COPENHAGEN BUSINESS SCHOOL
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# Corporate Governance in Financial Mutuals

# EXECUTIVE SUMMARY

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The report's six chapters introduce a wide range of important conditions for corporate governance in association-owned companies.

## Literature review

In chapter 1, the members' dual function as users and owners is identified as a special feature in association ownership, which also leads to a double bottom line where members are favoured, partly through prices and possibly through other member benefits, and partly through earnings in the company.

The chapter explains how members' knowledge of the ownership form is essential for the realisation and exploitation of the association-owned company's rasion d'etre, and it highlights that the specific characteristics are increasingly communicated to members and potential customers. This makes it particularly important to consider:

- The purpose of the activity and tasks to be executed in order to optimise the interests of members;
- Members' ownership, share of profits, and benefits;
- Governance and the members' democratic influence in the company in order to safeguard the activity;
- Management's role, handling of the activity purpose, and interaction with members.

The focus of the chapter is association-owned financial companies and, in particular, co-operative banks and, to a lesser extent, insurance companies with similar forms of ownership. Data collected from the EACB (the European Association of Co-operative Banks) show that their members work well with these specific characteristics. For instance, they have gained greater market shares since the mid-2000s.

A review of a large number of scientific, quantitative studies in this area also shows that there is no difference between risk-adjusted returns among co-operative financial companies and companies with other forms of ownership, even though the co-operative companies operate with a double bottom line, handle wider purposes, and could be expected to have higher agent costs as well as costs related to the management of the democratic membership system. A separate finding in the scientific literature is that the co-operative financial companies have a lower risk of bankruptcy than the sector as a whole due to relatively good and stable results, thus ensuring greater stability in the sector, with consequent positive effects on the economy.

At the same time, the literature shows that co-operative banks have a steadier lending growth, with the retention of lending to their primary customer groups (private households and small and medium-sized enterprises) during the financial crisis. This supports the closeness (local rooting), sense of security, and safety that are highlighted as key characteristics of the co-operative ownership form, and which the co-operative companies practise in relation to their members with greater effect and conviction than other ownership forms do.

The chapter's literature review also stresses that the conversion of cooperative companies into other forms of ownership is not on the agenda, but that instead, the diversity of ownership in the financial sector is highlighted as a crucial parameter for securing stability (including at a societal level), safeguarding of member interests with clearly defined, long-term activity purposes, as well as local rooting and preservation of activities in local and outlying areas, etc.

### Financial results of association-owned companies

Chapter 2 reviews the results of a study of new, extensive empirical evidence carried out for this report. The link between association ownership (as compared to other ownership) and financial performance in the financial sector in Europe is examined based on data from 2004 through 2017. A direct comparison shows that association-owned companies have lower profitability, but when company size, industry conditions and other relevant factors are taken into consideration, the association-owned companies perform just as well as other companies.

As a starting point, however, the picture appears less positive than in chapter 1. The return on investment of assets is lower and the difference is statistically significant. However, as is the case in the other studies, it is also less volatile. The return on investment of equity as well as the solidity and liquidity of the assets are also less in the association-owned company – this applies to the whole sector as well as specifically to the credit institutions.

However, in contrast to the other studies, this survey also looks at the risk-adjusted returns. For credit institutions, a number of additional data are available, which make it possible to calculate the risk-adjusted return on investment, among other things. For this variable, there is no statistically significant difference between the two groups – association-owned credit institutions and credit institutions with other ownership. Even on direct returns, there is no difference when important risk parameters are considered.
Furthermore, we see that the income of association-owned credit institutions, which include mortgage credit institutions and banks, is more interest-rate sensitive than the other banks. We also see that they have higher quality in their loans (fewer non-performing loans).

Over the entire period, the picture is thus that when many things are taken into account, there is little difference left and it is not significant. However, in the course of the financial crisis, there is a significant positive effect of association ownership; it appears that in times of crisis, this form of ownership increases the resilience of both the sector and society.

## The legal framework

Chapter 3 sets out the legal framework for corporate governance in association-owned companies. The chapter compares this company form with a number of other forms of association, including limited liability companies and foundations, in a list of different dimensions. The chapter emphasises that the boundary between, inter alia, foundations and associations can be difficult and even very fine-drawn. For example, in the same way as with foundations, it may have been decided that in the event of a dissolution, the assets of an association may not revert to the founders or members. Unlike companies, associations are based on a collectivity concept, which results in, among other things, a duty of loyalty and the possibility of being excluded.

Once again, this highlights the member's key role, both in terms of the association's responsibility towards the member (present as well as future) and in terms of the member's duties, rights and possibilities in relation to the overall management of the association (a variant of the members' dual function).

The chapter also touches on association-owned financial companies that are converted financial enterprises where the financial activity has been separated off into a limited company newly formed for this purpose, and where the association, in this connection, has received shares in the limited company. The chapter focuses in particular on the enhanced regulatory control with these companies.

It is also interesting to highlight the opportunities and actual uses of boards of representatives that are displayed. On the one hand, the board of representatives can be seen as a weakening of democracy, as it introduces an additional element between the members and their elected members of the board of directors. On the other hand, the board of representatives can help secure a smaller representation gap between the many members and the few board members, while at the same time it can help strengthen local rooting. The possibility of membership ballots is also worth noticing.

### Case studies

Chapter 4 presents five cases. These deal with four banks (Rabobank, Raiffeisen Banking Group Austria, Crédit Agricole, and OP Financial Group) and one insurance company (Gjensidige). These examples evoke very sharp images of the co-operative identity and distinctiveness. Examining a number of their historical and current narratives and practices, it becomes clear how strongly these association-owned companies dedicate themselves to the association's activity purposes and the joint ownership, exposing the unique features of the co-operative model through visible and active publicity.

In this context, the chapter also discusses the fact that the extensive and detailed regulation of the financial sector to some degree dilutes and renders redundant the unique co-operative values, while at the same time regulation impedes the practice of the co-operative business model.

Ownership is exercised through the principle of one vote per member with a board of representatives as the company's ultimate governance body and materialises on (at least) two levels: the macro level, which considers the needs of the surrounding society, and the micro-level, which considers the users and the local communities of which the members and the co-operative financial companies are a part. Local rooting in proximity to the main customer groups (private households as well as small and medium-sized enterprises) and local member influence are the foundation of all the co-operative banks that were studied.

It is interesting to note that among the selected companies, there seems to be no lack of equity; this is primarily raised through earned profits and contributions from members (in the form of member certificates). Member certificates may be transferable and might also be available for external investors to acquire, but always without associated voting rights, and remuneration is typically paid with a fixed rate of return and in a few cases with correction in relation to the company's residual earnings. It is in the latter cases that there is a potential risk of conflicts of interest.

At the same time, the co-operative companies are active in the capital market and use a wide range of instruments to procure loan capital, but without sharing control with external players. On the other hand, a couple of the co-operative companies have established listed companies that operate without any direct significance for the maintenance of the association-owned company's activity purpose. Thus, it would seem that they have succeeded in raising capital from new external investors without having to change the behaviour of the cooperative company in relation to the double bottom line and the dual function of its members.

The case studies therefore clearly illustrate that the co-operative companies are shielding themselves from the significant latent conflicts of interest that arise from the involvement of external owners. In the case of OP Bank in Finland, the ultimate solution has been to delist a listed branch of the company. The insurance company Gjensidige stands out from these observations in that it is the actual core activity that is listed, albeit with the original members as majority owners through an association formation. In this way, the chapter contributes to ascertaining that the activity purpose can be sustained by ownership sharing, but that the co-operative banks operate under conditions where this confusion of ownership interests is complicated if the activity purpose defined by the members of the association is to be sustained.

## Conflicts of interest

Chapter 5 deals with the handling of conflicts of interest between associations and external investors when the operational company is listed or attracts equity in another form. It is therefore an investigation into the conflicts of interest that arise when, for some reason, an association sells some of its ownership – or issues new shares to someone other than its members – in order to finance activities for which there would otherwise not be any money.

Danish company law has limited regulations on how to handle conflicts of interest, and apart from these, it is up to the parties to take advantage of the extensive freedom of contract offered by the Danish Companies Act. They are dealing with ownership agreements, the statutory possibilities, and a number of principles of company law and principles relevant to the conflict of interest. Similar regulations do not exist for associations, but the principles of association law in themselves aim to counteract conflicts of interest, if:

- Members have a duty of loyalty under the association's statutes, purpose and decisions;
- Members who are not loyal to the association can be excluded;
- All members as a rule are equal as regards voting rights;
- Amendments of the statutes, and in particular the purpose, are deliberately difficult and at times impossible.

The chapter also explains that conflicts of interest can be handled through corporate governance. In this context, a number of observations from the case studies are taken into account, and it is clear that the association-owned companies use corporate governance to a large extent to offset and reconcile interests with both external lenders and external owners. For instance, Rabobank, which is very active in the loan capital market and only offers external owners the opportunity to acquire non-voting member certificates, chooses to compose its board of directors solely of external members independent from the member organisation, and this may be a confidence-building measure in relation to external interests, lenders and investors.

Similarly, it is clear that all co-operative banks communicate actively with the lending and capital markets with, among other things, continual quarterly reports and announcements, even if they are not listed on the stock exchange. In relation to the remuneration of loan capital, the predominant tool of operation is a fixed rate of return, i.e. not remuneration contingent on the residual earnings, which could trigger significant conflicts of interest between external investors on the one hand and members who are also users of the company's services on the other.

When there is an initial public offering (IPO) of activities, as in the case of Austrian Raiffeisen and French Crédit Agricole, it should be noted that it relates only to activities without direct relation to the members, and that any transactions between the listed company and the co-operative entity are based on market prices. At the same time, the listed entity will typically operate with activities that have been separated off, and which are geographically located away from the members of the co-operative entities. The exception to this general rule is the insurance company Gjensidige, where the IPO relates to the operating or core activity of its members (customers), but, conversely, it is a variation over the same mechanism that unites the ownership interests in the cases of the co-operative banks, since the insurance market is characterised by full competition and a high degree of transparency.

Based on the data from chapter 2, some implications of public listing of association-owned financial companies are also examined. The results indicate that listed association-owned companies perform better than non-listed companies (in terms of financial returns), while the opposite is true for companies with other forms of ownership. In other words, it appears that public listing may have beneficial effects on association-owned companies and that the conflicts of interest related to it can, to some extent, be feasible and for the benefit of the company. However, it is noteworthy that most converted companies have now disappeared.

## Association ownership as long-term ownership

The report's last chapter looks at association ownership as long-term ownership. Association-owned companies will often have a broader purpose than the maximisation of the return on invested capital. In particular, they will attach importance to the dual function of members as users and owners, and typically, they will have an obligation to continue the activity for the benefit of future users and owners. In other words, they are born with a broader objective than investor-owned companies, and in this way, they are very similar to trade funds.

By virtue of their purposes, association-owned companies will typically be considered long-term owners, something that may be evident in a number of ways in the management of the company, for instance through:

- Responsible, active ownership – to safeguard the association's purpose;
- Sustaining the association's values – not just profit maximisation;
- Stability of the board of directors;
- Stability of the board of management;
- Long-term incentives;
- Long-term, sustainable strategy;
- Performance targets in accordance with the association's purpose;
- Accountability to the surrounding society.

It is a combination of favourable conditions for all these mechanisms which, if redeemed in the right way, will allow an association to exercise long-term ownership and eventually profit from this.

The purpose and the performance targets are important prerequisites, and the organisation of the company's management – the relationship between the association and all the underlying representative bodies (board of representatives, board of directors, board of management) – is crucial to the success with which they are realised in the operation. It is important, for instance, that the association's management continually contributes to ensuring that the persistence that helps uphold the purpose does not turn into tardiness that might be the death of the association.

Finally, the chapter contains a quantitative analysis of the survival of association-owned financial companies – also based on the data from chapter 2. Survival in particular can be said to be the ultimate test of the sustainability of an owner form and a business model. The analysis shows that association-owned companies live longer than other financial companies, but it cannot be ruled out that this might be due to industry conditions and size ratios.