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# Alternative banking: Theory and evidence from Europe

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Since financial liberalization in the 1980s, non-profit maximizing, stakeholder-oriented banks have outperformed private banks in Europe. This article draws on empirical research, banking theory and theories of the firm to explain this apparent anomaly for neo-liberal policy and contemporary market-based banking theory. The realization of competitive advantages by alternative banks (savings banks, cooperative banks and development banks) has significant implications for conceptions of bank change, regulation and political economy.

Keywords: cooperative banks; savings banks; development banks; banking theory; banking systems; bank performance; bank ownership.

JEL Classification: G21.

## INTRODUCTION

Research on public banks in Brazil has shifted from criticism and expectations about privatization to reconsideration of their competitive advantages and policy capacities (Hermann, 2011; Jayme and Crocco, 2010; Mettenheim, 2010). This paper seeks to broaden perspectives by reporting research from Europe that suggests alternative banks have out-performed joint-stock banks since liberalization of the industry in terms of efficiency, risk management and profitability. This is a puzzle for market-based banking theory because alternative banks still rely on deposits for finance, originate-to-hold business models and avert profit-maximi-

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zaion. Traditional savings banks, cooperative banks and development banks (especially where not privatized or demutualized) have realized competitive advantages over private and foreign banks since market-based reforms, liberalization, increased competition and adoption of new information technologies. We draw from banking theory to explain how confidence and trust, relational banking, shared wholesale operations and mechanisms to reduce agency costs and transaction costs provide alternative banks with competitive advantages.

Alternative banks matter. Their large scale and conservative policies help avert the formation of asset bubbles and provide more patient capital for firms and households to get through hard times. The retail networks of cooperatives and savings banks help avert credit rationing and capital drain. Confidence and trust reduce liquidity risk and the cost of capital. Alternative banks avert unscrupulous marketing and unethical sales that arise from profit maximization imperatives at private banks. Independent local ownership, relational banking and stakeholder governance make alternative banks better able to monitor firms, debts and the economy, especially when markets fail to provide accurate information and efficient pricing. Social mandates, profit sustainability orientations and board-centered stakeholder governance avert excessive risk and permit long-term investments. Development (special purpose) banks reduce the cost of government, increase control over public policy, and are uniquely positioned to lead consortia and tap markets for green policies, industrial renovation and investment in infrastructure and social capital. Slim central offices, low cost-income ratios and government guarantee of bonds and deposits provide special purpose banks with powerful competitive advantages.

This paper is organized as follows. We first define alternative banking. We then turn to history to explain how European savings banks and cooperative banks emerged as retail depositories for popular savings able to share wholesale divisions in a distinctive *two-tier organizational structure*. We then review evidence of the realization of competitive advantages by alternative banks since liberalization, modernization and market-oriented reforms. This sets the stage for discussion of theories of banking, agency costs, transaction costs and financial intermediation to explain the competitive advantages of alternative banks. The conclusion reviews the implications of recent findings.

## DEFINITION AND TYPOLOGY OF ALTERNATIVE BANKS

Banks are institutions that accept deposits and make loans. This minimal definition captures the core characteristics of banks.[1] We define alternative banks as banks with long-term profit sustainability orientations, stakeholder models of

[1] On minimal definitions, see Gerring, J. (2010 p. 135).

governance and social or public mandates.[2] This definition excludes private commercial and investment banks, but includes a wide variety of institutions such as savings banks, cooperative banks, credit unions, mutual guarantee associations and development or special purpose banks. Alternative banks differ in terms of organization, ownership and governance. However, they share traditions of *stakeholder* governance that empower corporate boards instead of delegating management to CEOs and top staff like joint stock banks. Management of alternative banks involves participation of stakeholders such as employees, public officials and social and political representatives. Development banks retain centralized operations directly responsible for public policy. For Hackethal et al. (2005) and Schmidt (2007), the stakeholder governance of alternative banks favors voice over exit, produces more stable management and reinforces the autonomy of banks and power of boards. Stakeholder governance at alternative banks involves cooperation and coordination with associate institutions, industry organizations, social and political forces and government representatives. This differs fundamentally from private banks marked by a competitive ethos, shareholder delegation of management to CEOs and staff, profit maximization imperatives and greater exposure to capital markets.

Alternative banks generate profit to sustain operations but do not seek to maximize profits. The large scale and capital reserves of alternative banks make it possible to reconcile long-term profit sustainability and mandates to pursue social or public missions. Cooperative banks traditionally cater to low and mid-income groups, small firms and local communities. Savings banks remain independent municipal, local or regional institutions with public missions and often redistribute dividends to social organizations, welfare programs and the arts. Development banks direct funding toward public priorities such as social housing, health care, innovation, environmental sustainability and infrastructure renovation. Alternative banks share corporate cultures that remit to founding missions and histories of social economy.

## ALTERNATIVE BANK HISTORY

Histories of banking in Europe often cite the transformation of money-lenders into merchant banks during the 16th century as the origins of modern banking (Cameron, 1972; Hicks, 1969). Alternative banks emerged well before. Catholic orders and monarchs created pawnshops and savings institutions in the 14th and 15th centuries to reduce usury, weaken money-lenders and promote official currencies (Giannola, 2009). By the 17th century, reserves and patrimony accumulated by *Monti di pietà* were used to fund crown and court, especially for war and repression

[2] Alternative banks are called "not for profit financial institutions" in Canning et al. (2010) and "stakeholder banks" by Coco and Ferri (2010).

of rebellions (Cameron, 1972). In the 18th and 19th century, *Monti* became regional and, later, national banks.[3]

Savings bank began as municipal government savings departments and reached 110 banks across Germany territories by 1825 (Wysocki, 1996). In Britain, savings banks adopted two practices that became the core business model: free savings accounts and liquid deposits. Savings banks were created to teach popular classes the habit of saving, increase the liquidity of capital and spur economic growth. Local savings banks emerged throughout Europe during the 19th century, often amidst famine and economic recession, and formed associations in the late 19th century to create clearing houses and provide wholesale banking products and services. Savings banks maintained a third of domestic banking market shares in many European countries through much of the 20th century, flourishing both under dictatorship and democracy.

Cooperative banks are deposit taking and loan making institutions grounded in the one-member one-vote principle of governance. Schulze-Delitzsch and Raiffeisen movements founded cooperative banks in the mid-19th century as philanthropic self-help institutions to encourage workers to join resources and accumulate savings. Cooperative banks were designed to counter famine, failures in labor markets and problems with public grants inspired by Ferdinand Lassalle.[4] The movement soon extended to other European countries, notably Austria, Italy and the Americas.

After 1860, cooperative banks across Europe also grew rapidly and formed wholesale associations. This second tier of central cooperative agencies or *Girozentralen* emerged in German territories in 1895. Historical time series (Bundesbank, 1976) record how interbank payment services, capital and metal reserves, foreign exchange, securities, credit and interbank credit and acceptances grew at central cooperative agencies (one in Prussia, nine across German states consolidated into 6 by 1913). Similar two-tier organizations emerged in Italy, with cooperative associations acquiring substantial market shares in loans, discounts, commercial paper, public bonds and industrial securities. Elsewhere, creation of second-tier wholesale banking divisions involved state support as reported by Gueslin (2002) for France and Cabo and Rebelo (2005) for Portugal.

Credit cooperatives had flourished by the early 20th century only to succumb, in many cases, to nationalism, xenophobia and mobilization for World War I. Moreover, by the 1920s in Italy and 1930s in Germany, Spain and Portugal, fascist and phalange movements centralized cooperative banks and credit unions under single party and central government control. After 1945, cooperative banks re-

[3] For example, the *Banco de Napoli* was created by consolidation of eight popular pawn banks in the 16th century.

[4] "The co-operative societies which have prospered are those that have made up their own capital by the heroic setting aside of part of working men's daily wages. Those to whom the Government made loans in 1848 have soon broken up." Des Essars (1896, p. 210).

gained autonomy and acquired large market shares in many European countries, while becoming less important in the US and UK.

Continental European governments created development banks in the 19th century to finance industrialization in lieu of private banks and capital markets (Sylla, 1991; Diamond, 1957). The French Caisse de Dêpots (1816) and Crédit Mobilier (1852) were emulated abroad to finance railroads and industry (Aghion, 1999; Kindleberger, 1984). Development banks were also created to manage industrial reconstruction after World War I.[5] After 1945, the Kreditanstalt fur Weidaraufbau (Reconstruction Credit Agency, KfW) and Japan Development Bank channeled Allied funds for reconstruction. Development banks have since adopted new policies and strategies to help transform industrial production towards environmentally sustainable practices and channel strategic investments to priority sectors such as home construction and public finance.

Development banks lack the broad retail networks of cooperative banks and savings banks. However, they retain powerful competitive advantages and provide comparative advantages for government policy. The lean administrative structures of development banks translate into very low cost-income ratios. For example, in 2009, German special purpose banks reported cost income ratios of 33.0 (KfW=22.1), far below commercial banks (79.9), foreign banks (69.9), savings banks (67.2) and cooperative banks (70.6 for central coops; 69.1 for regional coops) (Bundesbank, 2010). In 2010, the cost income ratio for the French CDC was 17.0. Development banks thus provide more government for less. Over ten times more. For governments without banks, one million available in budgets translates into one million invested or spent. With the same one million, development banks can lend *10 times this value* under Basel Accord capital risk guidelines (i.e., ten times reserves, rounding and ignoring risk weighting and profits and losses). Special purpose banks such as the KfW also raise capital on bond markets (often with government guarantee). This further reduces fiscal cost and reinforces competitive advantage.

In sum, a historical approach suggests that alternative banks acquired institutional foundations of competitive advantage because of safer strategies of profit sustainability, solid deposit bases and capital reserves, greater client/member/depositor confidence, unique two-tier organizational structures, corporate cultures of social economy and closer control and supervision of management. This has provided competitive advantage since liberalization, reform and the adoption of new technologies.

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[5] Aghion (1999) cites: Société Nationale de Crédit à l'Industrie (Belgium, 1919), Crédit National (France, 1919), National Bank, Poland (928), Industrial Mortgage Bank (Finland, 1928), Industrial Mortgage Institute (Hungary, 1928), Istituto Mobiliare Italiano (Italy, 1933), Istituto per la Ricostruzione Industriale (Italy, 1933).

## ALTERNATIVE BANKS SINCE LIBERALIZATION, REFORM AND TECHNOLOGY REVOLUTION

Since 1980, liberalization, market-centered reforms and new technologies have revolutionized banking by increasing competition (from banks and other firms and instruments), encouraging market-based banking and consolidating banks through mergers and acquisitions (Boot and Marinç, 2008). Alternative banks have pursued a wide variety of strategies across Europe. Some public savings banks opted for conversion into cooperatives and pursued market-oriented banking, notably in France. In Sweden, Belgium, Italy and Spain, savings banks were privatized (privatizations in Italy granted shares to foundations designed to separate banking from the traditional social roles of savings banks). Spanish savings banks retained social mandates under regional and local control while expanding across regions to compete with each other and private banks. In Portugal, Ireland and Greece, alternative banks modernized only to confront severe downturns since 2008, while Austrian banks were caught exposed to Eastern Europe. German savings banks and cooperative banks retained their legal forms (mostly independent local or regional public companies) to consolidate market shares, deepen wholesale associations and operate in financial markets (often through provincial government Landesbanks). In the Netherlands, the Rabobank cooperative bank declined during the 1980s and 1990s only to recover large market shares and globalize after 2000. Europe thus provides a quasi experimental opportunity for study of bank change. We focus on the realization of competitive advantages by alternative banks. Instead of being replaced by more efficient joint-stock private banks and market-centered finance, alternative banks have reaffirmed traditional business models, stakeholder governance, principles of profit sustainability and modernized.

Considered individually, local and regional savings banks are often very small. However, as a whole they sum to large market shares in many European economies (Butzbach, 2006). And since financial liberalization, savings banks have maintained or *increased* market shares. In 2007, savings banks retained the following market shares of bank assets; 39.0% in Spain, 34.8% in Germany, 22.0% in Sweden and 16.9% in Austria.[6] Assets of German savings banks (including Landesbanken) totaled 2.36 trillion euros in 2009 (35.5% of German bank assets) or the third largest bank group in the world. In 2009, Sparkasse held 38.7% of bank deposits and 28.1% of loans to non-financial firms in Germany. Spanish savings banks held 50% of bank deposits and 46.9% of loans in 2008.

Cooperative banks have also modernized. Cooperative banks have restructured, merged local banks and regional groups to reap economies of scale[7] and expanded shared wholesale divisions to improve bring new products and services

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[6] Data from European Savings Banks Group (2009); total banking assets are from European Central Bank (2010).

[7] The number of cooperative banks in Germany dropped from over 3,000 in 1980 to under 900 in 2010.

to members and clients. In 2009, the cooperative bank market share of lending to small businesses in Italy, France, Germany and the Netherlands ranged between 25% and 45%; market shares of ATMs reached over 50% in France and Austria and over 35% in Germany and the Netherlands.[8]

For many cooperative banks, the 2000 downturn in European markets was a turning point because members and clients sought more secure deposit and savings accounts. For example, Rabobank members had declined by half to near 500,000 by 2000 only to reach over 1.6 million in 2010. Booming capital markets once again pressured cooperative banks during the 2000s by attracting members and clients to accounts and funds at private banks. However, since 2008, members and clients once again appear to favor the security of cooperative banks and their social models and missions. The broader branch office networks, better local information, governance principles of one-member one-vote and participation of members in strategy, control, supervision and decision making improve the self-regulation and risk assessment of cooperative banks.

Special purpose banks such as the German KfW and French CDC have also modernized since liberalization, market oriented reforms and transition to the euro.[9] The KfW has grown substantially since the 1950s, expanding its share of German bank assets 2.4%-4.5% 1990-2010. During the 2000s, the KfW managed privatization of the German Telekom and Post companies and provided counter cyclical credit 2008-10 to shape recovery. KfW lending in 2010 reached 81.4 billion euros (27% above 2009; municipal finance up 69% to 15.8 billion euros) while also providing loan to Greece under guarantee from German federal government and special finance lines for domestic firms.[10] In 2010, the KfW managed 441.8 billion of loans and finance through 10 provincial and regional development banks in Germany, while maintaining a conservative 14.7 capital ratio and low 21.1 cost income ratio on base of 4.531 employees. New priorities for small and medium business, globalization, export finance, international development and environmental sustainability suggest that past missions have been replaced by new strategies and policies.

The French government CDC also continues to function under parliamentary supervision and public guarantee to manage popular savings, sustainable savings and judicial deposits (211.9 billion euros) as well as one in five French pensions and social funds (200 billion euros). The French government *Élan 2020* plan sets new goals for CDC investments in housing, universities, SMEs and sustainable development. In 2009-10, the CDC created independent division for each goal. In 2009, purchase of a 26% stake in the public postal system capitalized La Poste and

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[8] European Association of Cooperative Banks (2009).

[9] Subsidies to German banks criticized by the European Commission in 1999 were removed by 2004 (Chakravarty and Williams, 2006).

[10] Multiple bailouts of IKB bank led to resignation of KfW CEO Matthaus-Maier in 2008, while transfers on day of Lehman Brothers bankruptcy further tarnished bank.

provides a new retail network for the CDC. CDC total assets also increased from 221.0-269.5 billion euros 2008-10, in stark contrast to private banks and market declines.

In sum, development banks in Germany and France have modernized and sought capital and investment partners on markets to expand, provide policy alternatives and mobilize the private sector. These institutions serve as "banks behind the banks" to close financing gaps where markets fail, exactly the mission of development banks founded in the 19th century.

## ALTERNATIVE BANK PERFORMANCE

The evidence on performance is also compelling. Since 2000, studies of bank structure, behavior, and ownership suggest that alternative banks perform better than private banks in terms of cost efficiency, profitability and risk management (Cornett et al., 2010; Carbó Valverde et al., 2002). First, alternative banks appear to be as or more cost-efficient than commercial banks. Ayadi et al. (2009) find that savings banks in Europe are as cost-efficient as commercial banks, but that evidence is mixed for cooperative banks.[11] German cooperative banks appear slightly less cost efficient than German private banks. However, cooperative banks in France, Italy and Spain are, on average, more cost efficient than commercial banks (Ayadi et al., 2010). Iannotta et al. (2007) also report that government-owned and cooperative banks are more cost-efficient across 181 banks in 15 European countries. Altunbaş et al. (2003) found savings and cooperative banks more cost efficient than private banks in 12 of 14 European countries (1990-2000). Country case studies, such as Altunbas et al. (2001) on Germany, Giordano and Lopes (2009) on Italian cooperative banks, Berenguer-Maldonado et al. (2003) on Spanish mutual banks (and Ceneboyan (1993) on the US savings and loan institutions) find similar results.[12] This differs from past findings on savings and loans in the US (Mester, 1993).

Evidence on profitability also seems to be tilting in favor of alternative banks in Europe. For Dietrich and Wanzenried (2011), Swiss government banks outperformed private commercial banks during the crisis (pre-crisis performance was at par). Molyneux and Thornton found state-owned banks in Europe to posted *higher* returns on assets than private banks during the 1980s (Molyneux and Thornton, 1992); Ayadi et al. (2010) that German and Spanish cooperative banks are *more* profitable (ROA and ROE) than commercial banks. And while Iannotta et al.

[11] In comparison of a large sample of European banks from 1992-2000, Altunbas, Carbó, Gardener and Molyneux (2007) find "no major differences in the relationships between capital, risk and efficiency for commercial and savings banks" but, for cooperative banks, that "capital levels are inversely related to risks and we find that inefficient banks hold lower levels of capital."

[12] This differs from past findings on savings and loans in the US (Mester, 1993).

(2007) found government and cooperative banks to perform worse than private, commercial banks in terms of profitability and risk and Altunbas et al. (2003) that European commercial banks are slightly *more* profitable than their non-profit peers, case studies consistently find evidence in favor of alternative bank profitability. Chakravarty and Williams (2006) on Germany, Crespi et al. (2004) on Spain, Altunbas et al. (2001) on Germany, Valneck (1999) on the British Building Societies and Cebenoyan et al. (1993) all find non-profit banks to be *more* profitable than private banks.

Evidence also suggests that alternative banks are less risky. Alternative bank profits tend to be much more stable than private commercial and investment banks. Empirical studies find that cooperative banks and savings banks 1) produce *more stable earnings* over time 2) are less likely to default and 3) have fewer non-performing loans (Ayadi et al., 2010; Ayadi et al. 2009; Beck et al., 2009; Bongini and Ferri, 2008; Garcia-Marco and Robles-Fernandez, 2008; Hesse and Cihak, 2007; Iannotta et al., 2007; Salas and Saurinas, 2002; Esty, 1997). Carbó Valverde et al., (2008) find that savings banks also decrease risk levels in bank systems.

## EXPLANATIONS FROM BANKING THEORY FOR THE COMPETITIVE ADVANTAGES OF ALTERNATIVE BANKS

We turn to banking theory to explain these findings. Contemporary banking theory is based on theories of the firm (Coase, 1937; Grossman and Hart, 1986; Williamson, 1985; Hart and Moore, 1990; Hansmann, 1996) and emphasizes transaction costs of production and agency costs that arise from the separation of management from ownership (Bearle and Means, 1932; Jensen and Meckling, 1976).[13] Recent theories emphasize information asymmetries (Berger et al., 2010; Bhattacharya et al., 2004). Banks can reduce transaction costs created by asymmetric information in credit markets to reduce credit rationing (Stiglitz and Weiss, 1981) and act as delegated monitors for lenders and depositors to reduce the cost of monitoring borrowers (Diamond, 1984).

We focus on five sources of competitive advantage in alternative banking: lower cost of capital; lower agency costs; relationship banking and economies of scale; longer time horizons; and inter-temporal risk smoothing.

The large scale and broad retail networks of alternative banks lower pressure to maximize returns and provide more stable deposit bases and cheaper sources of capital.[14] Alternative banks raise funds largely through retained profits (cooperative and savings banks) and public endowments (savings banks and development banks)

[13] For overviews of theories of the firm applied to banking, see Boot and Marinc (2008, pp. 1193-4) and Swank, 1996).

[14] Large savings and cooperative banks have listed specialized subsidiaries and funding instruments (with a varying degree of success: see the fate of Natixis in France as an edifying example).

or bond issues. Because cooperative banks need only remunerate the part of equity represented by member shares, they can mobilize and retain capital for comfortable levels of liquidity, high deposit-to-loan ratios and lend on interbank markets.[15] Low pay-out ratios let al.ternative banks "enjoy rapid growth in their capital base and therefore fast organic growth" (Fonteyne, 2007:47). This has provided alternative banks with a "patrimonial advantage" during transition to BIS Basel Accords (Giannola, 2009). For Altunbas et al. (2001) more secure deposit bases and "less interest rate sensitive" retail customers provide alternative banks with lower funding costs. Retail positions and customer loyalty may lead alternative banks to become over dependent.[16] However, the exceptional level of customer trust in alternative banks is critical here (Kay, 1991). Trust in alternative banks is based on histories in low-income households and local communities and aversion to exploiting information asymmetries to favor banks over borrowers and depositors (Fonteyne, 2007).

Comparison of monitoring mechanisms in cooperative, public and private banks across six agency problems suggests that alternative banks may reduce agency better than joint-stock private banks. Alternative banks exercise greater control over managers and income streams while averting skewed incentives from stock options and performance based payment schemes (Altunbas et al., 2003; Ayadi et al., 2010). The shareholder value maximization approach has dominated corporate finance theory and practice since the 1980s. If alternative banks sell shares, they may rely on these mechanisms to discipline managers. Alternative banks have further external monitoring and control devices. If government banks are influenced by politics (Shleifer and Vishny, 1998), this implies that politicians and stakeholders are able to control bank managers. Ayadi et al. (2010) build on Fama and Jensen (1983) to suggest that the redeemability of cooperative membership equity claims makes exit a powerful disciplinary device. Cooperative banks and savings banks also rely on networks and shared wholesale operations to discipline managers. German cooperative banks created regional entities to audit and monitor local banks (Guinnane, 1997). Cooperatives also reduce free cash flows through dividends or mutual guarantee funds and exercise peer pressure to limit the independence of managers (Fonteyne, 2007). Cooperatives and savings bank networks also reduce risks and agency conflicts that may arise from input procurements (Desrochers, 2005).

Avoidance of performance incentives and stock options to reduce agency conflicts may have been a competitive advantage for alternative banks given problems of executive performance at private banks. Relations with depositors provide al-

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[15] Evidence from Germany suggests this is no longer the case.

[16] Before the 2008 crisis, Fonteyne (2007) argued that the cost of capital will lose relevance in financial services in the near future. However, given the re-capitalization of banks (whether as a regulatory requirement or as a prudential strategy), access capital at a low cost should remain a source of competitive advantage in banking.

ternative banks with further competitive advantages. Cooperative status means that owners, depositors and borrowers *are the same* and therefore share interests (Valneck, 1999). Conflicts between *net* borrowers and *net* lenders may arise, but pale in comparison to conflicts between depositors and borrowers in joint-stock banks. Moreover, net borrowers at cooperative banks retain vested interests in the sustainability of the bank over time and face peer pressure from fellow members and local communities (Ghatak, 2000). The greater trust of depositors and the general public also reduce agency costs, especially in times of crisis. In hard times alternative (and state-owned) banks are considered as "safe and better banks" (Dietrich and Wanzenried, 2011, p. 321).

Another agency problem (between shareholders and bondholders) is treated by asset substitution effect theories which hypothesize that equity holders have a higher incentive to gain from risk taking than debt holders who bear most of the consequences of risk. Alternative banks are also less prone to this asset substitution problem, having no shareholder in the case of public banks, and having owners with non-transferable equity stakes in the case of cooperatives (Ayadi et al., 2010; Drake and Llewellyn, 2001).

Diffused stockholding ownership makes it easier for managers to pursue their own interests and increases the agency costs of private banks. Managers of savings banks and development banks are controlled by a smaller number of stakeholders with greater interests (typically local, regional or national governments). This runs counter to theories of property rights that see public ownership as less able to create incentives for monitoring agents (Micco et al., 2008; Shleifer, 1998; Grossman and Hart, 1986; Fama and Jensen, 1983). Nonetheless, evidence and theory suggests that savings banks and development banks retain significant competitive advantages over private banks because of lower agency costs.

Member owned cooperative banks also reduce agency costs differently. The dispersed membership structure of cooperatives may increase managerial autonomy (Cuevas and Fischer, 2006). However, Fama and Jensen (1983) argue that a board with outside directors may exercise a check on management in nonprofit firms. Internal procedures for accounting and control appear able to reduce agency costs in cooperative banks.

Conflicts between managers, owners and stakeholders in cooperative and mutual savings banks may arise from weaker incentives of non-private ownership. One member one vote implies that control is unrelated to equity stakes. Moreover, members can relinquish but not sell equity stakes. Cooperative bank equity is therefore different. Fonteyne speaks of an "intergenerational endowment" that does not belong to anyone. Because managers of cooperative banks are custodians of endowments, this may reduce the incentives of members to exert oversight and produce governance problems (Fonteyne, 2007). However, a variety of institutional procedures for internal and external control may ameliorate these problems.

Alternative banks specialize in relationship banking. This reduces risks arising from information asymmetries. Cooperative banks and savings banks are closer to clients (depositors and borrowers) because of their small size and networks of

stakeholders and branch offices. Soft information gathered in proximity to customers reinforces competitive advantages (Oliver Wyman, 2008; Ayadi et al., 2009; 2010; Fonteyne, 2007). For Carnevali (2005), local networks and lending discretion provide savings banks with competitive advantages and help usher small and medium enterprises through economic downturns. While Fonteyne (2007) argued that branch networks generate high fixed costs and may lose relevance, alternative banks tend to see branch networks as essential for competitive advantage. Alternative banks also continue to operate in markets (such as low-income areas) where information asymmetries discourage private banks (McKillop and Wilson, 2011; Bresler et al., 2007).

For private banks, small size and expensive branch office networks may impede acquisition of economies of scale (Berger et al., 2005; Fonteyne, 2007). However, independent cooperative banks and savings banks developed two tiered structures to overcome this problem. Shared wholesale divisions of savings banks and cooperative banks encourage economies of scale, enhance funding opportunities and help ensure against volatile returns through joint-liability and/or mutual guarantee agreements. Two-tiered networks help alternative banks reap economies of scale, avoid pitfalls of vertical integration[17] and increase products and services to reinforce retail and relationship banking (Boot, 2000; Degryse and Van Cayseele, 2000).

Long-term profit sustainability orientations at alternative banks also help avert excessive risk, reduce volatility and produce higher returns over time. This long-term orientation is reinforced by stakeholder-oriented governance, social missions or public mandates and branch office networks embedded in communities. Alternative banks retain more stable boards and greater continuity in top management to sustain longer-term strategies and earnings (Bongini and Ferri, 2007). Aversion to short-term profit maximization and risk helps explain better long-term performance. Alternative banks retain higher quality loan portfolios and avoid risky market operations (Giordano and Lopes, 2009; Iannota et al., 2007). Lower revenue diversification 'more than offsets lower profitability and capitalization' (Hesse and Cihak, 2007). And more stable revenue lowers the cost of credit risk — an important factor in the greater cost-efficiency of alternative banks (Gurtner et al., 2002).

Traditional deposit-taking and loan-making business models also improve risk management at alternative banks. Contrary to contemporary market-based banking theory, the reluctance of alternative banks to diversify sources of revenue has reinforced stability and profitability. On the asset side, banking theory expected markets to reduce risk. This view has lost credibility since 2008 (De Jonghe, 2010). A turn to fee-based income also appears to increase revenue volatility (De Jonghe,

[17] The expense preferences of managers increase with institutional size — but less so in networks (Fama and Jensen, 1983). Two-tiered networks may produce appropriability hazards of free riding (Ayadi et al., 2010, Desrochers and Fischer, 2005), but alternative banks avert this through integration and peer pressure (Akella and Greenbaum, 1988).

2010; Mercieca et al., 2007; Stiroh, 2004). Resistance of alternative banks to diversify revenue helps explain the more stable long-term performance of these institutions and is related to their business and governance models.

Alternative banks also resisted the originate-to-distribute model and retained less risky originate-to-hold practices. Because banks selling loans on the secondary market face issues of adverse selection and moral hazard, Berndt and Gupta (2009) found that banks active in secondary markets *underperform* their peers by about 9% per year. Alternative banks therefore maintained higher, more stable earnings (Coco and Ferri, 2010).

A key advantage of banks over capital markets is their ability to smooth intertemporal risk (Allen and Gale, 1997). Large banks are able to accumulate capital in good times for use in bad times. As Ayadi et al. note: "Creating and unlocking reserves is a specific technique of risk management" (2010, p. 108). In this respect, greater client confidence and trust in alternative banks provide competitive advantages. Clients tend to withdraw deposits from private banks during banking crises while deposits often *increase* at alternative banks during crises. This reinforces the capacity of alternative banks to provide counter-cyclical lending and inter-temporal risk smoothing.

## CONCLUSION

This article has looked to Europe to reassess alternative banking (Jayme and Crocco, 2010; Hermann, 2011). Research suggests that stakeholder governance, social missions, profit sustainability orientations, shared wholesale entities and capacity to multiply public policy are competitive advantages specific to alternative banks in Europe. Savings banks, cooperative banks and development banks have thereby retained or increased market shares since liberalization of the industry and transition to unified regulations under BIS Basel Accords, International Financial Reporting Standards and European Commission regulations. This runs counter to expectations of convergence toward private banking, joint-stock ownership and shareholder governance in banking and finance. Contemporary bank theory, regulators and financial managers expected alternative banks to disappear, either sooner through privatizations or later under competition from more efficient private and foreign banks. Instead, the realization of competitive advantages by alternative banks has produced a back to the future modernization of savings banks, cooperative banks and special purpose banks.

This also implies a back to basics approach in banking theory and regulation (De Grauwe, 2010; Gorton, 2010). Since 1980, reforms and regulations have sought to reinforce market based banking to reduce financial repression and free market forces. However, given the competitive advantages, policy alternatives and systemic importance of alternative banks, a back to basics approach to bank regulation may be in order. Building on a minimal definition of alternative banks as stakeholder-oriented deposit taking and loan making institutions, we explored the

governance, histories and competitive advantages of savings banks, cooperative banks and development banks. Greater client/customer/member confidence and trust, the value of longstanding brands, effective relational banking in local and regional networks, solid deposit bases, conservative capital reserve policies, principles of long-term profit sustainability, governance models that keep management under control, aversion to unethical marketing and sales, ties to social and political forces and sharing of wholesale operations sum to serious competitive advantages. Although discredited for decades, alternative banks in Europe have modernized since financial liberalization amidst revolutions in information and communications technologies to provide more secure savings, credit, finance, insurance and other services to increase competition, transform risk, allocate resources and flatten credit and growth curves.

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