a	n.a	n.a.	n.a.	A2	n.a.	100	69,216	10	n.a	57,606	n.a	n.a
United Kingdom																		
The Co-operative Bank [e]	51,764	38,719	39,699	0,17	3,81	71,6	9,9	4,59	n.a.	A2	A-	10,780	5,111,008	n.a.	342	2,004,743	5,0	1,5
Total (EU 27)	5,656,492	3,111,306	3,308,318									777,469	181,100,597	3,874	65,970	50,438,374	21,00 [e]	19,00 [e]

Associate Member Organisations																		
Canada																		
Desjardins Group	129,344	84,798	87,552	0,85	11,6	71,9	17,7	18,7	AA-	Aa1	AA-	42,641	n.a.	451	1,375	5,806,001	43,4	32,4
Japan																		
The Norinchukin Bank / JA Bank Group [c]	591,579	348,363	119,098	0,2	3,5	89	16,8	22,8	A+	A1	n.a.	223,239	n.a.	715	9,015	4,778,919	10,5	6,8
Total (Non EU 27)	720,923	433,161	206,650									265,880	n.a.	1,166	10,390	10,584,920		

a) 2009 data
b) 2008 data
c) Fiscal Term 1 April 2010 to 31 March 2011
d) Before tax
e) Estimate
f) 2,065 local banks

5 2011 data not due to be released by EACB until November 2012

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