

The Capital Conundrum for Co-operatives



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Preface



In 2012, in conjunction with the United Nations International Year of Co-operatives (IYC), the International Co-operative Alliance (the Alliance) published the *Blueprint for a Co-operative Decade* to take the co-operative way of doing business to a new level. The *Blueprint's* ambition is for the co-operative form of business to become the acknowledged leader in economic, social, and environmental sustainability; the model preferred by people; and the fastest growing form of enterprise in the world. Our belief is that co-operatives build a better world.

To achieve this bold vision, the *Blueprint* lays out a strategy with five pillars, namely, Participation, Sustainability, Identity, Legal Frameworks, and Capital. To guide the work on the Capital pillar, the Alliance established (in late 2012) the Blue Ribbon Commission on Co-operative Capital to consider issues and challenges faced by co-operatives in accessing and retaining capital, in particular, how to “secure reliable co-operative capital while guaranteeing member control”.

Co-operatives, like business of all forms, face challenges in securing the right amount of capital of the right kind. Following the global financial crisis, financial institutions, in particular, have been confronted with heightened regulatory demands on capital adequacy. Financial co-operatives, despite their historically strong capital positions, have found themselves looking beyond traditional withdrawable membership capital and retained earnings to meet heightened capital requirements. This, in turn, has created some debate on the suitability of different types of capital instruments for co-operatives. Beyond financial institutions, co-operatives across various industries and from different countries also continue to face myriad challenges in attracting long-term funding in sufficient amounts given the competition for capital from enterprises of other forms and the unique aspects of co-operative structure.

As a first step towards understanding the co-operative movement's approach to capital, the Blue Ribbon Commission appointed the Filene Research Institute to conduct a *Survey of Co-operative Capital*, covering global co-operatives' existing sources, uses, and structures of capital. The Survey was completed and published in March 2015 and is readily available on the Alliance's website¹ for reference.

At the same time, the Blue Ribbon Commission realised very early on that the issue of co-operative capital was not just a technical matter of instruments and tools. Co-operative capital is distinct from other capital because of fundamental Values, Principles, and philosophies that set co-operatives apart from other enterprises. The work of the Blue Ribbon Commission also comes at a time when the norms and values that have underpinned our global economic system are being questioned – including beliefs about the role and definition of capital. As a movement, co-operatives have an opportunity to make our voices and perspectives heard, as the world searches for alternative economic models that are balanced and sustainable.

It was in view of this insight that we embarked on this thought leadership *Paper on Co-operative Capital* as the second work stream of the Blue Ribbon Commission. In his

¹ <http://ica.coop/en/blueprint-themes/capital/capital-survey>

Introduction, Editor and fellow Commission member, Mr. Tan Suee Chieh – together with his colleague Mrs. Chuin Ting Weber – distils for us the key philosophical underpinnings of co-operative capital and challenges us to push the boundaries of our thinking and vision as a movement. The authors of the chapters – all distinguished co-operative practitioners and thinkers from various countries and sectors – share their valuable experiences and insights from their particular perspectives. On behalf of the Alliance and the Blue Ribbon Commission, I thank them for their generous contribution of time and effort that has made this publication possible.

As readers will realise, this Paper does not try to force a convergence of views among the various authors. Neither is it prescriptive in terms of what co-operatives should do in the area of capitalisation. Rather, it presents a rich diversity of views – which rightly reflects the complexities of the issues we are dealing with – for further contemplation and debate by co-operators and the co-operative movement as a whole. I trust that you will find this stimulating and provocative, and yet informative, as your own co-operative explores capital solutions for continued growth and development.

KATHY BARDSWICK
CHAIR, BLUE RIBBON COMMISSION ON CO-OPERATIVE CAPITAL

Editors' Foreword

TAN SUEE CHIEH AND CHUIN TING WEBER

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Capital is necessary and desirable for co-operatives, because it enables us to conduct business, grow, and meet the demands of our key stakeholders. At the same time, unlike other enterprises, co-operatives' Principles and structure exhibit a profound guardedness and unease about capital and its power. As one of our authors in this Paper puts it, capital is "a troubling issue" for co-operatives.¹

“Co-operatives today have many practical anxieties about accessing capital of suitable forms and in sufficient quantum. The first set of issues stems from the withdrawable nature of co-operative membership shares. This is a disadvantage for financial co-operatives *vis-à-vis* their commercial peers.”

“The other major set of capital issues is the purported economic unattractiveness of co-operatives relative to other forms of enterprise, which limits co-operatives' access to capital.”

Problems with Co-operative Capital

This is not just philosophical angst. Co-operatives today have many practical anxieties about accessing capital of suitable forms and in sufficient quantum. The first set of issues stems from the withdrawable nature of co-operative membership shares. This is a disadvantage for financial co-operatives *vis-à-vis* their commercial peers because regulators do not recognise such “non-permanent” shares as core equity capital. Financial co-operatives have to fall back mainly on retained earnings to meet solvency requirements, which have increased dramatically after the global financial crisis. In contrast, commercial companies' share capital is recognised because it cannot be withdrawn from the company, even if the shareholder as a person “withdraws” by selling or transferring his shares to someone else. Beyond the financial sector, non-financial co-operatives such as those in the agricultural sector have also faced capital instability because of the withdrawability of shares.²

The other major set of capital issues is the purported economic unattractiveness of co-operatives relative to other forms of enterprise, which limits co-operatives' access to capital. In contrast to commercial companies, co-operatives do not maximise shareholder value or returns in proportion to capital contributed, but give benefits to members in proportion to transactions done with the co-operative. While a commercial company's shareholder has a claim on the net asset value of the business and can thus look forward to “capital appreciation” of their shares, there is no such equivalent claim in many co-operatives whose shares are often maintained at nominal value. More money also does not buy you more control, as co-operatives are democratically controlled by members.

Co-operative Principles on Co-operative Capital

Why do we co-operatives circumscribe our access to capital by rendering shares withdrawable and limiting their compensation? The rudimentary answer is that this is the result of Principles laid down in the International Co-operative Alliance's (the Alliance) Statement on the Co-operative Identity. (The full text is in Appendix A.) Below is a brief narration on specific Co-operative Principles that set co-operative capital apart from company share capital:

a. Principle 1 – “Voluntary and Open Membership” and “Definition” of co-operatives:

The voluntary nature of co-operatives allows a member to resign from the co-operative at any time – usually taking his/her share capital with him/her. Even if the co-operative can delay the withdrawal for reasons of solvency or liquidity management, it would

1 Bill Hampel, Chapter 4, “Cooperative Capital: A Necessary Evil”

2 See Chapter 8, Prof. Nicola M Shadbolt and Alex Duncan, “Perspectives from the Ground: Fonterra Co-operative Case Study”

ultimately have to redeem the shares if they are not transferred to another member. Company share capital, however, cannot be “forcibly” redeemed in the same way; the very nature of a limited liability commercial company is that of a permanent entity with permanent capital, until and unless it is brought to dissolution. The open doors of a co-operative also implies that new shares will be issued to new members as a matter of course and usually at nominal value if share subscription is a condition of membership, unlike in companies where existing shareholders have the right to reject new share issuance out of dilution concerns.

b. Principle 2 – “Democratic Member Control”: One member, one vote – or other democratic forms of organisation – means that members who contribute more share capital do not have greater control than those who contribute less. This is diametrically opposed to the “one share (or unit capital), one vote” system of control in commercial companies.

c. Principle 3 – “Member Economic Participation”: This Principle introduces several aspects of co-operative capital:

1. At least part of the capital is “common property” and the establishment of “indivisible reserves” is encouraged. Where this is practised, co-operative members have no claim on the net asset value of the co-operative beyond their withdrawable membership capital. In contrast, a company share represents a claim on the net asset value of the company.
2. Membership capital receives limited compensation, if any at all. It would appear that capital, on its own, is not necessarily entitled to compensation. This runs counter to the prevailing commercial company’s core purpose of maximising shareholder return and shareholder value.
3. Benefits to members should be in proportion to transactions with the co-operatives, not in proportion to shareholding as in companies.

d. Principle 4 – Autonomy and Independence: The raising of external capital (e.g., issuing debt) elicits concerns from co-operatives on the preservation of democratic control. This is sometimes translated into national legislation requiring membership approval for incurrence of external debt, but not for issuance of new shares. In contrast, most company shareholders are happy to allow management to use leverage insofar as it increases return to equity without adversely impacting the credit or regulatory standing of the company, but would definitely be concerned about issuance of new shares.

The Philosophy behind the Principles

The next question, then, is why are the Principles written this way? While the last revision of the Principles was done in 1995, the main Principles on voluntary and open membership, democratic member control, limited interest on capital, and transaction-based distributions have persisted throughout modern co-operative history. This indicates that there are deep and distinct convictions and beliefs that underpin the co-operative movement’s treatment of capital.

We find out a clue about the underlying philosophy of co-operative capital in the very same Statement on the Co-operative Identity, in the section on Co-operative Values. Co-operative Values are listed as: “*self-help, self-responsibility, democracy, equality, equity and solidarity.*” We might say that these combine elements of a socially and community-oriented philosophy and those of a self-help movement. In Britain – the birthplace of the Rochdale Principles – socialism and co-operation were not so far apart. In Europe, many

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“Indeed, at the root of the complexity of co-operative capital is a tension of philosophies and values. While modern co-operation has always had strong social and community underpinnings, co-operatives operate and are regulated within a global economic and financial system that is largely framed by market-oriented principles, which some may also term “capitalist”.”

“Co-operation is first and foremost about people coming together to meet common aspirations and needs; that a business enterprise is involved and that the business might need financial capital are ancillary.”

of the traditions that inspired co-operatives were religious – centred on the belief of the brotherhood of humankind – and the founders aimed to improve the wealth of co-operative members by empowering them in the market.

Indeed, at the root of the complexity of co-operative capital is a tension of philosophies and values. While modern co-operation has always had strong social and community underpinnings, co-operatives operate and are regulated within a global economic and financial system that is largely framed by market-oriented principles, which some may also term “capitalist”.

Co-operative philosophy believes in the possibility of a more egalitarian world. It is grounded in a worldview that human beings are social creatures who are willing and able to co-operate with one another for a greater good. Human relationships, community, and association are emphasised over property relationships. As a factor of production, labour has dignity and precedence over capital. Capital, if it enters the picture, should be a servant to labour.

Market-oriented thought, in contrast, emphasises individualism and competition. The pursuit of self-interest is natural and normal, and the market’s “invisible hand” will ensure the most efficient outcomes. Inequality is a natural reflection of the condition of humankind and not necessarily a bad thing. Any effort to reduce inequality should be philanthropic in nature and handled separately from the economic system. In this philosophy, the focus on individualism means that property relationships are core. Capital is the master that hires labour.

From this lens, we can see why co-operatives redeem the capital of a resigning member, curtail financial return to shareholders, and make distributions mainly in proportion to a member’s transactions. Co-operation is first and foremost about people coming together to meet common aspirations and needs; that a business enterprise is involved and that the business might need financial capital are ancillary. In fact, one of our authors has pointed out that it was not always the case that businesses needed capital to be started: many European financial co-operatives were started on the basis of the collective guarantee of a community. The “founding energy” of a co-operative, as he puts it, is thus not necessarily in a provision of funds but in their desire to work together.³ Contribution of financial capital, along with other types of resources, is a responsibility of membership, not a claim to individual ownership.

For a co-operative, the cardinal relationship is that of membership of a community of “real” people. The manifestation of a co-operative’s meaning for existence is the active participation of people as producers, consumers, and/or workers – stakeholders who have some organic relationship to the “real” business. A co-operative will thus maximise benefits to the group of stakeholders for which it is formed. For a market-oriented company, the cardinal relationship is that of shareholding, and it does not matter if these are faceless people or institutions whose identities change all the time because the share capital remains paid up. A shareholder need not have any organic relationship with the company’s business, and the meaning for a company’s existence is the maximisation of value for the shareholders, whoever they might happen to be at that point in time. Other stakeholders’ demands are to be “managed” as inconveniences and costs and as a matter of regulation, except where serving them well also contributes to shareholder value.

From this philosophical lens, we can also better understand why a gulf remains between co-operatives and regulators on the issues of withdrawability of capital. Co-operators fun-

³ Jean-Louis Bancel, Chapter 5, “Co-operative capital: an essential combination of science (management) and conscience (co-operative principles)”

damentally believe that their fellow members are capable of looking beyond self-interest. This includes allowing their capital to absorb actual losses or opportunity costs and providing for indivisible reserves for intergenerational use, i.e., co-operators think of the community of future members and not just current ones. In one of the chapters, the authors gave the example of how members – being contributors of “philosophical capital” – had practised “altruism” in the history of their insurance co-operative when it ran into difficulties.⁴ In another chapter, we read arguments to the Basel Committee about the availability of co-operative capital to absorb losses.⁵ In yet another piece, we read that the author has argued to the accounting standards boards that co-operative shares should be recognised as equity because the turnover of membership in industrial co-operatives is actually very low.⁶

For regulators schooled in the dominant market-oriented framework, however, the worst case scenario of each man looking out for himself must always be considered: if a financial institution is failing, which reasonable person would not withdraw his shares if he is able to? The Basel Committee also does not understand how an instrument with a limited return can be loss-absorbing equity. In this frame of mind that atomises and distributes risk, it is unthinkable that an investor would accept “fixed income” if he was taking equity risk.

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Resolving the Capital Conundrum – Three Options

If the problems of co-operative capital are due to a fundamental tension between the philosophy underpinning Co-operative Principles and that which frames the dominant economic and financial system, what, then, are the options open to co-operatives that need suitable, long-term capital?

We suggest that there are three broad categories of solutions, which span what our group of authors have touched on to varying degrees in the Chapters in this Paper:

1. Adapt tactically and pragmatically, both accepting the realities of the dominant market-oriented framework and preserving current Co-operative Principles as they are.
2. Change the dominant market-oriented paradigm through advocacy and promotion of our co-operative philosophy and Principles as they are.
3. Shift the paradigm of our Co-operative Principles.

“We suggest that there are three broad categories of solutions, Adapt tactically and pragmatically, Change the dominant market-oriented paradigm, Change the dominant market-oriented paradigm. Shift the paradigm of our Co-operative Principles.”

OPTION 1 – ADAPT TACTICALLY AND PRAGMATICALLY

Over the last decade, there have been more instances of co-operatives issuing new capital instruments beyond membership shares. This includes some of the largest co-operatives in the world, especially (but not limited to) financial co-operatives facing heightened regulatory demands. A typical solution consists of issuing non-withdrawable investment shares that do not carry voting rights to existing members, if there are a large number of members. These may or may not be tradeable in an internal market. Where there is an anticipated lack of liquidity or a threat of failure in the internal market, non-voting capital instruments are sometimes created or modified to allow external investors to hold them. In terms of return, investors obtain market return or a fixed coupon, plus a variable additional payment subject to business performance and/or a cap.

Many of the Chapters in this Paper describe or advocate such innovations undertaken by co-operatives. Messrs. Arnold Kuijpers and Hans Groeneveld share the perspectives of the capitalisation journey of Rabobank; Mr. Bill Hampel is of the view that US credit union

⁴ Frank Lowery and Wayne Schatz, Chapter 2, “The Co-operators Group Limited: A Canadian Perspective”

⁵ Jean-Louis Bancel, Op. Cit.

⁶ Bruno Roelants, Chapter 1, “Capital building in industrial and service co-operatives”

“A large and financially successful co-operative will have no shortage of investors both within and outside the membership who are willing to participate in either debt or equity capital issuances, even if they have no say in the running of the organisation. The same dynamics are unlikely to apply to start-up co-operatives and co-operatives that fall on hard times.”

“The other elephant in the room is that no new complex financial co-operatives, can be formed in the developed world under the prevailing regulatory framework.”

“The current times present co-operatives with a unique opportunity.”

“There is a keen sense of the failings of the hitherto dominant philosophy of the single-minded, short-term pursuit of profit and growth, and reliance on “efficiency” of financial and capital markets.”

regulations should allow new capital instruments; Mr. Bruno Roelants mentions quasi equity instruments, such as the French participation certificates issued by co-operative SMEs; Prof. Nicola Shadbolt and Mr. Alex Duncan introduce the innovative capital instruments created by Fonterra Dairy Co-operative in 2012; and Mr. George Ombado argues for the need for an African Co-operation Bank to help capitalise African financial co-operatives. From the mutual sector, Mr. Peter Hunt also shares insights from the UK’s Mutual Deferred Shares Bill 2015, which would allow mutuals, for the first time, to issue shares.

These are fundamentally pragmatic approaches. The perspective, as Mr. Ombado argues, is that “capital is the most important factor in fulfilling member’s economic needs”. There is sufficient flexibility within the wording of the Co-operative Principles to encompass such instruments, and the spirit of voluntary membership is deemed to be preserved because the non-withdrawable investment is often over and above minimum membership capital and optional. The red line that cannot be crossed, however, is “Democratic Member Control”, and in all these cases capital contribution is not accompanied by voting rights.

Does this pragmatic approach enable co-operatives to “secure reliable co-operative capital while guaranteeing member control” – the objective of the capital pillar in the Alliance’s *Blueprint for a Co-operative Decade*? We submit it would – if you were a co-operative of a suitable size, strength, and in a particular life-cycle stage. A large and financially successful co-operative will have no shortage of investors both within and outside the membership who are willing to participate in either debt or equity capital issuances, even if they have no say in the running of the organisation. The same dynamics are unlikely to apply to start-up co-operatives and co-operatives that fall on hard times. For external capital, in particular, Messrs. Frank Lowery and Wayne Schatz argue forcefully that co-operative capital is “philosophical capital” that is inherently incompatible with investor-owned capital, and that investor-owned capital, “in times of crisis... will by its very nature bring the co-operative form of enterprise down”.⁷

The other elephant in the room is that no new complex financial co-operatives, excepting credit unions providing basic services, can be formed in the developed world under the prevailing regulatory framework.⁸ If that is so, co-operatives may eventually become sidelined in the global financial system, as even the incumbent co-operative banks and insurers would come up against natural growth limits at some point in time. Given the importance of financial institutions in the global economy, this could mean that co-operatives might end up with crumbs from the dominant table, unless we are able to overhaul the global financing system itself.

OPTION 2 – ADVOCATE FOR A CHANGE IN THE WORLD’S DOMINANT PARADIGM

This brings us to the second option of changing the world’s dominant paradigm. The current times present co-operatives with a unique opportunity. After having been on the ascendant for decades, modern capitalism is now in crisis following the economic and financial market turbulence of 2008-2009. There is a keen sense of the failings of the hitherto dominant philosophy of the single-minded, short-term pursuit of profit and growth, and reliance on “efficiency” of financial and capital markets.

Co-operatives have much to offer the world as it searches for alternatives to capitalism. As we had proclaimed in the United Nations International Year of Co-operatives in 2012, “co-operatives build a better world”, and the *Blueprint* hopes to promote co-operatives as the preferred form of enterprise. This cannot just be based on marketing or a polemic

⁷ Lowery and Schatz, Op. Cit.

⁸ This is the broad consensus of the authors working in this sector, when polled by the Editor.

against the ills of the existing system. Rather, our proposition must be sound, inspirational, attractive yet practical.

We already have the building blocks of this inspirational model in our co-operative heritage and philosophy. Fundamentally, we believe that co-operatives are better because we put people at the core of our business. The Principles of democracy and autonomy safeguard the dignity of the human person and community over money. Mr. Bruno Roelants emphasises that in a co-operatives, stakeholders rather than shareholders are the owners.⁹ In looking beyond money, we can begin to appreciate the whole range of resources or “capital” in dimensions beyond financial or accounting capital.¹⁰

Secondly, co-operatives bring communities together. Mr. Jean-Louis Bancel paraphrases the humanist scholar Jean Bodin: that the “wealth of the co-operatives resides in the men and women who work to bring them to life”.¹¹ This is much longed for in a world torn apart by armed and sectarian conflict, displacements of communities, disparities of wealth and income, and a host of other social dislocations. In their evocative piece, Messrs Lowery and Schatz call on co-operatives to innovate co-operatively to be “a catalyst for a co-operative society”.¹²

Thirdly, co-operatives contribute to greater sustainability. Without the need to boost listed share prices, co-operative managers are not compelled to take large risks with the money of depositors, or to use excessive leverage to maximise short-term return on equity – two of the primary causes of the financial crisis. With less pressure to secure short-term financial gains, we need not borrow from the future to do so. Messrs. Bancel and Roelants both talk about inter-generational stability and development, made possible by co-operative structures such as indivisible reserves.¹³ Principle 7 on “Concern for Community” also mentions sustainability in the context of co-operatives working for their communities’ sustainable development through member-approved policies.

Are there any arguments against the co-operative model that we propose to advocate to societies, governments, and regulators? One major question that the co-operative movement has yet to resolve is whether there can truly be global, large-scale enterprises that are also co-operatives *par excellence*. This is a conundrum that is inherent in the philosophy of co-operatives, which arises from the centrality of human relationships in the co-operative model. In a separate paper on co-operative governance,¹⁴ it was suggested that co-operative governance is more effective in small co-operatives than in large ones, and in worker and producer co-operatives than in consumer co-operatives. In large co-operatives, members do not feel as much owners or as much part of the community. This leads to issues of dormant members, factionalism in voting, and managerial capture – which renders barren the form of democracy and inclusiveness. Regarding the types of co-operatives, members of producer and worker co-operatives are also more likely to feel engaged because of their “non-alienable” relationship with the co-operative – usually within a local community – compared to consumer co-operatives whose members could have many other choices. If these conclusions are valid, we as a movement would need to think about our vision in terms of changing the world one co-operative community at a time, rather than growing large, global co-operatives, and whether this vision is powerful enough for governments and regulators to change their framework for co-operatives.

“Co-operatives build a better world” cannot just be based on marketing or a polemic against the ills of the existing system. Rather, our proposition must be sound, inspirational, attractive yet practical.”

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9 Bruno Roelants, Op. Cit

10 Jean-Louis Bancel, Op. Cit.

11 Ibid.

12 Frank Lowery and Wayne Schatz, Op. Cit.

13 Bruno Roelants and Jean-Louis Bancel, Op. Cit.

14 Ed. Karen Miner and Sonja Novkovic, Various Authors, “Co-operative Governance Fit to Build Resilience in the Face of Complexity”, International Co-operative Alliance (2015) <http://ica.coop/en/blueprint-themes/participation>

“The competition for co-operatives as the alternative economic model posed by “new capitalism” and its various incarnations should give us pause.”

Related to this is the competition for co-operatives as the alternative economic model posed by “new capitalism” and its various incarnations such as “stakeholder capitalism”, “community capitalism”, and so on. “New capitalism” has a powerful proposition in combining the strengths of capitalism in terms of efficiency, risk-taking, and scale, with a rediscovered sense of meaning and responsibility to people, society, morals, and the environment. Social enterprises and Benefit Corporations¹⁵ have grown in strength and numbers, attracting high-profile sign-ups and meeting with much general approval. The narrative that it is possible to make money while doing good for society is a powerful and attractive doctrine. This should give us pause, even as we seek to claim the space of a new way of doing business for the co-operative movement.

OPTION 3 – CHANGE OUR CO-OPERATIVE PARADIGM

“To challenge the co-operative movement to consider whether our people-centred philosophy and philosophies are adequate and up-to-date – or if we risk anachronism and ultimate irrelevance.”

In this last part of the Foreword, therefore, we would like to push the boundaries to challenge the co-operative movement to consider whether our people-centred philosophy and philosophies are adequate and up-to-date – or if we risk anachronism and ultimate irrelevance. This third option we would like to put on the table is to consider a reappraisal of our time-honoured co-operative paradigm and Co-operative Principles.

Among our authors, Messrs Lowery and Schatz have issued a challenge for co-operatives to move co-operation to a new level, by living out Principle 6: “Co-operation Among Co-operatives” more fully. Specifically, co-operatives should facilitate access to capital by other co-operatives, and as a movement we need to look into such structures like a co-operative stabilization fund, a mutual and co-operative benefits association, and other funding and investment vehicles. The authors have thus broadened the co-operatives’ primary stakeholders from members only to also encompass all other members of the co-operative movement.

Are we able to push the envelope and draw an even wider circle to draw in, not just other co-operatives, but also the larger society? Can Principle 7 on “Concern for Community” –manifested through support for sustainable development – no longer be filtered through the lens of the primacy of members’ interests? The time is ripe for a conversation on a bold new model for not just market-oriented companies but also co-operatives. We need to shift the paradigm from benefitting a single class of persons to promoting the interests of all stakeholders; from short-term concerns to long-term sustainability; and from “maximisation of benefits” to optimisation, balance, inclusiveness, and co-operation in its highest form.

“The time is ripe for a conversation on a bold new model for not just market-oriented companies but also co-operatives. We need to shift the paradigm from benefitting a single class of persons to promoting the interests of all stakeholders; from short-term concerns to long-term sustainability; and from “maximisation of benefits” to optimisation, balance, inclusiveness, and co-operation in its highest form.”

We suggest for the co-operative movement’s consideration, that businesses of all forms need to set their sights high and explore the concept of a sustainable, responsible, and long-term enterprise that embraces all 3 “Ps” of People, Planet, and Profit – the triple bottom line coined by John Elkington in 1994 and which so aptly describes the desired destination of our economic world’s thought journey.

For co-operatives, philosophically speaking, this means broadening the definition of our mission to serve not only members, but also other stakeholders and society at large. For producer co-operatives, this means also taking care of consumers and employees; for worker co-operatives, also customers; for consumer co-operatives, also the interests of non-member customers. To be true champions of sustainability, we would have to extend our care for people to the stewardship of the planet in which this generation and future

¹⁵ These new corporations are required to consider the impact of their decisions not only on shareholders but also on workers, community, and the environment, and are required to make available to the public an annual benefit report that assesses their overall social and environmental performance against a third party standard. More than half of the states in the US have adopted the benefit corporation legislation.

ones live and work. Capital and profit, then, should not be viewed as adversaries, but partners and enablers that help bring managerial discipline and promote financial sustainability. Practically speaking, the international co-operative community would have to reappraise the current Principles to see if they can be enlarged and elevated. Co-operatives would also have to find metrics for their new “bottom lines” and to measure their performance in a robust and appropriate way.

Conclusion

We started this foreword discussing the philosophical and practical angst that co-operatives experience over capital. As our readers digest the various chapters in this Paper, we hope that valuable insights will be garnered from the experience and thoughts of co-operators around the world in the aspect of capitalisation.

Ultimately, as significant as the capital issues might be, the greatest treasure we have to offer the world is the co-operative spirit. For the co-operative spirit to remain strong and indomitable, we need to bring the ideals of co-operation to a more consummate form. Only then can the co-operative movement ensure our continued relevance in the global economy and fulfil our aspirations of building a better world.

“Capital and profit, then, should not be viewed as adversaries, but partners and enablers that help bring managerial discipline and promote financial sustainability.”

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1

Capital Building in Industrial and Service Co-operatives

BRUNO ROELANTS

1. Capital Building in Industrial and Service Co-operatives

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Introduction

This chapter introduces a few considerations on co-operative capital based on the experience of industrial and service co-operatives.

To begin, a few introductory data on industrial and service co-operatives in the world may be useful. Around 65,000 co-operative enterprises are affiliated to members of CICOPA, the sectoral organization of the International Co-operative Alliance for industry and services. These members employ more than 3 million people the vast majority of them being co-operative members. According to the recently published *Industrial and Service Co-operatives – Global Report 2013-2014*, their main sectors of activity are manufacturing (20%) construction (9%) and, above all, services (67%). Among the latter, the main activities are wholesale and retail trade (18%); health and social work (16%); professional, scientific and technical activities (12%); education (12%); administrative and support activities (10%); transportation and storage (8%); and accommodation and food services (7%). The vast majority of them (95%) are small and medium-sized enterprises or SMEs (CICOPA 2015, p. 9-18).

Their being SMEs without being on the financial markets makes their capital needs similar to non-co-operative SMEs that are in the same condition and, in particular, family businesses. According to the above-mentioned report, access to finance is indeed the first overall concern of the co-operatives belonging to the CICOPA network (CICOPA 2015, p. 22-23). In terms of governance, most of these co-operatives are majority worker-owned (worker co-operatives and part of the social co-operatives), while we also find co-operatives owned by self-employed producers, as well as multi-stakeholder co-operatives (namely with different types of members).

“Capital in one same co-operative includes both nominal capital and common reserves. The two types of capital reflect the fact that the co-operative combines the individual interest of the distinctive members and the latter’s common interest.”

A first key consideration considering co-operative capital is that, according to the third Co-operative Principle, “*member economic participation*”,¹ capital in one same co-operative includes both nominal capital and common reserves. The two types of capital reflect the fact that the co-operative combines the individual interest of the distinctive members and the latter’s common interest. The simultaneous existence of these two types of capital is a fundamental element in the financial management of industrial and service co-operatives across the world.

However, a discussion on co-operative capital, at least from the point of view of industrial co-operatives, would not be complete if it did not also include considerations on capital generated by the co-operative movement itself as a community of co-operatives in close relation with the capital in the individual co-operatives.

In the first section below, we analyse capital **in** the co-operatives themselves: both the nominal capital (often referred to in English as “share capital”) that “[*m*]embers contribute

¹ “Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership” in the International Co-operative Alliance (1995) Statement on the Co-operative Identity and International Labor Organization (2002) Promotion of Co-operatives Recommendation (No. 193)

*equitably to, and democratically control*² and the co-operative reserves. In the second section, we analyse the capital in the co-operative **movement** aimed at strengthening the capital in individual co-operatives.

1. The capital *in* the co-operatives

1.1. NOMINAL CAPITAL CONTRIBUTED BY MEMBERS

The nominal capital contributed by each member in industrial and service co-operatives can oscillate from very low to very high amounts. The average amount contributed responds to different co-operative traditions rather than to regulatory provisions, even though some provisions can help leverage higher amounts as we will see in the second section below. In the same country, one finds industrial or service co-operative SMEs where each member contributes the equivalent of a few hundred USD, whereas in others such contributions can reach several tens of thousands of USD. Co-operatives with such a high level of members' equity logically tend to be more sustainable economically, especially in capital-intensive activities, such as those that the Mondragon group deliberately decided to develop since its inception. Logically, their members also tend to show a particularly high level of concern for and participation in shared management.

The nominal capital in co-operatives is clearly a different type of financial instrument compared to ordinary share capital in the hands of shareholders. To avoid such confusion in this chapter, we are neither using the term “share capital” nor “share” as far as co-operatives are concerned. Notably, in a number of other languages than English, a different term is used.³ The third Co-operative Principle itself does not mention the term “share capital”: instead it stipulates that “[m]embers contribute equitably to, and democratically control, the capital of their co-operative”, and that this capital is “subscribed [by members] as a condition of membership”. Let us first try to clarify the intrinsic differences between the two types of capital.

A first fundamental difference between members' nominal capital and shareholders' shares has to do with the fact that the people and/or entities owning and controlling the co-operative are stakeholders (in general workers or producers in the case of industrial and service co-operatives) rather than shareholders: by this we mean that the key reason why they become members of the co-operative is not to invest capital in it to profit from, but to solve specific needs or aspirations linked to their stakes as stakeholders – in the case of industrial and service co-operatives, such stakes usually have to do with employment, production, and/or community services. The “capital subscribed as a condition of membership” (excerpt from the third Co-operative Principle) is thus secondary to the fact that the co-operative gathers persons “united voluntarily to meet their common economic, social and cultural needs and aspirations” (excerpt from the Co-operative Definition).

A second fundamental difference, which is a corollary of the first one because it reinforces the role of co-operative members as stakeholders and not as shareholders, has to do with the fact that “[m]embers usually receive limited compensation, if any, on capital subscribed as a condition of membership” (excerpt from the third Co-operative Principle). This latter provision is generally well abided by in industrial and service co-operatives: co-operative members do not normally invest in their co-operative for the purpose of having high yields on their investment, but rather to make their jobs or production more economi-

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“The “capital subscribed as a condition of membership” is thus secondary to the fact that the co-operative gathers persons “united voluntarily to meet their common economic, social and cultural needs and aspirations.”

² Excerpt of the third Co-operative Principle, “member economic participation”, Statement on the Co-operative Identity.

³ For example, in French the term “part sociale” is used instead of “action”, whereas in Chinese the term “股金” (gufen) is used rather than “股份” (gufen).

cally sustainable, which is the key mission of their co-operative. If they just want to get high yields from an investment, they will normally opt for other options.

As a further confirmation of this second difference, members generally do receive variable returns as a part of the co-operative's surplus, but such returns are aimed at "*benefiting members in proportion to their transactions with the co-operative*" (excerpt of the 3rd co-operative principle). The transactions that members have with the co-operative can be of three kinds (from the point of view of the member): purchase in the case of user-members, e.g., in consumer co-operatives, sale in the case of producer-member in producers' co-operatives that deal with the commercialization of the producers' products, and remuneration in the case of worker-members (in worker co-operatives and social co-operatives). Thus, co-operative returns to members are to be seen as an adjustment of the transaction price (of purchase, sale, or remuneration) and not as dividends.

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As a consequence of the two above-mentioned fundamental differences (stakeholder nature of the members and limited return on the capital invested) comes a third one, namely that the nominal capital contributed by members is not tradable: it is not a financial instrument that can be bought and sold from one member to another member, and even less so, of course, from a member to a non-member. The nominal capital is redeemed to the member through a board or general assembly decision according to a series of statutory conditions which the member agreed upon when entering the co-operative (e.g., gradual redemption over a period of time). This practice is well abided by in industrial and service co-operatives, where one of the main issue has to do with the redemption period after the worker-member or the producer-member leaves the co-operative, especially when his/her contribution to the co-operative's nominal capital is substantial.

Differently from shareholders' share capital, co-operative capital should be considered as equity and not liability for the enterprise. After the International Accounting Standards (IAS) Board published IAS 32 on equity instruments in 2003,⁴ it published the International Financial Reporting Interpretations Committee (IFRIC) 2 interpretation for co-operatives, which considers that co-operative members' nominal capital could be considered as equity provided that the co-operative's general assembly has the power to (at least in theory) uphold its redemption to a member.⁵ The rationale behind the IAS Board's interpretation is, seemingly that if the general assembly is able to uphold the redemption of any part of the co-operative's nominal capital, it effectively exercises control on it in its entirety.

“In the case of co-operatives, the very fact that the enterprise is “jointly owned and democratically controlled” (excerpt from the Co-operative Definition) by members ensures that there is both ownership and control over the enterprise by a community of members whose turnover is very slow.”

Since the publication of IAS 32 and IFRIC 2, the IAS Board and the US Federal Accounting Standards Board (FASB) have made it increasingly clearer that the most important criterion concerning the distinction between equity and liability has to do with control rather than ownership (Sanchez Bajo & Roelants 2003, p. 84). Nevertheless, as CICOPA communicated to the IAS Board within the framework of the latter's consultation on the "*Review of the Conceptual Framework for Financial Reporting*",⁶ in which the concepts of equity and liability stood out prominently, it is not necessary for the co-operative to have the power of withholding redemption in order to consider that the co-operative capital is equity and not liability. Indeed, in the case of co-operatives, the very fact that the enterprise is "*jointly owned and democratically controlled*" (excerpt from the Co-operative Definition) by members ensures that there is both ownership and control over the enterprise by a community of members whose turnover is very slow. It is particularly slow in industrial and service co-operatives, where members are comparatively few but where a worker or a producer

⁴ See <http://www.iasplus.com/en/standards/ias/ias32>

⁵ See <http://www.iasplus.com/en/standards/ifric/ifric2>

⁶ See <http://www.ifrs.org/current-projects/iasb-projects/conceptual-framework/discussion-paper-july-2013/documents/discussion-paper-conceptual-framework-july-2013.pdf> and <http://www.cicopa.coop/IASB-Consultation,1227.html>

usually remains a member for many years or even decades. In users' co-operatives (such as consumer co-operatives, housing co-operatives, or co-operative banks), the turnover may be quicker, but this is compensated by the fact that members are comparatively far more numerous: in both cases, the turnover between old and new members remains marginal; therefore, the vast majority of members remains stable over time and we usually find basically the same community of members from one year to the next controlling the co-operative. Such stability and constancy in the community of members ensures that effective control by the latter over the co-operative's overall strategy and management remains thorough, and that if as the IAS Board itself claims the main criteria to define equity is control, the co-operative nominal capital is indeed equity and not liability for the co-operative.

Over the last decades, we have observed a debate in a number of countries on whether or not to open up the co-operative nominal capital to external investors, to what extent, and with or without voting power. The basis for such discussions has invariably been the need for further capitalization. This debate was particularly lively in France, Italy, and Spain in the late eighties and early nineties when legislation was passed to make it possible to partly open up the co-operative capital to external investors provided that the co-operative's general assembly so decides and always keeping the co-operative members with a strong majority both in terms of ratio of the nominal capital and in terms of voting power. Twenty years later, the results of this regulatory wave in terms of capitalization has not reached the expected results while it has reportedly brought about other interesting outcomes: the so-called external investors that have invested capital have often done so because they in fact had another stake than financial being clients, providers, or entities linked to the co-operative through joint ventures or other network arrangements.⁷ This phenomenon actually reinforces the fact that the co-operative is a stakeholders' enterprise, because such investors invest as stakeholders (clients, providers, partners) to build value chains rather than as shareholders seeking financial yields.

1.2. CO-OPERATIVE RESERVES

The third Co-operative Principle stipulates that “[m]embers allocate surpluses for ... *developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible*”.

As we can read, the idea of setting up reserves is instrumental to the purpose of developing the co-operative. Again, the development of the co-operative is linked to it being a stakeholder-based enterprise: it must develop in such a way that the “*persons united voluntarily to meet their common economic, social and cultural needs and aspirations*” (excerpt from the Co-operative Definition) through the co-operative can do so even better qualitatively (e.g., through safer jobs or a more stable activity for producers) and/or quantitatively (e.g., by generating more jobs or welcoming more producers in the co-operative).

When they are able to do so, co-operatives by and large dedicate part of their surplus to financial reserves and use their accumulated financial reserves to invest in the type of entrepreneurial development described above. But what are exactly the “*indivisible reserves*” mentioned in the third Co-operative Principle?

Let us first try to clarify what *divisible* reserves are. Divisible reserves are non-nominal assets (thus not part of the members' nominal capital), which the members of a co-operative being closed down are entitled to share among themselves after payment of any outstanding debt.

⁷ Personal communication from François Soulage, President until 2010 of the French Financial Institution ESFIN-IDES (a CICOPA associate member).

This possibility is, instead, totally excluded in an indivisible reserve regime: indivisible reserves can never be distributed among co-operative members, even after dissolution and payment of all outstanding debt. National or regional legislation making indivisible reserves mandatory (e.g., France, Italy, Quebec, or Uruguay) have actually created a *sui generis* type of property, clearly distinct from both individual private property and from public property, and more akin to the “commons” discussed by late economy Nobel Prize winner Elinor Ostrom in “*Governing the Commons*”⁸. This is also why specific tax regimes have been established for the percentage of results earmarked for indivisible reserves. These laws oblige co-operatives to earmark to such reserves a minimum percentage of their year-end results, e.g., 30% in Italy (Zanotti 2011, p. 81). Beyond this legal minimum, though, co-operatives are free to earmark a higher percentage of their year-end results to indivisible reserves: e.g., in Italy, even after a drastic decrease in fiscal advantages in 2003, industrial and service co-operatives have continued to reinvest a significant amount of annual results to indivisible reserves with an average of 86.8% of net profits reinvested in the firm and only 10.2% distributed to members in 2005 (Petrucci, 2006). By 2009, the average share of profits allocated to indivisible reserves did not see any decrease in the accumulation of indivisible reserves (Navarra, 2009).

Where are indivisible reserves channelled after dissolution? In some cases, e.g., Argentina, they are channelled towards the governmental fiscal system but must be used to promote co-operatives.

In other countries, such as France or Italy, when co-operatives are affiliated to a federation, they are systematically channelled towards that organization or another one linked to it, which normally redistributes it for the development of co-operatives (start-ups, conversions, or development projects in existing co-operatives) in that country. Since the 1990s, the Italian legislation has established development funds under each of the three main co-operative confederations, which, among other mechanisms, channel all assets from dissolved co-operatives within their membership whereas a similar fund under the government has the same function for all non-affiliated co-operatives. We will return to these development funds in the second section.

The philosophical rationale behind indivisible reserves is that a co-operative is seen as an intergenerational enterprise, namely meant to last several generations, established among the same category of stakeholders (such as workers, producers, or users) who remain the same category of stakeholders, with a constant generational turnover. Under this vision, the reserves accumulated by former members in older co-operatives do not legitimately belong to the present members only; at the same time, the reserves accumulated by the present members are also not the exclusive property of the latter but are an investment for future members as well. Thus, if the present members decide to get hold of reserves accumulated by their predecessors and/or to destroy an entrepreneurial instrument meant to serve future generations of members, this is considered unfair towards predecessors or future generations.

It is widely considered that this type of reserves is particularly decisive for the survival and development of enterprises in the case of co-operative SMEs in industry and services. SMEs in general have a low survival rate in their first years of operation, e.g., 50% of French SMEs die after 5 years, as we can observe in the table below. Co-operative SMEs in countries where indivisible reserves are mandatory have shown a substantially higher survival rate than the average for SMEs, e.g., in France 66% of industrial and service co-operatives are still alive after 5 years, as also shown in the table below.

“The philosophical rationale behind indivisible reserves is that a co-operative is seen as an intergenerational enterprise, namely meant to last several generations, established among the same category of stakeholders (such as workers, producers, or users) who remain the same category of stakeholders, with a constant generational turnover.”

“Co-operative SMEs in countries where indivisible reserves are mandatory have shown a substantially higher survival rate than the average for SMEs.”

8 Ostrom, E. (1990) *Governing the Commons* (Cambridge: Cambridge University Press).

SURVIVAL RATE OF CO-OPERATIVES IN 2012 IN FRANCE AS COMPARED TO ALL FRENCH ENTERPRISES

| | Survival rate within 5 years | Survival rate within 3 years |
|------------------------------------------------------|------------------------------|------------------------------|
| All French enterprises (INSEE ¹ data) | 50 % | 66 % |
| All cooperatives affiliated to CG Scop ² | 66,1 % | 82,5 % |
| Transfert of sound enterprises into cooperatives | 82,1 % | 90,5 % |
| Transfert of enterprises in crisis into cooperatives | 61,0 % | 80,2 % |

Source: CECOP (2013) Business Transfers to Employees under the Form of a Co-operative in Europe – Opportunities and Challenges; Brussels: CECOP, p. 12.

As far as industrial co-operatives in the CICOPA network are concerned, the density, average sustainability, and long-term development of such co-operatives, and of the jobs therein, appear to be substantially higher in countries and regions where indivisible reserves are mandatory by law. This has caught our attention as a key criterion for the development of co-operative SMEs in the most varied industrial and service sectors. Indeed, such characteristics can be found in particular in Argentina, France, Italy, Quebec, Spain, and Uruguay where indivisible reserves have been mandatory for years or decades. There certainly are other criteria by which co-operatives in these places have developed strongly (such as a good network of business support entities providing training, consulting and non-banking financing; the existence of co-operative groups; or a strong inter-sectoral integration at the level of representative organizations) but we find no other key criterion that would be common to all of them in such a significant way.

The main advantages of indivisible reserves that have been identified are the following:

- They stimulate the development of the firm beyond the individual interests of its members: as we saw above, the co-operative aims at combining both the individual and common interests of its members; the proper balance between these two elements seems to be best attained through the existence of indivisible reserves.
- They allow members to enter and leave the enterprise without destabilizing it, because they gradually become more important than the nominal capital: in some industrial co-operatives that are a century old or older, they can reach 90% of all the co-operative's assets. This is of strong importance to industrial and service co-operatives, where the need for stable capital is strong and the number of members is low. As a corollary, they gradually become a more important part of the enterprise's equity than the nominal capital for investment projects and as collateral for bank loans.
- They have proved to be a very strong incentive towards intensive capital investment, as in the co-operatives of the Mondragon group (Sanchez Bajo & Roelants 2013, p. 176-211).
- They provide a particularly strong anchor in times of crisis, giving time and space to rethink present and future strategies (Roelants et al. 2012, p. 30-52)
- They act as a powerful deterrent on any aggressive or speculative potential buyer who would never be able to get hold of such assets: the amount to acquire the business of the co-operative (once members decide to close down the co-operative and sell the activity or assets) includes the value of indivisible reserves, but the latter will never be under the control of acquirers. Internationally known co-operative legislation specialist Hans Münkner says in this respect that in indivisible reserve regimes, *"hostile takeover of co-operatives is excluded. Where these rules are abandoned: plural voting, investor-members, transferable shares and other participation certificates, preferred*

non-voting stock etc., co-operatives and co-operative groups lose their special character as member-oriented self-help organisations and become ordinary commercial (i.e. investor-driven, shareholder value-oriented) enterprises for which the commercial law rightly applies” (Sanchez Bajo 2013, p. 3-4).

- They also act as a powerful deterrent on the members themselves, who would have to think twice before closing their business, especially when indivisible reserves have become substantial assets;
- They help prevent or limit corruption, e.g., managers’ corruption that can endanger the existence of the co-operative: as they are clearly regulated by law, nobody can run away with them.

Interest in indivisible reserves among industrial and service co-operatives in countries where they do not exist yet or exist only partly is on the rise. For example, the draft Japanese worker co-operative law also introduces the idea of indivisible reserves. Some of the UK worker co-operatives have instituted indivisible reserves, which are optional in that country. And the Canada Worker Co-operative Federation (CWCF), a CICOPA member, has tabled a recent general assembly resolution promoting optional indivisible reserves in other provinces than Quebec, where they are mandatory as we have seen above.

Coming back to the above-mentioned sentence from the third Co-operative Principle, now that we have clarified the meaning of indivisible reserves, the expression “*setting up reserves, part of which at least would be indivisible*” may still appear partly unclear because of the term “*would*”. The fact that only part of the reserves should be indivisible is not a problem per se, since even in countries where indivisible reserves are mandatory, it is possible to also earmark part of the surplus to divisible reserves once the minimum legal percentage earmarked for indivisible reserves has been attained. As for the term “*would*”, it is softer than “*should*”, and is clearly aimed at leaving the option open for national legislation not to make indivisible reserves mandatory, even though the text is drafted in such a way that such reserves are clearly recommended.

2. A systemic approach to capital in the co-operative movement

“Co-operative capital - be it members’ nominal capital or reserves – should not be seen as purely limited to the co-operative itself. The evolutionary trend of these co-operatives, wherever density is strong and the development history long, is built at a “meso” level, by using innovative financial instruments.”

Co-operative capital - be it members’ nominal capital or reserves – should not be seen as purely limited to the co-operative itself, and this is even more the case in industrial and service co-operative SMEs. The evolutionary trend of these co-operatives, wherever density is strong and the development history long, is built at a “meso” level, by using innovative financial instruments.

Members’ nominal capital in co-operative SMEs can be boosted by instruments of “*quasi equity*”, such as the French “*titre participatif*” (participation certificate): a type of bond that provides the buyer with a remuneration that includes minimum fixed remuneration and a variable additional amount indexed to the enterprise’s results and which is subscribed mainly by investors in the social economy (co-operatives, mutual etc.). This instrument is considered as equity and not liability for the issuing co-operative, because the latter can retain this bond without redeeming it as long as it deems fit. The average redemption period is between 7 and 10 years, making it “patient” capital. The participation certificates invested by French specialized financial institutions such as SOCODEN or ESFIN-IDES in co-operatives that issue such bonds are usually invested according to a matching contribution to the members’ aggregate nominal capital, often 1 to 1. They thus encourage further capitalization by co-operative members. The substantial increase in equity, which this system brings

about, creates a tangible leverage on banks, and first of all on co-operative banks, which tend to be sensitive to the dynamics of trust that is generated (Soulage 2011, p. 166-169).

This mechanism has been widely used in cases of business transfers to the employees under the co-operative form, in which business plans often have to be elaborated within weeks. A similar mechanism exists in Italy through other forms of equity within the framework of the 30-year old Marcora Law, also in great part for business transfers to the employees. Through a sophisticated matching contribution system – which sees on the one hand the workers invest part of their unemployment benefits cashed in as a three-year lump sum, and on the other a financial co-operative called *Cooperazione Finanza Impresa* (a CICOPA associate member) provides matching venture capital – several thousand jobs have been saved in a sustainable manner over the last 25 years in industrial enterprises that were about to close down (Zanotti, 2011, p.92-97).

The Italian development funds that channel indivisible reserves from dissolved co-operatives to re-invest them in other ones, as we saw in the first section, also (and predominantly) channel contributions by Italian co-operatives corresponding to 3% of their results. The mechanism involves all Italian co-operatives, but many of the beneficiaries are industrial and service co-operatives (worker and social co-operatives) (Zanotti 2011, p. 87-92). In France, a mechanism limited to the worker co-operative system channels one per thousand of the turnover of all French worker co-operatives affiliated to the French confederation of worker co-operatives (over 90% of them) to a similar solidarity fund (Soulage 2011, p. 172).

Another mechanism being used at the “meso” level and in which the building of indivisible reserves in single co-operatives is a key element is the use of guarantee consortia. For example, the 2009 annual financial statement of Cooperfidi Italia (a consortium of 9 co-operative guarantee consortia) showed that it had built up a good level of capital funds equivalent to 28.8 million Euros, 18.5% of which was held as nominal capital and 13.8% in indivisible reserves with the remaining 67.7% composed of the accumulated risk funds. On the basis of these capital funds, the company issued guarantees for a value of close to 78 million Euro, with a ratio of guarantees issued and capital funds of slightly more than one to three (Zanotti 2011, p. 98).

When they are generated within the framework of co-operative groups, indivisible reserves help in bidding public and private contracts: In Italy, for example, the Consorzio Nazionale Servizi (CNS) – a large horizontal consortium of service co-operatives with over 200 co-operatives active in the fields of facility management, catering, logistics, the environment, tourism, and cleaning – has been allocating high amounts of group-level surpluses to indivisible reserves since its inception in 1977. Through accumulated indivisible reserves plus the introduction of successive processes to increase its capital stock (with the support of the Coopfond development fund), CNS has managed to gather enough financial resources to support its smaller members and has been able to shorten the public administration’s payment terms, which are particularly lengthy and inconvenient. The CNS was created in 1977 by 11 worker co-operatives in the service sector with the aim of obtaining contracts from private customers or public bodies for work that would then be carried out by the member co-operatives, particularly in the sectors of cleaning, logistics, maintenance, ecology, catering, arts and cultural services, reception and caretaker services, and finally, facility management services. The CNS has been so successful that it is now one of the leaders in its field at the national level (Zanotti 2011 p. 65). Similar mechanisms have been developed within the Mondragon group where, additionally, the returns to members are capitalized till the latter leave the co-operative (Sanchez Bajo & Roelants 2013, p. 176-211).

Conclusions

Although capital is indeed a key issue in the development of industrial and service co-operatives, this co-operative sector has shown its capacity to capitalize through innovative financial instruments which not only abide by the provisions included in the third Co-operative Principle, but have even given to such provisions strong economies of scale at the level of the co-operative movement itself, in the most varied situation: from co-operative start-ups being established by young people in activities such as media or ICT, to the Mondragon group with its around a hundred industrial enterprises in mainstream sectors, one of the top Spanish entrepreneurial groups and employers, with an aggregate turnover of 12.5 billion € and a workforce of 74 000 persons.⁹

The level of innovation in industrial and service co-operatives is unequal around the world due to different historical evolutions. But the countries and regions where such co-operatives have developed most provide strong evidence that substantial levels of capitalization and development can be reproduced elsewhere provided that the organizational, economic, entrepreneurial, and regulatory conditions are met.

The experience of industrial and service co-operatives also teaches us that capitalization, even though it is essential and a key concern, is seldom the only issue to deal with: equally important is the design of a good entrepreneurial project with sufficient know-how and motivation, with a strong co-operative spirit, and with the necessary inputs in terms of training and follow-up by the wider co-operative movement.

The experience of such co-operatives in the regions and countries where it has attained their highest evolution (e.g., Emilia-Romagna in Italy or the Basque Country in Spain), including in their way of building capital, can contribute both strategic inspiration and a strong potential engine for SMEs in general, in particular through the establishment of co-operatives of SMEs, which can provide the latter with the necessary inputs in terms of clustering, financing, innovation, and internationalization.

“The experience of industrial and service co-operatives also teaches us that capitalization, even though it is essential and a key concern, is seldom the only issue to deal with: equally important is the design of a good entrepreneurial project with sufficient know-how and motivation, with a strong co-operative spirit, and with the necessary inputs in terms of training and follow-up by the wider co-operative movement.”

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2

The Co-operators Group Limited: A Canadian Perspective

FRANK LOWERY AND WAYNE SCHATZ

2. The Co-operators Group Limited: A Canadian Perspective

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Summary

Co-operatives face various needs and challenges in accessing, generating, and using capital. Co-operative capital is distinct from other models because of fundamental differences in co-operative thought, Values, and Principles. As we look for answers as a movement, it is important that we distil the co-operative essence so that we can embark on strategic solutions without compromising the spirit and intent of co-operation.

Based upon the experience of The Co-operators Group Limited ("The Co-operators") in Canada, the authors submit that:

- Co-operative capital is inherently incompatible with investor-owned (that is, non co-operative) capital and that introducing the latter into a co-operative may lead to the demise of the co-operative particularly where the profitability of the co-operative is such as not to be able to fulfil the capital maximization needs of the investor-owners of capital or where financial profitability of the co-operative is inconsistent over time.
- Investor-owned capital intrinsically has no commitment to the co-operative form of enterprise or to its success, and as a result, in times of crisis, it will by its very nature bring the co-operative form of enterprise down.
- A significant threat to any co-operative, particularly as it grows in size, is if it has by its own choice embedded investor-owned capital into its structure or, due to circumstances beyond the control of the co-operative itself, investor-owned capital has become embedded in its structure due to changes in its members or their philosophical predispositions.¹
- Co-operative capital must of necessity be and continue to be philosophical capital focussed on returns based on Co-operative Principles including returns of members' interests and the interests of the community, not returns based primarily on maximizing the economic return to the owner of the capital.
- There is an abundance of co-operative capital in the financial world as well as capital controlled or directed by the owners of co-operative capital.² To the extent possible, co-operatives should be accessing this capital, not investor-owned capital. The real issue is how accessible the co-operative capital is to co-operatives in an organized and disciplined³ way.
- The issue of accessibility to capital, and particularly co-operative capital, by co-operatives can and should be addressed by legislative and structural change supported and promoted by co-operatives and like-minded or like-structured organizations⁴, including changes to the International Co-operative Alliance's (the Alliance) Co-operative Principles.

1 This is meant to encompass a situation where the original co-operative capital which was philosophically based is seen over time by the successors to the original co-operative members not in terms of the original purpose of the capital but more as an economic "asset" to be treated like any other investor-owned economic "asset", without a view to the original purpose, the original beneficiaries or the original "trust" (if there was one).

2 The total equity alone of the 300 largest co-operatives and mutuals as analysed in the "Survey of Co-operative Capital", International Co-operative Alliance, Andrews, Michael, is approximately US\$1.347 trillion.

3 Capital should not be provided just to maintain a sinking ship; rather it should be provided in a manner (and with additional human and professional support) to remediate the problems of the recipient co-operative and to assist it to adopt a sustainable business plan for its members and the providers of co-operative capital.

4 It should be noted that the authors include in the concept of "co-operative capital", capital which is created or retained by like-minded or like-structured organizations such as mutuals, fraternal benefit associations, and reciprocal exchanges, among others.

- Options should include, at a minimum:
 - Making the Alliance Co-operative Principles much clearer regarding “Co-operation among Co-operatives” as it relates to co-operative capital and capital controlled by co-operatives (collectively, “co-operative capital”);
 - Creating a co-operative stabilization fund to assist co-operatives that are experiencing financial difficulty;
 - Creating a mutual and co-operative benefits association, which would allow mutual insurance companies to merge with co-operatives and other like-structured, membership-based organizations without the need to demutualize or to deco-operativize; and
 - Creating funding and investment vehicles that would allow co-operatives access to market financial instruments on market terms and conditions, where the instruments are owned or controlled by the owners of philosophical capital.

Background: The Co-operators Group Limited

The Co-operators is a federal, Canadian co-operative governed under the *Canada Co-operatives Act*.⁵ Its holding company and operating company subsidiaries (the “group of companies”) are comprised primarily of Canadian financial services companies⁶ and, due to regulatory constraints, are structured as stock companies rather than as co-operatives. The Co-operators is essentially a federation of co-operatives. Its 42 member-owners, with two exceptions⁷, are either second tier or first tier co-operatives. Its 42-member membership consists of co-operatively organized entities and representative farm organizations operating on the basis of co-operative principles.

The Co-operators originated from the coming together of two predecessor co-operative groups of insurance companies: one in western Canada, Co-operative Insurance Services, (“CIS”) and one in Ontario, Co-operators Insurance Associations of Guelph (“CIAG”). Both predecessors were formed near the end of World War II to serve the needs of Canadian farmers and had philosophical groundings in the co-operative movement in Canada. Some of their founding statements included:

- “To encourage people to work together to the end that they may create, own and control such economic institutions as they may consider necessary to provide for their needs.” (CIS)
- “To promote the use and development of other co-operatives, and the organization and growth of credit unions.” (CIAG)
- “To contribute to the welfare and expansion of the co-operative movement in Canada and abroad.” (CIS)

Like many such co-operatives, from its early days The Co-operators struggled to meet its capital needs. Contributions to capital in the beginning came from *ad hoc* contributions from individual organizations such as the Saskatchewan Wheat Pool in Saskatchewan, as well as from direct investments by three sponsoring organizations in Ontario: United Co-operatives of Ontario, the Ontario Federation of Agriculture and the Ontario Credit Union League, as well as the broader membership of CIS.

5 The Co-operators Group Limited is the only co-operative within the group of companies. Canadian legislation prescribes the types of companies that can be used for the business of insurance (including mutual companies) but does not prescribe (and therefore does not allow) co-operative insurance companies.

6 The primary companies within the group of companies include the holding company, The Co-operators Group Limited (“CGL”), an intermediate holding company, Co-operators Financial Services Limited (“CFSL”), Co-operators General Insurance Company (“CGIC”), Co-operators Life Insurance Company (“CLIC”), and Addenda Capital Inc. There are a number of other companies within the group, which are directly or indirectly held by Co-operators Financial Services Limited.

7 One member-owner, United Steelworkers District 6, is an administrative division of a trade union. The other: Pacific Blue Cross is a not-for-profit organization without share capital. Both entities are grand fathered under The Co-operator’s by-laws as they operate on a “co-operative” basis.

The Co-operators was originally formed as a joint stock company in the mid-1970's, but was continued shortly thereafter as a co-operative. Direct investments, which the founders had in the predecessor companies were converted into non-voting, investment shares (i.e., preference shares) in The Co operators.

THE CO-OPERATORS - CAPITAL RAISING AND CONTRIBUTION

In its evolution, The Co-operators (as well as its predecessors) utilized and experimented with different structures and different forms of capital including what can be described as both co-operative and non-co-operative instruments. Many of the forms of capital surveyed in the Alliance's "Survey of Co operative Capital"⁸ are reflected in The Co-operator's own experience.

It is said that capital instruments used to raise money would most commonly consist of "common stock, preferred stock, retained earnings and long-term debt".⁹ The Co-operators has used and continues to use these instruments. Investor-owned firms also use these instruments. However, there is and has been a subtle difference in how and why these forms of capital have been used by The Co-operators. This is attributable to the "philosophical" character and underpinning of the capital raised or used by The Co operators.

The predecessors to The Co-operators were directly financed by their members through the ownership of both common and preference shares.¹⁰ However, it is clear that these shares were owned by co-operative entities, which viewed the shares as philosophical capital. Having said that, because of the different structure of the predecessors to The Co-operators, democratic control was not always exercised or reflected by share ownership. In the case of CIAG, democratic control was exercised based on what made sense to the sponsors in their capacity as trustees of the co-operative insurance program in Ontario. United Co-operatives in Ontario (UCO), in particular, notwithstanding having the largest number of common shares in CIAG, freely transferred director seats on The Co-operators Board to other organizations based not on the fact that UCO had recapitalized the insurance program or that it was their capital at stake but on the fact that over time there would be more and more "urban" policyholders. As such, the Ontario Credit Union League would be in a better position to represent their interests and so should have more director positions¹¹. These directorship transfers were not carried out for organizational control and economic reasons but for philosophical reasons¹².

The altruistic orientation of the original contributors of capital in The Co-operators continued up to the time of the continuation of The Co-operators as a co-operative in 1978 and beyond. At the time of the merger of its two predecessors, the financial valuation of the Ontario-based predecessor (CIAG) was significantly greater than the Saskatchewan-based predecessor (CIS).¹³ Notwithstanding this, CIAG agreed to an equal, share-for-share exchange as though both companies had an equal value. Even Revenue Canada agreed that there would be no taxable disposition since the value being transferred would be retained within The Co-operators for co operative purposes.¹⁴

8 Op. cit., note 5.

9 'Status of Co-operatives in Canada', Report of the Special Committee on Co-operatives, Blake Richards, MP, Chair, September 2012, 41st Parliament, First Session, at page 24.

10 For CIS particularly preference shares were the means of corporate financing, not common shares. CIA used both common and preference shares.

11 Op. cit., note 19, page 3.

12 See Member Share Monograph, the Ontario Region, CIS and CFCC board meeting minutes, CIAG Management minute book, letter to George Beecroft from Griffin, Beke, Thorson, Oliver and Walter regarding the transfer of shares to CIAG Management Limited, April 30, 1978.

13 Letter to Mr. C.G. Rounding, Director, Rulings Division, Department of National Revenue, Taxation from George A. Beecroft, Corporate Counsel, CIAG, requesting an advance tax ruling, May 30, 1975.

14 'Advance Income Tax Ruling, Co-operators Insurance Association, et. Al., a letter to George Beecroft, Corporate Counsel for CIA dated November 7, 1975.

This altruistic orientation was reflected not just by the original sponsors of The Co-operators in Ontario, but also by the member-owners of The Co-operators across Canada as, in each region, ownership shares in The Co-operators were freely transferred as member-owners joined and left the organization. No thought was given in the early years to the idea that the interest of each member owner in The Co operators was anything other than philosophical.

“No thought was given in the early years to the idea that the interest of each member owner in The Co operators was anything other than philosophical.”

Over the years, The Co-operators also engaged in a number of other capital raising and contribution initiatives that reflected the philosophical nature of the organization and its approach to capital. Many of these approaches would not find favour with investor-owned capital because they rely on the altruism of the contributors of capital to succeed.

INFORMATION BOX: THE CO-OPERATORS – CAPITAL RAISING AND CONTRIBUTION INITIATIVES

- **1957:** To raise CAD\$50,000 in capital to maintain the co-operative insurance program in Ontario, the company asked each of its policyholders for an additional CAD\$2 over and above the premium required for their insurance coverage.
- **1965:** To provide insurance for young male drivers, the company asked each young male driver to purchase a CAD\$25 second preference share in the company when they became insured.
- **1988:** The Co-operators considered accessing public equity markets through its intermediate financial services holding company, CFSL. To accomplish this, residual rights to surplus held by individual shareholders within CGIC were surrendered at values significantly below fair market value. The Minutes of the special general meeting of CGIC shareholders reflect that that they did so on the basis that their shares had been originally purchased as “co-operative capital” and not with a view to speculative gain.
- **1993, 1995:** After several years of poor financial results, The Co-operators reached out to its philosophical partners in the International Co-operative and Mutual Insurance Federation (ICMIF) as well as to sympathetic co-operative sources of capital within Canada to purchase a new “participating preference share” in The Co-operators. This was a share that enabled philosophical capital to invest in The Co-operators when it could not raise money on the public equity markets. Over time, the holders of these unique shares, many of these shares are still outstanding today, would be able to participate in the economic success of The Co-operators.
- **1997 to present:** The Co-operators has engaged in traditional fund-raising techniques in the public markets, including two separate issuances of publicly traded, non-voting preference shares from CGIC and several debt issues in CFSL. Staff are also provided the opportunity to purchase, at a small discount, non-voting preference shares in CGIC which pay a competitive dividend of five per cent.
- **2002 to present:** The Co-operators introduced its “Member Loyalty Program” under which member owners’ transactions with The Co-operators are used, in years in which The Co-operators is profitable, as the basis to determine their respective shares of funds allocated to this program. Initially, payments were made to member-owners in the form of investment (preference) shares called “Member Participation Shares”, which could not be transferred or redeemed at the option of member-owners. The program was later reviewed and revised to make payments in the form of cash rather than shares, with the option for member-owners to invest the cash in five-year redeemable investment shares with The Co operators paying a five per cent annual dividend, with 1/5th of the original investment redeemed by The Co operators each year. This program provides predictable cash flows for both member-owners and for The Co operators.

Notably, one method of accessing capital that The Co-operators has not attempted, although its subsidiary, CFSL, was specifically designed for this purpose, is by issuing voting, common shares through public investment markets. With the benefit of hindsight, this may very well have been a blessing in disguise that The Co-operators did not find itself embedding investor-owned capital into the co-operative, with all of the potentially negative and deleterious effects that could go along with that.

THE INCOMPATIBILITY OF CO-OPERATIVE AND INVESTOR-OWNED (NON-CO-OPERATIVE) CAPITAL

“The important difference is not what instrument is used, but rather who is raising the capital, who is controlling it, what are the expectations of those controlling it, and – most fundamentally – is it “philosophical capital” in support of the co-operative form of enterprise or is it capital invested purely to maximize financial gain.”

“Capitalization may be defined most simply as the act of ‘raising money’.”¹⁵

Raising money may be done in a number of different ways — many of which would be common to both co-operatives and investor-owned firms. In the authors’ view, the important difference is not what instrument is used, but rather who is raising the capital, who is controlling it, what are the expectations of those controlling it, and – most fundamentally – is it “philosophical capital” in support of the co-operative form of enterprise or is it capital invested purely to maximize financial gain.

As noted earlier, the raising and use of capital in The Co-operators and its group of companies has been varied and, in some respects, experimental. The Co-operators’ capital structure has evolved in a manner such that it has continued to be philosophical capital while meeting the high demands placed upon financial services companies in terms of financial strength, solvency, and protection of the interests of policyholders and clients. That is not to say that there have not been challenges along the road in retaining its core characteristics as a co-operative. There have been challenges, but the group of companies has continued to be true to its core philosophical predisposition as a co-operative.

“It is our view that co-operative and investor-owned (that is, non co-operative) capital are fundamentally incompatible, and that to inject investor-owned capital into a co-operative organization may be a recipe for the demise of that organization as a co-operative. It is not necessarily so, so long as the co-operative remains profitable and can pay the return required by the investor owned capital, but it is almost inevitable if the co-operative becomes unprofitable.”

We also subscribe to the belief expressed in “Co-operative Capital: What it is and Why Our World Needs It” where the authors of that article suggest that “Co-operative capital must behave in such a way as to not erode the co-operative business model comprised of its purpose, values and principles.”¹⁶ To put it slightly differently, it is our view that co-operative and investor-owned (that is, non co-operative) capital are fundamentally incompatible, and that to inject investor-owned capital into a co-operative organization may be a recipe for the demise of that organization as a co-operative. It is not necessarily so, so long as the co-operative remains profitable and can pay the return required by the investor owned capital, but it is almost inevitable if the co-operative becomes unprofitable. In 1993 and 1995, if The Co operators had been compelled to rely upon investor-owned capital for its own survival, it may very well not have ended up being the co-operative organization that it is today. In fact, if in 1988 The Co-operators had accessed the public equity markets by the issuance of voting, common shares that also might have affected our co-operative difference and more fundamentally our continuance as a co-operative.

¹⁵ See [Http://www.larousse.com/en/dictionaries/french/capitaliser/12905](http://www.larousse.com/en/dictionaries/french/capitaliser/12905) as quoted in ‘Status of Co-operatives in Canada’, Report of the Special Committee on Co-operatives, Richards, Blair, M.P., Chair, September 2012, 41st Parliament, First Session, page 24.

¹⁶ “Co-operative Capital: What it is and Why Our World Needs It”, Robb, Alan J, Smith, James H, Webb, Tom J, St. Mary’s University, Halifax, Canada, March 28, 2010, page 6.

Co-operative Capital – Availability and Access

AVAILABILITY OF CO-OPERATIVE CAPITAL

As noted in the introduction, there is no shortage of co-operative capital, and given the appropriate structures and legislative framework, there should be no issues with co-operatives being able to access capital. Here are some pertinent facts and figures:

“By the end of the 1980s there were 6,916 co-operative corporations in Canada with a total membership exceeding 21 million people. Twelve million Canadians belonged to at least one co-operative corporation, and the assets of the movement were CAD\$105.9 billion.”¹⁷

The above statistics are now 35 years old, and the co-operative movement in Canada and its assets have grown considerably since then:

“Canada has about 9,000 co-operative representing 18 million members. The ICA also says four out of every ten Canadians belong to at least one co-operative, which includes about 70 per cent of Quebec’s population and 56 per cent of people in Saskatchewan.”¹⁸

“Some 150,000 people work for Canada’s co-operatives which own total assets of approximately CAD\$330 billion.”¹⁹

On a worldwide basis, in 2013 co-operatives and mutuals alone had combined assets of US\$7.8 trillion.²⁰

ACCESS TO CO-OPERATIVE CAPITAL

“A Co-operative is an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.”²¹

“The co-operative principles are guidelines by which co-operatives put their values into practice.

....

“Co-operation among Co-operatives: Co-operatives serve their members most effectively and strengthen the co-operative movement by working together through local, national, regional and international structures.”²²

CO-OPERATIVES NEED TO BE MORE COLLABORATIVE AND HOLISTIC

In the authors’ respectful view, the primary challenge for co-operative capital and access to it is not that there is not enough co-operative capital. Rather, the key challenges relate to the evolution and structure of co-operatives in an investor-dominated world and include co-operatives not interpreting and applying Co-operative Principles in a more holistic and robust way.

“The primary challenge for co-operative capital and access to it is not that there is not enough co-operative capital. Rather, the key challenges relate to the evolution and structure of co-operatives in an investor-dominated world and include co-operatives not interpreting and applying Co-operative Principles in a more holistic and robust way.”

17 “An Overview to Co-operatives”, Canada’s Social Economy, Quarter, Jack, 1992, page 31.

18 “Building Resilient Businesses” by Brenda Bouw, Corporate Knights; the Magazine for Clean Capitalism, October 8, 2014. “ICA” is the old acronym for the International Co-operative Alliance.

19 House of Commons Report of the Special Committee on Co-operatives, September 2012; information drawn from: Canadian Co-operative Association, the Power of Co-operation: Co-operatives and Credit Unions in Canada, Ottawa.

20 “Protecting lives & livelihoods”, the ICMIF Global Manifesto 2015, International Co-operative and Mutual Insurance Federation, Cheshire, United Kingdom, 2015, page 8.

21 Statement on the Co-operative Identity, International Co-operative Alliance.

22 Ibid.

“Co-operatives will never be catalysts for a co-operative society if they sit back and watch as fellow co operators and co-operatives are eviscerated by investor-owned capital.”

The first challenge arises from the fact that the Co-operative Principles, though emphasizing that co-operatives are democratically controlled self-help organizations, do not truly emphasize that co operation among co-operatives should be more rigorous than just creating trade associations and occasionally having common advocacy.

Co-operatives will never be catalysts for a co-operative society if they sit back and watch as fellow co operators and co-operatives are eviscerated by investor-owned capital. In the many years that the authors have worked for The Co-operators, we have seen numerous examples of long-standing co operative organizations being lost to the private sector because they have embedded investor owned capital in their structures, and when push came to shove, there were no co operative alternatives to save them. For those who have argued that this is because they were poorly run, there is some truth to that. But there is no truth to the suggestion that they are or were poorly run because they are co-operatives. But if they had had access to co-operative capital, and co operatives had the structures and legislative ability to go into other co operatives, to refinance them and to put them on the right track, such failures would likely not happen. There are studies that support the fact that co operative organizations have a much higher success rate than investor-owned firms. Co-operative structure is not the problem.²³

OVERCOMING SECTORAL SILOES

A second challenge is the fact that co-operatives have tended to evolve in sectors. The challenge this has posed is that often participants in one sector do not see a need to be involved in other sectors. This has been amplified by the fact that many people in grass-roots co operatives do not see themselves as having much in common with larger co operatives. And those in the larger co-operatives oftentimes forget their own history and do not view solicitations or needs exhibited by smaller co-operatives as having much merit.

In Canada, as in many countries, there have been waves of co operative development. Many of the first co operatives in this country were in agriculture, fishing, and mining. Parallel to this development was the development of the *caisses populaires* movement by Alphonse Desjardins in Francophone Canada and the credit union movement in Anglophone Canada. Then there was the development of co operative housing. More recently we have seen the development of co-operatives in emerging sectors such as energy, student issues, and funeral assistance. All of these movements over time have developed co operative capital but more often than not, whatever co-operative capital they have developed has been accessed within the siloes of their own sectors.

LARGE CO-OPERATIVES VERSUS SMALL CO-OPERATIVES

In many cases, as larger co-operatives have grown, their own co-operative capital has been used either for internal growth or for distribution to their members. However, they did not develop capacity to assist other co-operatives within their sectors when they are in financial need or to provide alternatives for them to investor-owned capital.

“Co-operatives large and small, capital needy and capital rich, should be co operating together to create a co-operative society.”

23 “Taux de survie des coopératives au Québec, Sommaire”, Développement économique innovation/Exportation, Edition 2008, page 5; “Co-operative Survival Rates in Alberta”, The BC-Alberta Social Economy Research Alliance, Richard Stringham, Alberta Community and Co-operative Association, Celia Lee, BC-Alberta Social Economy Research Alliance, August 2011, at page 10 ; “Co-operative Survival Rates in British Columbia”, The BC-Alberta Social Economy Research Alliance, Carol Murray, BC Co-operative Association, June, 2011, at page 2; Op. cit., note 5, at page 20.

INFORMATION BOX: THE CO-OPERATORS – SUPPORTING THE CO-OPERATIVE COMMUNITY IN CANADA

The Co-operators has a charitable foundation that it has been funding since the 50th anniversary of the company in 1995, which provides charitable capital for economic development in Canada.¹ Since the fund's inception in 1995, we have disbursed over CAD\$4.3 million to 105 organizations in Canada. In 2012, a total of CAD\$461,509 was granted to 24 organizations that assist marginalized individuals and communities by helping them build the capacity for economic self-reliance and sustainable livelihoods. We also provide funds annually to assist start-up co-operatives.² Over the past 21 years The Co operators has provided over CAD\$1.8 million Canadian in grants and investments to developing co operatives.

1 The original intention was to create a dedicated fund within the Co-operative Development Foundation of Canada. This was not particularly successful, so the Co-operators set up its own charitable foundation, which consisted of the charity itself as well as a parallel non-profit corporation: Co-operators Community Economic Development Fund.

2 This program has evolved into the Corporate Giving Program, which includes "small donations to numerous co operatives, not-for-profit organizations and charities across Canada...". The program now consists of The National Co-operative Challenge, the United Way and corporate donations.

CO-OPERATIVES “CO-OPERATING WITH EACH OTHER” TO CREATE A CO-OPERATIVE SOCIETY

It is the authors' vision that co-operatives large and small, capital needy and capital rich, should be co operating together to create a co-operative society. There is no reason that co-operatives that begin as small, self-help enterprises and grow to be large, multi-faceted enterprises should lose touch with the Values and Principles under which they were established. There are many examples of very large co-operatives in Canada, which very clearly view themselves as part of the co operative fabric and do their utmost to help other co-operatives succeed. These co operatives help not only in their own sectors, but cross-sectorally. They also help fund trade organizations on behalf of the broader co-operative community to promote co-operatives in Canada and abroad.

STRUCTURAL INHIBITIONS AND OPPORTUNITIES

The Desjardins group in Canada is a special act co-operative organization, which has one interesting feature that could be used as a model for other co-operatives. That feature is the ability that the special legislation gives them to move into a *caisse populaire* which is in financial stress, and which is a member of their federation, and have 100% control in providing remedial action to either restore or to close the *caisse*. Desjardins can bring all of the power they control, including the use of co-operative capital, to remedy the situation. This feature is really only available due to the terms of the special statute in Quebec. Legislative change and the creation of a co-operative stabilization organization funded by all Canadian co operatives would be required to make this available for others more broadly in the co-operative sector.

When it comes to “Co-operation among Co-operatives” in Canada, this has tended to take the form of co operation in lobbying for common objectives, supporting trade associations, and occasionally co-operating in key initiatives such as sustainability. Co operation designed to provide greater access to co-operative capital or helping to save co operatives that have run into financial difficulty has generally not been contemplated.

Co-operatives tend to work in their own areas of interest. Their focus is on their own membership and not necessarily on the broader ideal of a co-operative society. We respectfully suggest that the third and fourth Principles from the Alliance's Statement on the Co operative Identity actually reinforce this tendency not to get involved and not to help.



Springfield Seniors Non-Profit Housing Co-operative celebrates construction start of a new \$14.5 million, 47 unit housing co-operative development to provide quality, affordable housing in Springfield, USA.

The third Principle “Member Economic Participation” suggests that:

“Members allocate surpluses for any of the following purposes: a) Developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible. b) Benefitting members in proportion to their transactions with the co-operative. c) Supporting other activities approved by the membership.”²⁴

No suggestion is made in this Principle that perhaps surpluses should be used to create a co-operative stabilization fund or a co-operative development fund.

The fourth Principle, “Autonomy and Independence” suggests that:

“If they [co-operatives]...raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain the co-operative identity.”²⁵

This Principle deals with the issue of philosophical capital and ensuring that the capital remains co-operative capital, but it does not go to the next level – which is to promote the raising and accessing of capital within the co-operative sector itself. It also does not deal with the problem that is created when co-operatives embed investor-owned capital into their structures and later run into financial difficulty.

²⁴ Op. cit., note 55.

²⁵ Ibid

To its credit, in the many iterations in which The Co-operators has engaged in raising or distributing capital, it has actually engaged in co-operation among co-operatives, with respect to contributing capital and with raising capital within the co-operative sector from philosophically similar organizations. The Co-operators has utilized seed capital, which has been co-operative capital; we have assisted our members and other organizations with our own co-operative capital; and we are currently supporting efforts within Canada for the establishment of a co-operative development fund.

The Co-operative Difference and Philosophical Capital

“Co-operative businesses are islands in a sea of investor-owned firms. As islands they take on the language and concepts of the world around them even when they know they are not for them and do not fit. Co-operatives are profoundly different from investor-owned firms, and that difference is the key to meaningful understanding of any aspect of co-operative business.”²⁶

The influence of the “sea of investor-owned firms” cannot be over-emphasized since it invades all aspects of business. Even the nomenclature is driven by the investor-owned firms. Co-operatives often buy into the idea that if they are not doing what investor-owned firms are doing, then somehow they are not actually following best practices. In Canada, co-operatives, which are incorporated or continued under the Canada Cooperatives Act, do not report into a “co-operative regulatory authority”, but rather the Director of the Corporations Branch whose primary historical focus has been on the stock company type of business rather than the co-operative. If one looks at the courts, law firms, and other professional advisors, very few actually have particular expertise in co-operative law or theory – and even fewer actually believe in philosophical capital.

The co-operative difference is not well understood by the market or by investor-owned financial intermediaries. They do not understand the risks or the strengths inherent in co-operatives. There are many misconceptions around co-operatives as being not-for profit and around co-operatives’ financial viability. As a result, the co-operative difference is also perceived as an impediment for co-operatives wishing to access capital. Capital and capitalization are per se no different for co-operatives and non-co-operatives or investor-owned firms. What is perceived to be different is the ability of co-operatives to access capital as readily as investor-owned firms.²⁷

“Co-operative capital” is a broader concept than non-co-operative or investor capital. It includes the key types of instruments used for investor capital as well as a broader concept related to “meeting member and community need”²⁸, “that member and community needs will be met in a fair and equitable manner consistent with co-operative purpose, values and principles.”²⁹

Although the authors have been focussing primarily on co-operative capital in this paper as financial instruments that support co-operatives in their beginnings, growth, and success, we have done so primarily because we want to compare it to investor-owned capital instruments. However, the broader concept of co-operative capital should not be forgotten. This broader concept may not have value to investors, but it has great value to co-operatives.

The Co-operators has engaged in many activities, which focus on the “social” aspect of co operative capital (see the examples in the information box below). Its primary business

26 Op. Cit., note 18, page 2.

27 ‘Status of Co-operatives in Canada’, Report of the Special Committee on Co-operatives, Richards, Blair, M.P. Chair, September 2012, 41st Parliament, First Session, page 25.

28 Op. cit. note 49, page 6.

29 Ibid.

INFORMATION BOX: THE CO-OPERATORS – ENGAGING IN THE SOCIAL ASPECTS OF CO-OPERATIVE CAPITAL

- **Community Advisory Panel (CAP) program:** Now in its 10th year, these community panels allow us to meet with, listen to, and respond to the concerns of key community stakeholders and to incorporate their input to strengthen and enhance our products, services, and community programming.
- **Service Review Panels:** This is a unique insurance claims appeal process, which entails allowing policyholder panels to review and adjudicate the outcome of certain claims. The company agrees to be bound by these policyholder decisions.
- **Employee co-operative involvement:** The Co-operators offers support within and to the co-operative community on a pro bono basis by allowing staff to utilize their specialized expertise to assist other co-operatives and like-minded organizations. Through the “Leave for Change” program, our staff compete to be awarded the opportunity, with company assistance, to help co-operatives in developing countries. We also support our own staff in pursuing co-operative education.
- **Co-operative Education:** The Co-operators supports post-secondary programs in research and management of co-operatives, including Saint Mary’s University (Sobeys School of Business – Master of Management Co-operatives and Credit Unions), University of Victoria (Centre for Co-operative and Community Based Economy), University of Saskatchewan (Centre for Study of Co-operatives), York University (Schulich School of Business - Co-operative Certificate management program), Université de Sherbrooke (Maitrise en gestion et gouvernance des coopératives et des mutuelles).
- **Co-operative Trade Associations:** The Co-operators is one of the primary supporters of the major co-operative and mutual trade associations in Canada including Co-operatives and Mutuals Canada, the Canadian Association of Mutual Insurance Companies, as well as international associations such as the International Co-operative and Mutual Insurance Federation and the International Co-operative Alliance.
- **Multi-Stakeholder Co-operatives:** In 1985, The Co-operators began an experiment with “multi-stakeholder” co-operatives with the intention of achieving a greater and more direct relationship between the co-operative and its staff and clients/users. The holding company structure of The Co-operators otherwise made it difficult for users/clients of its operating companies to directly influence those companies through democratic control. The multi-stakeholder concept also involved looking to staff and clients to contribute capital, which would effectively be philosophical capital. Pilots were initially targeted for two subsidiaries, and the concept was fully implemented in one of them: Co operators Data Services Limited (CDSL). The founders of The Co operators viewed themselves as trustees for the interests of members, staff and clients. The multi-stakeholder co-operative concept was an attempt to replicate this philosophical orientation – with The Co-operators representing the founders, and both staff and users being represented on the Board of Directors and making a financial contribution. Unfortunately, the pilot was ultimately abandoned as CDSL was sold, as it was not considered a core part of The Co-operators business.

is insurance and many of its approaches to insurance reflect its philosophical belief in the value of people democratically controlling their own welfare and futures. However, this is not an inherent motivation for non-cooperative, investor-owned companies.

The Challenges and Opportunities Going Forward

As proposed earlier, to promote greater access by co-operatives to co-operative capital, rather than investor-owned capital, the starting place needs to be the Co-operative Principles. It is true that co-operatives tend to be organizations which are focussed on the self-help needs of particular groups and that – other than co-operative federations or

similar groups and trade associations – there are not necessarily the types of interactions between co-operatives which would promote broader access to and use of co-operative capital. However, this presents a profound opportunity and should be changed.

The Co-operative Principles should more robustly promote the idea of co-operatives being catalysts for a co-operative society. In so doing, the Principle of “Co-operation among Co-operatives” should include the concept that co-operatives should facilitate access to co-operative capital by other co-operatives, rather than investor-owned capital.

This concept should be complemented by the creation of new institutions and laws, which would support and encourage co-operatives to contribute to co-operative stabilization and financing initiatives. With such initiatives, stabilization organizations would be given the power and ability to take over the management of a financially distressed co-operative, assist in refinancing it, and strive to set it back on course, or (in the worst case scenario) to wind it up; all with the best interests of the co-operative sector in mind.

A number of years ago, the Butterfills legislative amendment in the United Kingdom enabled the merger of two, similar, member-based organizations without the need for demutualization. This revised law permitted the Co operative Group and the Britannica Building Society to merge into a new organization. Unfortunately operational problems arose, but these seemed to have been related more so to poor, business, due diligence rather than the structure of the merged co-operative itself.

In 2015, the Government of Canada in 2015 issued new regulations permitting the demutualization of mutual property and casualty insurance companies. As part of the government’s public consultation process, The Co-operators proposed that consideration should be given to the creation of a mutual and co-operative benefits association. The idea behind this proposal is to take an approach similar to the Butterfills amendment in the UK and enable similar and like-minded, democratically controlled organizations to merge without the need of demutualization. The advantage to this approach lies in the fact that the capital of like-minded organizations could be aggregated for the benefit of the members of both (or multiple) like-minded organizations with a common, democratic membership. In this way, co-operative capital would not be used to purchase investor-owned firms nor would it be dissipated to the advantage of investor-owned capital. It would instead be retained to further strengthen the co-operative, mutual, and like-minded sectors.

As the authors are lawyers working in and for a co-operative, we are fully aware of the lack of support in the investor-owned capital world for co-operative and other similarly structured organizations. You will not generally find courses in co-operative or credit union law at most law schools. Most judges, lawyers, regulatory officials, and even elected officials have little-to-no knowledge of co operatives. In the investor world, ‘unlocking capital’³⁰ is not viewed as a negative but as a positive. However, this is truly not the fault of the private and public sectors. It is our responsibility as co operators to take up the challenge – to promote the legislative and structural change necessary to allow and encourage co-operatives to access co operative capital with new and innovative mechanisms.

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Conclusion

“Accessing additional member capital or capital from external sources and adhering to cooperative principles is not an either-or proposition. There are many options and

³⁰ “Unlocking capital” is the term often used by predatory organizations looking to get access to the surplus built up over time within mutuals, co-operatives, and similarly structured organizations without regard to who built it up or why and certainly without the intention of ensuring that those who actually created the wealth should keep it.

*structures that preserve democratic control by ensuring all or a majority of the voting rights in a co operative enterprise remain in the hands of members.*³¹

The thesis of this article has been that co-operative capital is inherently incompatible with investor-owned capital, and that there is an abundance of co-operative capital available to support co-operatives. The real issues, however, relate to the Co-operative Principle of “Co-operation among Co-operatives” and how co-operatives may be empowered to access the co-operative capital that is available.

The history of The Co-operators demonstrates the success that one large financial services co-operative in Canada has experienced over time in its struggles to remain true to its co-operative roots and the nature of its founding members’ philosophical capital. This history also illustrates that The Co-operators is not just a user of co-operative capital, but also a provider of capital to other co-operatives in the spirit of co-operation among co-operatives. And The Co-operators is not alone; there are many other co-operatives around the world that are doing the same thing.

In the authors’ view, access to investor-owned capital by co-operatives will generally occur in one of two situations; simply put, in good times and in bad times.

In the first, and arguably more typical situation, the co-operative seeking capital is financially healthy and strong and is able to compete for available investor-owned capital, often on as-good if not better terms than those normally available in the market. But once accessed, given the security and priority that investor owned capital demands, no “options and structures that preserve democratic control by ensuring all or a majority of the voting rights in a co operative enterprise remain in the hands of members”³² will prevent the investor-owned capital from eviscerating the co-operative in a financial downturn. As noted earlier, co-operative capital must of necessity be and continue to be philosophical capital. It should be focussed on returns based on Co-operative Principles, including returns on the interest of members and their communities, not solely on maximizing economic returns to the owners of the capital (which is the sole focus of investor-owned capital).

The second situation where co-operatives might turn to investor-owned capital is in times of financial uncertainty, stress, or crisis. In these circumstances investor-owned capital may become attractive to a struggling co-operative. It is also in these times of organizational stress and weakness that a co-operative becomes most at risk of losing its way, and – by seeking investor-owned capital – may begin the slide down the slippery slope towards the loss of its co-operative identity and its ultimate demise. As such, access to reliable sources of co-operative capital becomes critical, and investor-owned capital should be considered as a solution of absolute last resort. In a world where co-operation among co-operatives is more than a phrase, such access would not be necessary. Fellow co-operatives would assess the need and provide capital to assist in remediating the co-operative or, in the worst-case scenario, save what is salvageable for the co-operative sector and movement. In doing so they would be focussing on both the best interests of the members as well as keeping the members involved in the co-operative form of enterprise.

There is no scarcity of co-operative capital. Globally, co-operatives need to focus on the Principle of “Co-operation among Co-operatives” as being more than common branding or governmental lobbying. We should be leveraging our immense collective strength to assist other co-operatives to survive in a world dominated by investor-owned capital. Many mechanisms already exist.³³ We need to take the best of each of them and replicate them in jurisdictions where they do not yet exist. If this means lobbying for legislative change,

“There is no scarcity of co-operative capital. Globally, co-operatives need to focus on the Principle of “Co-operation among Co-operatives” as being more than common branding or governmental lobbying. We should be leveraging our immense collective strength to assist other co-operatives to survive in a world dominated by investor-owned capital. Many mechanisms already exist. We need to take the best of each of them and replicate them in jurisdictions where they do not yet exist. If this means lobbying for legislative change, then let us get on to the challenge. Co-operatives were an innovation in their day; let us now innovate co-operatively to be a catalyst for a co-operative society.”

31 Op. Cit., note 4, at page 36.

32 Ibid., at page 38.

33 Ibid., at pages 16 – 26.

then let us get on to the challenge. Co-operatives were an innovation in their day; let us now innovate co-operatively to be a catalyst for a co-operative society.

If the Rochdale Pioneers could overcome the adversity that they faced – with a work day that stretched from dawn to dusk, the inability to even lease space to provide quality food and supplies to the workers, the lack of a common currency for workers to pay for the goods they were purchasing from the co-operative, the lack of economic capital, and the active and often violent actions taken by investor-owners to suppress them – with only their spirited, principled approach, values and their own human capital, then surely we with all of the resources available to us, we can overcome this challenge of co-operative capital and access to it.

Are we, as 21st century co-operators, up for the task? Bring it on.

ACKNOWLEDGEMENTS:

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3

Co-operative Capital of a Large Financial Co-operative: The Capitalization Evolution of Rabobank

ARNOLD KUIJPERS AND HANS GROENEVELD

3. Co-operative Capital of a Large Financial Co-operative: The Capitalization Evolution of Rabobank

ARNOLD KUIJPERS AND HANS GROENEVELD¹

In this chapter, the capitalization of a co-operative bank at its inception and subsequent further evolution is highlighted. To provide other co-operative institutions with possibly relevant and useful insights, we shall address this issue on the basis of the evolutionary experience of the Dutch co-operative Rabobank. Internationally, it is commonly acknowledged that this bank is one of the most highly integrated co-operative banking groups in the world with strong, internal, institutional arrangements that have resulted in solid capitalization and effective risk sharing. All these elements contribute to the financial solidity of the bank and are important reasons for credit rating agencies to award Rabobank with high credit ratings. This in turn has facilitated continued access to international capital markets in recent periods of financial distress as well as relatively favourable conditions for attracting external funding. In short, Rabobank's high capitalization has proven to be a key success factor and has been conducive for its strategic development over the years. Before we discuss the Rabobank case, we first pay attention to the definition of bank capital.

What is capital?

As in every industry, capital in banking is the amount of financial resources available for business operations. Capital providers of banks are shareholders in the case of joint stock companies or members in the case of co-operative banks. The way banks are capitalized reflects the primary objectives, risks, and expected financial returns by its owners, i.e., shareholders or members, respectively.

For a co-operative bank, profit maximization is not the main goal. However, an appropriate level of profits is indispensable for capitalization, to ensure continuity of goods and/or services delivery to its members, to realize growth ambitions, as well as to be able to fulfil social objectives. Members do not take an investor's perspective but support the organization because it contributes to their well being in the long run. In other words, a co-operative bank must be useful to and meaningful for its members. At the same time, this orientation enables the co-operative to direct its product supply predominantly towards the objective to satisfy the needs of its members. A satisfactory profit level signals that the co-operative is operating in an economically sound and efficient manner. In this case, members are also entitled to some financial rewards for providing member capital to the co-operative bank.

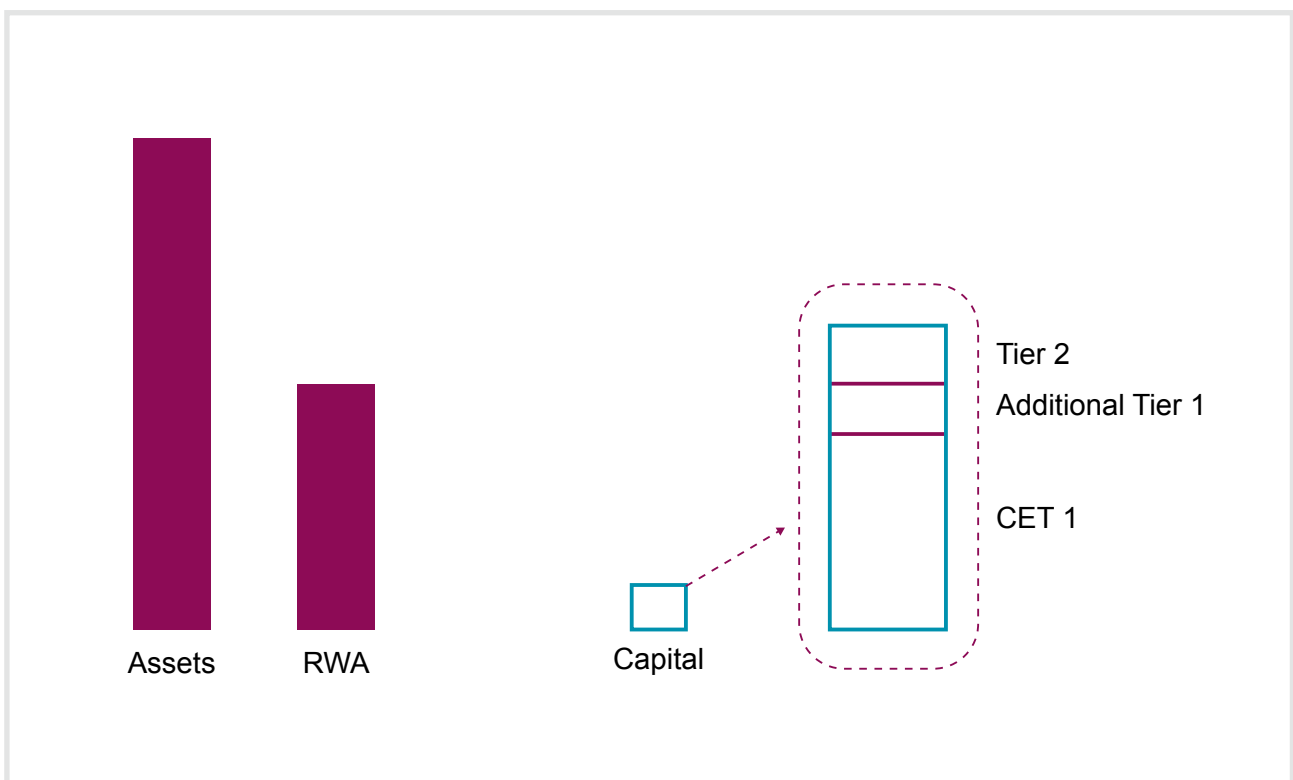
“Profits are particularly important for co-operative banks because retained earnings are their primary source for capitalization.”

However, profits are particularly important for co-operative banks because retained earnings are their primary source for capitalization. Co-operative banks cannot issue shares on the stock exchange and are thus dependent on internal capital accumulation for growing their business and increasing their value for its members. Profit, consequently an internal source for capital, is paramount for the future of a co-operative bank. For banking, increasingly more capital is required by the supervisors, and hence capital accumulation is a must. Co-operative banks predominantly build their capital base the hard way: via retained earnings.

¹ Arnold Kuijpers and Hans Groeneveld are employees of Rabobank. The views in this paper are personal and do not necessarily reflect those of Rabobank.

A bank differs from an industrial company because its creditors are not the ones that deliver goods and services to the company. Banks' creditors are mainly private depositors that place their excess liquidity at a bank because they do not need it for immediate use and trust the bank. A second distinction is that private savings are usually the largest component of banks' liabilities, whereas this is very unusual for creditors in other economic sectors. Finally, capital and other long-term liabilities serve in an industrial company to finance fixed assets such as land, buildings, and machinery. By contrast, banks mainly use savings to finance companies and private individuals. Consequently, bank capital is needed to provide comfort to the depositors (and bondholders) that they can avail of their money at all times, even if the bank is confronted with heavy losses and/or write downs. The amount of bank capital should therefore be sufficient to offset potential losses from credit defaults and from other risks. Because of the type of risks and the way they are being managed, the proportion of capital required for a bank relative to its total assets is substantially lower than in industrial companies. It is therefore very important that the bank is adequately capitalized in the eyes of depositors. If this is not the case, a bank run is likely to occur, which will lead to a failure of the bank and a discontinuation of its operations. Since savers cannot assess the health and solidity of their bank, banks are strictly regulated and supervised. Stringent capital and liquidity requirements apply to support confidence among depositors in the soundness of their banks. Capital requirements pertain to the level of capital a bank must have relative to all kind of risks in its operations and business. Therefore, a distinction is being made between business capital and regulatory (minimum) capital requirements.

The amount of regulatory capital is determined by banking regulation (Capital Requirement Directive IV and Capital Requirement Regulation in the European Union). For a bank, this constitutes the minimum level of necessary capital. If the actual capital level falls below this threshold, the banking license could be withdrawn and the Resolution Authority will step in in order to restructure or resolve the bank. In the present regulatory framework three categories of capital are distinguished: Common Equity Tier 1 (CET1), Additional





Round table dialogue in April 2015, on the role of co-operative banks and social finance institutions in promoting and financing social initiatives and social and solidarity enterprises, Mumbai, India.

Tier 1, and Tier 2 capital. The main purpose of capital is to absorb losses when they occur, and this principle forms the basis of the main requirements. CET1 consists basically of shareholders' capital or member certificates, retained earnings, and other reserves. Additional Tier 1 capital comprises essentially perpetual instruments for which redemption under conditions needs the approval of the supervisor. Besides, the dividend payments on these instruments can be suspended at any time at the full discretion of the bank. For Tier 2 instruments, the conditions are somewhat looser. This category comprises subordinated bonds, but also contingent convertible bonds (CoCos), which are bonds that will be converted into equity if the capital ratio drops below a certain benchmark. The total capital, CET1, Additional Tier 1, and Tier 2, relative to the risk-weighted assets (RWA) of the bank (this is the capital ratio) should be at least 8% (excluding specific buffers). The corresponding CET1 ratio has a minimum requirement of 4.5%.

There are, however, compelling arguments for a bank to strive for a higher capital level than what is required. Higher capital ratios make the bank safer and boost trust and confidence among depositors, as well as among external capital providers. Indeed, apart from savings many banks rely heavily on capital markets for the funding of their activities via the issuance of bonds. Investors will demand a premium on the interest rate when the creditworthiness of the bank, reflected in its credit rating, is considered low. In addition, a high credit rating attracts business from financial institutions and corporates because the counterparty risk is considered to be lower. Generally speaking, a high credit rating enhances the reputation of a bank. For this reason, it might be economically desirable to have a substantially higher level of capital than the minimum level required by regulators and supervisors.

Capitalization at inception

Most of the co-operative banks in Europe were initially capitalized by issuing member shares. Usually, members expected a lower return on member shares compared to the required returns on shares of listed banks. However, they did expect to receive a somewhat higher return on member shares than the interest rate on a savings deposit. Member shares have a nominal value meaning that the entitlement of the member relates to a nomi-

nal amount and not to a proportionate part in the capital of the bank. This means that at redemption of the shares – only to happen under strict circumstances, for instance, when the member has died – the increase in net assets of the bank due to retained profits will not be paid out to the inheritors of the member. As a consequence, the largest part of the capital of these co-operative banks in Europe currently consists of reserves to which no one has an entitlement. Members of a co-operative bank have no ownership claim on the reserves of a bank and therefore do not have any incentive to dispose of their bank for personal financial gain.

Local Rabobanks in The Netherlands emerged in the late 19th century by drafting Articles of Association that obliged borrowers of the co-operative bank to become members first. In another provision, it was stated that all members were personally liable for all the debts of the bank. If a member wanted to obtain a loan, other members had to “stand bail” for her/him implicitly. Hence, the capital on the balance sheet at inception was zero. These requirements provided assurance and encouraged savers to place their money in a co-operative bank, as savers knew that other members would step in if a capital shortfall was imminent. Over the years, the banks built up capital by retaining profits. Because no member shares existed, all profits could be retained instead of being redistributed as dividends to members. Over time, this capital base became very substantial allowing the liability of the members to be gradually reduced and finally abandoned (in 1998). This final step stimulated the business and competitive position of the bank, because many potential borrowers were not inclined to obtain a loan from Rabobank while putting a part of their welfare at stake at the same time.

A large benefit for members establishing their own local Rabobank was that they could start banking operations without having to provide the bank with a substantial amount of capital from their own savings. They could keep their financial means for other business purposes. At the same time, the member liability feature demonstrated a huge commitment of members to their co-operative bank, because the guarantee was initially unlimited. They also needed to have faith in the board members they elected – in terms of integrity, expertise, and attitude – in order to run the bank in a prudential manner.

Capital for growth

In the late 20th century, Rabobank could not generate sufficient capital anymore by retaining profits, because the bank opted to expand substantially in other financial services (insurance, asset management) and in new markets, domestically (corporates) and internationally. After a long period of intense discussions – also known as the Great Co-operative Debate of 1995-1998 – it was decided that Rabobank would remain a co-operative bank into the future. Therefore, tapping shareholders’ money via a listing on the stock exchange was not regarded as a satisfactory option for obtaining additional capital.

At some point in time, a stock listing for a minority part of the shares was considered. In that case, the majority part of the shares – and therefore the voting power – would remain in the hands of the local banks. In this way, some claimed that the bank would be controlled by co-operative constituents and therefore would effectively stay a co-operative. Others objected to this view and expected that the requirements of external shareholders would lead to conflicts with the priorities of members. Opponents also argued that external capital providers would affect the functioning of the internal governance. It was feared that external shareholders would start pushing for higher profits at the cost of providing added value to members. Tensions between the two groups of stakeholders would emerge and become subsequently impossible to manage. In the end, it was decided that

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any listing of a meaningful part of Rabobank would not be compatible with the objective to be a genuine co-operative institution.

At that point, the question arose as to how to obtain additional capital without introducing external shareholders and with maintenance of control by members simultaneously. Indeed, since the 1990s, local co-operative banks were confronted with a so-called deposit shortfall (i.e., local deposit growth was too low to accommodate local credit demand). At the same time, the capital base consisting only of retained earnings was too small to support domestic and international expansion. To bridge the deposit and equity gap, Rabobank began to issue various types of hybrid capital market instruments. Consequently, local banks remained able to meet credit demand of the private sector. The flipside was that Rabobank Group became more dependent on wholesale funding and had to comply with the requirements of the financial markets including obtaining a credit rating and fulfilling stringent reporting conditions. This had consequences for the functioning of the bank's internal governance.

“A solution was found in the introduction of a hybrid capital instrument: the member certificate. Basically a subordinated bond without voting rights and with an undefined maturity and a yield dependent on the realization of sufficient profits for capital formation.”

A solution was found in the introduction of a hybrid capital instrument: the member certificate. This financial title is basically a subordinated bond without voting rights and with an undefined maturity and a yield dependent on the realization of sufficient profits for capital formation. Such a capital instrument qualifies as Common Equity Tier 1 under European regulation. At that time, Rabobank still possessed a triple A credit rating and realized that there would be a large demand for member certificates among private individuals who were members. The bonds would carry a substantial premium due to its subordinated nature, but retail customers perceived the default risk of Rabobank as very low. Therefore, many customers regarded these subordinated bonds as an alternative to their savings deposits with a much lower yield. Rabobank issued these member certificates in 2000, 2001, 2002, and 2005. Around 150,000 members bought these certificates, which were not publicly listed but traded on an internal market maintained by Rabobank.

One could say that Rabobank had, after a century of existence, thus also enabled its members to become a capital provider to the bank – like the other co-operative banks in Europe had done since their establishment – with the difference being that the purchase of these certificates that did not entail any voting power in the co-operative was voluntary for Rabobank's members. The internal governance mechanism remained one that was based on the principle of “one member, one vote.” The total amount of outstanding member certificates increased steadily to almost EUR 6 billion.

In December 2013, Rabobank expressed its intention to enhance the tradability of these certificates. By making these certificates available to external investors, institutional investors could buy these certificates as well. This step was partially motivated by the fact that the supply on the internal market had increased significantly in the last quarter of 2013. An important cause was the requirement of the Dutch behavioural supervisor (Autoriteit Financiële Markten (AFM)) that Rabobank had to draw the attention of all certificate holders to the fact that a member certificate was no risk free savings product but should be considered an investment product. AFM also demanded that Rabobank advise each certificate holder to limit the share of member certificates in her/his total investment portfolio to 20%.

Since January 2014, these certificates have been listed as Rabobank Certificates on Euronext Amsterdam and still count as core Tier 1 capital without voting rights. This conversion could have impacted the functioning of the bank's 'bottom-up' governance; in particular, the legal question arose regarding to what extent the strategy of the group could be freely discussed in local and central governance bodies given the potential impact of these discussions on the price of the listed certificates. If members would for

this reason be constrained from freely discussing the policy and strategy of the group, the internal workings of the democratic control and co-operative governance model would be obstructed. After some months, it turned out that this fear was largely unfounded. Twice a year, at the same time when financial results are being presented to the press, a detailed presentation is made to the chairmen of the local boards and the general managers of the local banks. Also, stakeholders understand that – for a co-operative – the financials are only one aspect of performance. Other outcomes, like member/customer satisfaction, can be revealed and discussed without restriction.

Another concern relates to the unlikely scenario in which reserves or retained profits are decimated by heavy losses. This could put external capital providers in a much more powerful position and could lead to them securing some degree of control of the bank.² This situation could eventually be difficult to reconcile with the desired continuation of the co-operative character. To mitigate this potential and remote threat, more than half of the capital consists of reserves from retained earnings only.

In order to prevent external capital from becoming incompatible with co-operative philosophy and the co-operative model, it is paramount that the entitlement of external investors does not include voting power and that their reward is unrelated to the level of profitability of the bank. Long-term continuation of providing financial services should be in the interest of all stakeholders. For this reason, there should be a sufficient level of profit, but never a drive for maximizing profits.

In January 2014, Rabobank's CET1 amounted to EUR 31 billion, of which the Rabobank certificates constituted EUR 6 billion, a substantial part after the largest portion which was retained earnings. The outstanding amount of Additional Tier 1 was EUR 8 billion and that of Tier 2 instruments EUR 12 billion. Hence the total capital of Rabobank was EUR 51 billion, equivalent to a capital ratio of 21.3%, with a CET1 ratio of 13.6%. This was well beyond the required regulatory minimum thresholds of 8.0% and 4.5 %, respectively. (See chart below.)

High capital ratios are important for Rabobank in light of its dependency on wholesale funding, which is its most important source of funds after retail funding provided by its customers. The earlier mentioned deposit and funding gap also has to do with the specific situation in The Netherlands regarding the funding of pension schemes since the 1960s. A considerable part of the savings of private individuals is contractually invested into pension funds. At the end of 2014, total assets of Dutch pension funds amounted to EUR 1.3 trillion, whereas the savings deposits with banks only equalled EUR 390 billion. As a consequence, at this moment in time, one third of the liabilities of Rabobank consist of bonds and other debt instruments mainly bought by institutional investors. In order to keep the costs of this funding as low as possible, a high level of capitalization – and consequently a high standing credit rating – is paramount.

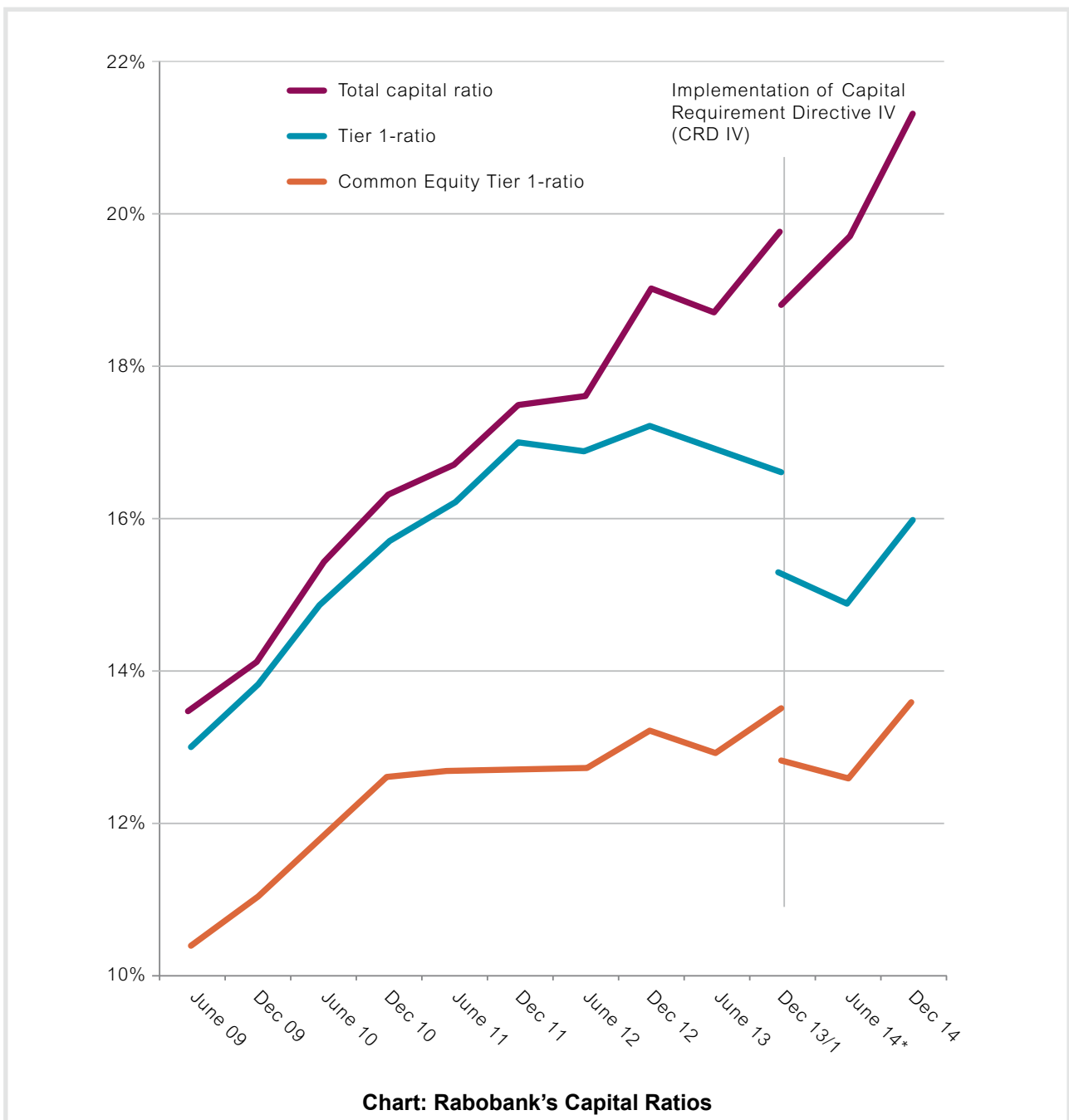
Apart from this, Rabobank anticipates higher future capital requirements. Regulatory capital that is considered to be sufficient to-date will presumably be inadequate tomorrow. A clear sign is that the Bank of International Settlements (BIS), a worldwide platform for supervisors, initiated a consultation on a Revised Standardized Approach and Capital Floors at the end of 2014. One of the implications of the proposals is that supervisors will rely less on banks' internal risk model calculations in determining required capital levels. The impact of the suggested new approach on the level of regulatory capital for banks will be substantial. The Financial Stability Board, another platform involved in banking regulation, stipulated that big banks would need to have even more additional capital for the

“In order to prevent external capital from becoming incompatible with co-operative philosophy and the co-operative model, it is paramount that the entitlement of external investors does not include voting power and that their reward is unrelated to the level of profitability of the bank. Long-term continuation of providing financial services should be in the interest of all stakeholders. For this reason, there should be a sufficient level of profit, but never a drive for maximizing profits.”

² Such a situation occurred at The Co-operative Bank in the UK resulting in hedge funds becoming (voting) shareholders.

(unlikely) situation in which the institution had to be resolved by the Resolution Authorities. This last proposal would imply a level of total regulatory capital of about 25% for the biggest banks. Such a ratio would significantly exceed the future target level even of a very prudent bank like Rabobank.

The issue of senior bonds should also be assessed in light of the Bank Recovery and Resolution Directive in Europe, which will come into effect in 2016. It will not suffice to have an adequate level of regulatory capital. On top of regulatory capital, a bank needs sufficient additional debt instruments (minimum requirement for “bail-inable” liabilities) to cope with the unlikely situation in which it enters into a potential resolution process. In this situation, senior debt will be converted into equity. Therefore, next to capital, the “buffer” becomes another yardstick to measure the resilience of a bank against unforeseen losses. In this context, the definition of capital or “loss absorbing capacity” is becoming somewhat blurred.



Potential issues with issuance of capital instruments

The regulator allows capital of a lower quality as an addition to CET1 but only to a limited degree. When raising additional capital by the issuance of capital instruments on top of the amount of retained earnings, it is important to be cognizant of potential issues and limitations.

Regulatory demands change frequently, and since the outbreak of the financial crisis the requirements for capital instruments to qualify for regulatory purposes have gradually become more stringent. Experience shows that what is considered as capital today may not be considered as capital tomorrow. There is a substantial degree of regulatory uncertainty in this regard. If an instrument loses its status as capital in the future, the yield paid on the (perceived perpetual) instrument has been too high in the past.

A second potential problem is related to volatility and uncertainty in financial markets. For example, if a bank fails and the value of its capital instruments dwindles, this might create substantial discomfort and concern with members and customers of Rabobank who hold these kinds of instruments. The bank could only buy back those instruments, with the consent of the supervisor, if its CET1 (mainly retained earnings) remains at a satisfactory level after such a buy back action.

A third potential problem concerns the costs attached to those capital instruments. Investors are only willing to assume the risks inherent in these instruments if they receive adequate compensation. These costs will suppress the profitability of the bank and hence its capacity to build reserves if the return on these additional capital instruments falls short of its costs. Therefore, the more a bank relies on the issuance of capital instruments, the more its capacity to improve its high quality capital base is negatively impacted.

In sum, the issuance of additional capital instruments can be a good way to strengthen the institution, to increase its business volumes, and to boost value for its members and customers. However, the effects of expanding the use of these instruments should be carefully assessed. It is important to closely monitor the relative weights of all capital categories as well as to carefully assess the costs and revenues of additional capital.

Conclusion

Whatever the type or form of capital, whoever the provider of such capital and whatever the stage of development of the co-operative bank receiving it, the baseline requirement must be that all forms of capital are used in a productive and profitable way. In other words, the returns on any type of capital must always exceed its costs. Underperformance eventually undermines the capital base of co-operative banks and threatens their viability. Because of limitations on raising significantly additional capital from members and the impossibility to obtain capital on the stock market, co-operative banks are fully dependent on retained earnings to enhance their capital position. The bottom line is that co-operative banks must be profitable, efficient, and innovative to withstand fierce competition in banking, fulfil future stricter capital requirements, and enable their continuity and growth into the future. Only if these preconditions are met is the issuance of additional capital instruments to spur growth justified.

“The baseline requirement must be that all forms of capital are used in a productive and profitable way. In other words, the returns on any type of capital must always exceed its costs. Underperformance eventually undermines the capital base of co-operative banks and threatens their viability.”

“The bottom line is that co-operative banks must be profitable, efficient, and innovative to withstand fierce competition in banking, fulfil future stricter capital requirements, and enable their continuity and growth into the future. Only if these preconditions are met is the issuance of additional capital instruments to spur growth justified.”

4

Co-operative Capital: A Necessary Evil

The Case of US Credit Unions

BILL HAMPEL

4. Co-operative Capital: A Necessary Evil The Case of US Credit Unions

BILL HAMPEL

Capital is a troubling issue for co-operatives. It is necessary for their operation but conjures up associations that go to the very heart of what distinguishes co-operatives from investor-owned enterprises. The contribution of capital (purchase of shares) by “capitalists” is the defining characteristic of an investor-owned firm. Some have even suggested that co-operativism can be the antidote to the system of capitalism that failed so dramatically and miserably in the financial crisis and Great Recession of the last decade.¹

Of course, capitalism and co-operativism, as those terms are commonly understood, are not taxonomic alternatives or mutually exclusive. Capitalism typically refers to how a society’s economic system is organized, characterized by private ownership of the means of production. Alternatives to capitalism are socialism, communism, statism, etc. Co-operativism deals with how individual firms within an economic system are structured. Co-operatives can, and do, exist in capitalistic societies. But the fact that the owners of investor-owned firms are sometimes referred to as “capitalists” adds to the confusion. And in the particular case of worker co-operatives, there is a real distinction in terms of ownership of the means of production between a co-operative firm and an investor-owned firm.

“Capital is indeed an uneasy topic for co-operatives. Capital may be necessary for the operation of a co-operative, but the interests of its owners are not elevated over other interests in the enterprise; just the opposite.”

All of this suggests that capital is indeed an uneasy topic for co-operatives. An investor-owned firm operates exclusively for the benefit of providers of capital, the capitalists. A co-operative instead functions to benefit some or all of the other stakeholders in the enterprise: consumers, producers, and/or workers. Capital may be necessary for the operation of a co-operative, but the interests of its owners are not elevated over other interests in the enterprise; just the opposite. Surplus in a co-operative is more likely to be distributed on the basis of patronage rather than on the amount of contributed capital.

The difficult nature of capital is evident in the case of credit unions in the United States. Maintaining sufficient capital is vital to a credit union, but doing so complicates pursuit of three of the seven Co-operative Principles: “Democratic Member Control”, “Member Economic Participation”, and “Autonomy and Independence”. More on this later.

First, a word on terminology. As used by co-operatives, the term “capital” can refer to something that functions in one or more of three ways:

1. As a source of funds to finance operations in anticipation of future revenues (short-term costs of production, inventory accumulation, or long term fixed-asset acquisition),
2. As the manifestation of the ownership of the co-operative, and
3. As capital at risk to protect creditors and the on-going viability of the co-operative.

For the first of these needs – general financing – the source of capital might be equity contributions from members, retained surplus, or debt capital from members or non-members. For the second of these functions – ownership – capital can only come from member

¹ See for example: Zamagni, Stefano. “Comparing Capitalistic and Co-operative Firms on the Ground of Humanistic Management.” SSRN Working Paper Series (2008). Simon Birch, *Can Co-operatives provide an alternative to capitalism?* The Guardian, (September 17, 2013). Harrison, Rob. *People Over Capital: The Co-Operative Alternative to Capitalism.* (New Internationalist Publications, Ltd., 2013).

shares. For the third – equity at risk – the source can be either member shares, retained surplus, and (in certain circumstances) debt capital.

For co-operative financial intermediaries such as credit unions – whose main function is to accept shares or deposits from some members and lend those funds to other members – the term “capital” is reserved for just the third aspect: equity at risk. For US credit unions, “capital” is almost exclusively comprised of retained surplus or earnings.²

“For US credit unions, “capital” is almost exclusively comprised of retained surplus or earnings.”

The issue is further confused by the fact that for US credit unions, member **shares**, despite the term, are not considered a component of capital because they are not at risk. The shares that members place in credit unions have two very distinct roles. First, they fully represent the members’ ownership interest in the credit union. There is no other ownership stake in a credit union. In the event of the liquidation of a credit union, all surplus is distributed to member shareholders in proportion to their shareholdings. In this sense, shares are indeed equity. But they are not exposed to much risk. They function as deposits, or liabilities, and are the primary source of funding of the credit union’s loans to members and other financial investments. Typically, over 85% of a credit union’s balance sheet is funded by member shares. The liability nature of member shares is evidenced by the fact that they are covered by a government-backed deposit insurance scheme just as are deposits in investor-owned commercial banks to a maximum of \$250,000 per account holder.

This is why, for US credit unions, the main function of narrowly defined “capital” is not to fund operations but to serve as a buffer or reserve to protect creditors and shareholders/depositors (and the share insurance fund) from losses that might occur to the assets of the credit union (losses on loans, investments, other assets, or arising from operations).

The divisibility of credit union retained earnings to shareholders could in theory create an incentive for members to call for the liquidation of a credit union that has built up substantial retained earnings. In practice, this has been a very rare occurrence. However, the divisibility of shares had induced some credit unions to attempt to demutualize by conversion to investor-owned banks. In these cases, only those members who purchase shares in the new bank will gain access to the former credit union’s retained earnings. This can concentrate the value of the retained earnings into a small number of stock purchasers: those knowledgeable of the transaction. There were virtually no such demutualization attempts before 1998, when a change in the law eased the voting requirements for a charter conversion. In the seventeen years since, there have been 35 successful demutualization conversions, 31 of which occurred in the first decade following the change in the law. The decline to four in the number of successful demutualization attempts since 2007 is due to a number of successful campaigns by credit union members to encourage voting against the conversion and a bank regulator that was less receptive to conversions.

“The divisibility of shares had induced some credit unions to attempt to demutualize by conversion to investor-owned banks.”

The amount of capital that a credit union requires to cover risk depends of course on the amount of risk it is exposed to, which is determined by both the size of the credit union’s balance sheet and how that balance sheet is managed. The second of these factors is not the topic of this chapter.

The size of a credit union’s balance sheet is determined by the amount of shares or deposits members place in the credit union. Since those shares or deposits are essentially risk free to the member, being covered by a federal deposit insurance scheme, there are few theoretical limits on the size of a credit union’s balance sheet, and therefore the amount of risk it can be exposed to. In other words, credit unions could conceivably take

² For a subset of credit unions with a “low-income designation”, certain forms of debt capital from non-members can be considered capital.



St. Pierre Fish Multi-Purpose Cooperative Society, Mauritius.
Credit: Nasseem Ackbarally/IPS.

on huge leverage, or the relationship between liabilities (deposits) and capital (equity at risk). Indeed, one of the many causes of the financial crisis of the last decade was the very high leverage exposure of large investor-owned financial institutions.

There are two forces that limit the amount of leverage in US credit unions. First is the natural tendency of the co-operative form of organization to induce a more risk-averse management style than that found in investor-owned firms.³ Not having a significant, personal ownership stake in the short-term results of the firm, the management (members of the board of directors and senior staff) of credit unions have little incentive to take on excessive risk. If a credit union succeeds in a high-risk, high-return venture, there is little opportunity for the managers and directors to benefit, unlike the case for an investor-owned

³ Edward J. Kane and Robert J. Hendershott, *The Federal Deposit Insurance Fund that Didn't Put a Bite on U.S. Taxpayers*, *Journal of Banking and Finance*, 20 (September, 1996), pp. 1305-1327. Kane and Hendershott describe how the co-operative structure of credit unions presents credit union decision makers with incentives that are strikingly different from those faced by a for-profit financial institution, making it less feasible for credit union managers to benefit from high-risk strategies.

bank whose management are likely stockowners and may hold stock options. If such a venture fails, the credit union's managers are likely to become unemployed. The asymmetry of risk and reward results in the risk-averse behaviour that served credit unions and other co-operatives well during the recent financial crisis.⁴ This risk-averse tendency of credit union managers influences both the riskiness of the assets acquired and the amount of capital the credit union holds relative to assets.

The second, and very powerful, limit on credit union leverage is the influence of the prudential regulator, the National Credit Union Administration (NCUA), which operates the federal deposit insurance scheme: the National Credit Union Share Insurance Fund (NCUSIF).⁵ The greater the equity at risk compared to total assets (the lower the leverage), the lower the probability the NCUSIF will be required to compensate credit union members in the event of a credit union's failure. In 1998, the US Congress mandated the minimum levels of capital for a credit union to be classified as "well" or "adequately" capitalized (7% and 6% of total assets respectively) in a Prompt Corrective Action statute enforced by NCUA. Under this law, the NCUA is required to take increasingly forceful supervisory actions against a credit union the lower its capital ratio falls below these regulatory minimums. To avoid such actions, credit unions typically attempt to hold sufficient capital in excess of 7% to avoid the consequences of being considered less than well capitalized. In addition, many credit unions report considerable pressure from NCUA examiners to maintain capital ratios well in excess of 7%.

As a result of both regulatory pressures and their own inherent risk aversion, most US credit unions operate with capital ratios of over 10% of assets, although some very well managed, vibrant, and safe credit unions operate successfully with capital ratios between 7% and 10%. And since virtually all credit union capital is held in the form of retained earnings, which would qualify as Common Equity Tier 1 under the Basel capital standards, credit unions as a group are very well capitalized.⁶

The perceived need or desire to operate with high leverage ratios can place restraints on a credit union's growth. It also makes it very difficult to form a new credit union.⁷ Unless a benefactor donates equity to a credit union, it begins its life with no retained earnings. The Prompt Corrective Action rule allows a new credit union a few years to build capital, but it is extremely difficult to bootstrap capital in this way. As a result, new credit union charters are rare. In the twenty-five years since 1988, only 209 new credit unions have formed – an average of just over 8 per year. Over the same period, 2,836 bank charters have been issued – an average of over 9 per month. New credit union charters are not impossible, but they are very difficult.

The arithmetic of desired or required capital ratios and growth is quite simple and unavoidable. Credit unions in the US do not have access to external or supplemental forms of capital.⁸ Thus, for most, the only source of capital is the retention of earnings, and the rate at which assets can grow without a reduction in the capital ratio depends on how rapidly

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4 See for example: Birchall, Johnston. *Resilience in a downturn: The power of financial co-operatives*. International Labour Organization, (2013). Chiamonte, L., Poli, F. and Oriani, M. E. *Are Co-operative Banks a Lever for Promoting Bank Stability? Evidence from the Recent Financial Crisis in OECD Countries*. European Financial Management, 21: 491–523. (2015).

5 The National Credit Union Share Insurance Fund (NCUSIF), administered by the National Credit Union Administration (NCUA), insures shares and deposits in all federally chartered US credit unions and in all federally insured state chartered credit unions up to \$250,000 per account. All but 240 of the nation's more than 6,000 federally and state chartered credit unions are covered by NCUSIF insurance.

6 The capital ratios discussed here are commonly referred to in banking as leverage ratios i.e., total capital divided by total assets, not risk assets.

7 This of course differs from the general usage of the term "leverage ratio," which is typically defined as the ratio of debt to equity.

8 Although credit unions with a low-income designation can access certain forms of supplemental capital, the practice is limited. Less than 1% of the total capital in low-income credit unions is in the form of supplemental capital, accounting for less than 0.1% of assets at those credit unions.

capital is augmented with additional earnings. This relationship is captured by the following equation, which holds that the maximum rate of asset growth that a credit union can sustain without a decline in its capital ratio is given by its return on equity:

$$\text{Return on Equity} = \text{Maximum Growth Rate} = \text{Net Income} / \text{Capital}$$

The average ratio of net income to total assets for credit unions over the past several years has averaged about 80 basis points. With a desired/required capital ratio of 10%, that implies a return on equity of 8% (0.8%/10%). This means that, under current conditions, total credit union asset growth is limited to 8% per year.

The average credit union growth rate over the past three decades has been just that: 8.2%. In the first decade of this century – before very low interest rates made deposits in financial intermediaries unattractive to consumers slowing credit union deposit and hence asset growth – annual credit union asset growth exceeded 8% four out of ten times. In other words, the capital requirement on credit unions is frequently binding as a restraint on growth. Indeed, credit unions frequently cite growth moderation as a tactic to protect capital ratios in times of reduced earnings or rapid growth opportunities.

This is the crux of the problem with capital for credit unions. In order to maintain relatively high, required capital ratios, credit unions must either boost earnings or retard growth. The first of these options entails credit unions acting, in some ways, more like investor-owned institutions than as co-operatives. The second requires credit unions to discourage members from making full use of the services of the co-operative. Neither of these is an attractive choice, and each runs afoul of the Co-operative Principles.

For a credit union to increase its earnings, it must either reduce costs or increase income. Cutting costs can be accomplished either by lowering operating expenses or reducing the amount of interest paid to members on their deposits. Since credit unions already operate in highly competitive markets, they tend to be quite efficient. Expense-to-asset ratios are similar to those of similar sized commercial banks. Therefore, cutting expenses typically means reducing some member service or pressing staff to be even more efficient. Increasing income almost always means less attractive pricing to members. Members either pay higher rates on loans, or pay more and/or higher fees for other services. Recently, with very low market interest rates putting downward pressure on interest income, credit unions have had to resort to higher and more frequent fees on member services.

All of these techniques to increase earnings or surplus make it more difficult for a credit union to adhere to the Principle of Member Economic Participation. Of course, interest income could also be increased by investing in riskier loans or investments, but this option is frowned upon by the prudential regulator and runs counter to credit unions' natural risk aversion.

Instead of boosting earnings to capitalize growth, a credit union could instead decide to limit growth to prevent the capital ratio from falling. That could interfere with furtherance of the Principle of Voluntary and Open Membership. Limiting growth will make the credit union less attractive than it otherwise would be to current and potential members, effectively limiting access to credit union services. It is also just simply counter to the goal of promoting and expanding the co-operative way of doing business.

Credit unions could break the limiting connection between growth and earnings by issuing alternative forms of capital whereby members or other investors would place at-risk funds in the credit union to augment retained earnings. Credit unions in the US are almost unique in the co-operative financial world in terms of not having this authority. Considering the successful use of supplemental capital by co-operative financial institutions in other

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counties, it certainly would be a valuable addition to the toolkit of US credit unions in managing capital adequacy. This would especially be the case for robust, successful credit unions facing significant growth opportunities where an injection of capital would obviate the need to rely on the slow process of earnings retention. However, supplemental capital would not be without its own drawbacks.

Supplemental capital could be created in a variety of ways from both members and outside investors. All members could be required to purchase a capital share subscription (as opposed to the more general shares that function as deposits) as a condition of membership. However, the total amount of capital from this source would be modest, and could not be quickly increased without requiring all members to simultaneously increase their subscriptions.

More significant or rapid injections of supplemental capital would require the issuance of fairly large denomination capital shares to members, or subordinated debt instruments to non-members, subject to appropriate disclosure and suitability requirements.⁹ Supplemental capital in this form would likely be concentrated in the hands of a relatively small number of significant investors. This raises one of the concerns with supplemental capital for credit unions. These investors with funds at risk, be they members or not, are likely to take a strong interest in the operation of the credit union. To preserve the co-operative nature of the credit union, the securities would have to specify that investors have no governance rights in the credit union. For example, contingent governance rights that exist in some subordinated debt instruments issued by investor-owned firms could not exist in credit union securities.¹⁰ However, in order to preserve access to continued sources of supplemental capital, credit union management might be induced to pay special attention to the interests of a small number of vocal, influential investors. This could interfere with the Co-operative Principle of Democratic Member Control. This potential problem could be minimized by explicit disclosure of the absence of any governance rights of investors, as well as strict discipline by the credit union's management and board.

“To preserve the co-operative nature of the credit union, the securities would have to specify that investors have no governance rights in the credit union.”

The second concern with supplemental capital would be its cost. Acquiring supplemental capital is essentially renting risk-absorbing capacity, rather than building it through earnings retention. Investors will require a risk-adjusted return sufficient to compensate them for taking on that risk. The risk premium would likely be elevated by the explicit absence of any contingent governance rights. Judging from the rates that commercial banks in the US pay for subordinated debt, the cost of acquiring supplemental capital for credit unions would not be prohibitive, but it would not be free. It might reduce the pressure to boost earnings in response to strong growth but it would certainly not eliminate it, because a credit union using supplemental capital would likely want to increase earnings somewhat to cover some of the cost of issuing the capital.

Of course, there is another way to address the problems arising from the need for capital in credit unions. Recalling the return on equity equation, where the maximum possible asset growth rate is determined both by the rate of earnings retention and the target capital ratio, it follows that the **lower** the required or desired capital ratio, the **faster** the growth rate that can be supported by a given earnings rate. In the case described previously, an earnings rate of 80 basis points of assets and a target capital ratio of 10% allows an annual asset growth rate of only 8%. Lowering the target capital ratio to 8% would permit a 10% growth rate with the same level of surplus retention. The long-term benefits of such

9 Disclosure entails providing a prospective investor with all they need to know to make an informed decision. Suitability requires going further; the issuer of the security has some obligation to screen investors as to whether they actually understand the risks and are able to absorb possible losses.

10 A typical contingency in a subordinated debt security is that bondholders become entitled to board seats, or that bonds convert to ownership shares, in the event the condition of the issuing firm deteriorates below a certain level.

a change would be substantial. After 10 years, a credit union growing at 10% per annum would be 20% larger than one growing at 8%; after 20 years, it would be 44% larger.

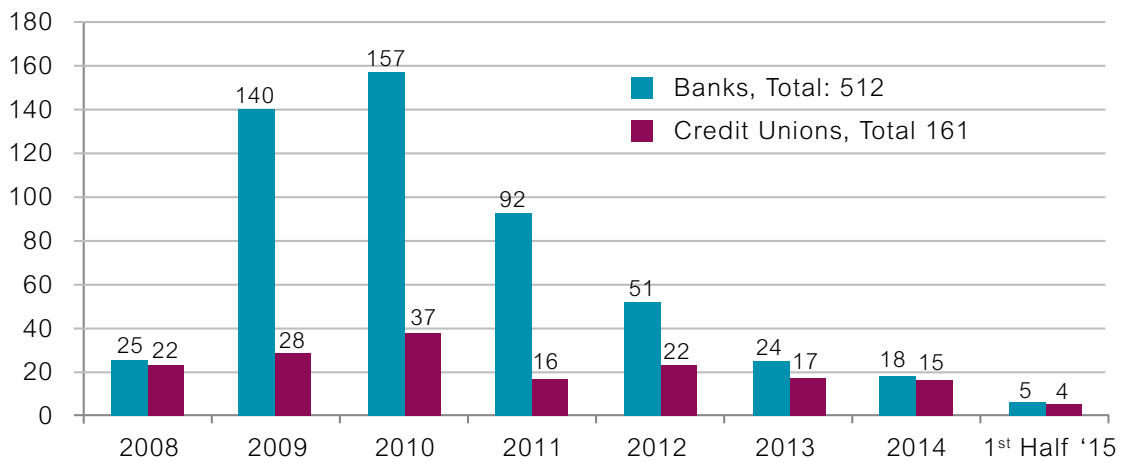
If holding “too much” capital is so harmful, what then is the appropriate level of capital to maintain? There is of course no easy answer to this question. In principle, it varies for each credit union depending on the amount of risk that credit union takes on in its operations: the types of loans it makes, how it invests, etc. However, there is evidence that the levels of capital that credit unions have come to consider necessary might be a bit elevated. US credit unions’ regulatory leverage ratio requirements to be adequately or well capitalized are fully two percentage points higher than those applied to commercial banks. Considering the powerful differences in risk-avoidance incentives inherent in the co-operative as opposed to investor-owned models, one might reasonably expect that credit union capital requirements should be lower than those applied to banks.

“The fact that US credit unions weathered the financial crisis and Great Recession with far less damage than commercial banks provides a recent empirical example of the risk reducing power of the co-operative structure.”

The fact that US credit unions weathered the financial crisis and Great Recession with far less damage than commercial banks provides a recent empirical example of the risk reducing power of the co-operative structure. Chart 1 shows the number of bank and credit union failures since the beginning of the Great Recession in 2008. (The beginning numbers of banks and credit unions were similar in 2008.) Bank failures exceeded 100 in 2009 and 2010, peaking at 157 in 2010, and totalled 512 from 2008 to mid-2015. Credit union failures peaked at 37 in 2010, and the total of 161 is less than a third of the bank total.¹¹

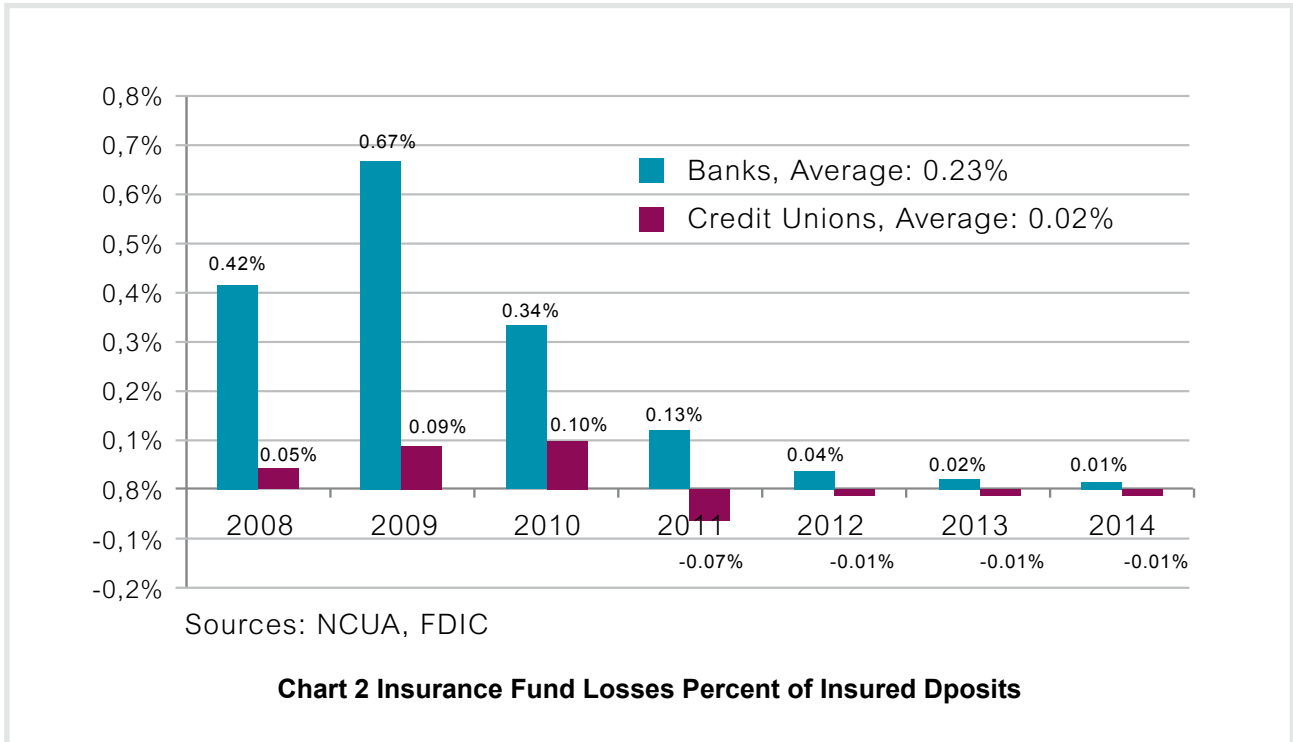
The difference in the relative dollar amount of losses generated by bank and credit union failures during the Recession and its aftermath is even more striking. During tranquil financial times, losses at deposit insurance funds are rare. In the decade preceding the Great Recession, insurance losses as a per cent insured deposits at both the insurance fund for banks operated by the Federal Deposit Insurance Corporation and the similar fund for credit unions operated by the National Credit Union Administration averaged approximately on

¹¹ The number of credit unions and banks at the beginning of the Recessions was very similar. As of December 2007, there were 8,534 FDIC-insured banking institutions in the US and 8,396 credit unions.



Sources: National credit Union Administration, Federal Deposit Insurance Corp

Chart 1 Bank and Credit Union Failures Since Onset of Great Recession



half of one basis point a year. However, as shown in Chart 2, in the seven years since the onset of the Recession, losses at the bank insurance fund have averaged 23 basis points, reaching as high as 67 basis points in 2009. In sharp contrast, over the same period insurance losses at the credit union insurance fund averaged less than one tenth the bank average or 2 basis points of insured deposits, with a maximum value of 10 basis points in 2010.

The stated purpose of the Prompt Corrective Action section of the Federal Credit Union Act, which establishes capital requirements for credit unions, is to minimise losses to the share insurance fund.¹² The robust performance and health of credit unions during the recent financial crisis as evidenced by the low level of losses incurred at the fund are strong evidence that credit unions did not enter the recession undercapitalized. Comparing credit union to bank results suggests credit unions could well operate with lower capital ratios than banks.

Despite the pressures that excessive levels of capital can place on credit unions, both in the form of reduced growth potential and less attractive pricing of services to members, credit unions have managed over the past few decades to navigate these waters well. As data in the Information Box (below) shows, although still small compared to the commercial banking industry, credit unions have outgrown banks over the past thirty-five years in the US. With an asset growth rate that has averaged more than two percentage points higher than the bank growth rate, the credit union share of the combined assets of banks and credit unions has more than doubled, from 3.6% to 7.3%. Credit unions have achieved this result by generating earnings that matched after-tax profits at banks. They have accomplished this by stressing operating efficiency, relying on generally uncompensated directors, and being exempt from federal income taxes. The absence of the requirement to pay dividends to stockholders has allowed credit unions to retain all earnings as capital, helping to maintain a capital ratio equivalent to that at banks. A number of sources routinely report that credit union fees, loan rates, and deposit rates compare favourably to those at banks.

¹² USC §1790d§216(a)

“A challenge for credit unions, and by extension all co-operatives, is to optimize the benefits of sufficient capital without incurring the costs and compromises to the Co-operative Principles that would result from holding too much capital.”

The need to hold adequate capital has not relegated credit unions to stagnation and irrelevance. Rather, it has held credit unions back from reaching their full potential. Without the need to hold levels of capital currently perceived to be necessary, credit unions could offer even more advantageous member pricing, and grow to become a really significant provider of financial services.

A challenge for credit unions, and by extension all co-operatives, is to optimize the benefits of sufficient capital without incurring the costs and compromises to the Co-operative Principles that would result from holding too much capital. This suggests that particular care be taken by credit unions to hold only that amount of capital that is really necessary. Given that there are two very strong forces that might tend to raise capital targets above what might actually be necessary – internal risk aversion and prudential regulatory pressure – frequent revisiting of capital goals is in order.

Capital for US credit unions can therefore be considered a necessary evil. Evil in the sense that its supply and maintenance requires credit unions to act in some ways that may seem to be in contravention of some of the Co-operative Principles. Necessary in the sense that it is vital to secure the on-going viability of a credit union in an uncertain and risky world.

INFORMATION BOX: COMPARING CREDIT UNIONS AND BANKS IN THE US

| As of December 2014 | Banks | Credit Unions |
|--------------------------------|-----------------|-----------------|
| Number of institutions | 6,509 | 6,513 |
| Total industry assets | \$15.6 trillion | \$1.1 trillion |
| Assets of largest institution | \$2.1 trillion | \$60 billion |
| Average institution asset size | \$2.4 billion | \$176 million |
| Median institution asset size | \$ 181 million | \$25 million |
| Average Leverage Ratio | 11.0% | 11.1% |
| Averages, 1980 to 2014 | | |
| Annual Asset Growth | 8.7% | 6.3% |
| Annual Loan Growth | 8.4% | 6.2% |
| Net Income to Assets | 92 basis points | 89 basis points |

5

Co-operative capital: An
essential combination of science
(*management*) and conscience
(*Co-operative Principles*)

JEAN-LOUIS BANCEL

5. Co-operative capital: An essential combination of science (*management*) and conscience (*Co-operative Principles*)

JEAN-LOUIS BANCEL

Introduction

Rational analysis of the concept of business structure requires the examination of its component parts: capital, work, activities with clients and other stakeholders. Classically, this analysis seeks to understand how these components oppose each other, form a hierarchy, and combine in action.

Today, the “agency theory” is most often used to describe how the business functions. Within this theory, business activity results from the sum of oppositions between the “principal” (sponsor) and the “agent” (officer or subordinate). This whole theory relies on the principle of opposition of interests between two stakeholders, namely: the stakeholder seeking to maximise his profits and the employees who seek to maximise their income at the expense of shareholders’ profits.

Uniformly applied without distinction to the type of business, this analysis does not take into account the specific characteristics of co-operatives. With the “double aspect” of co-operatives – of employees also being providers of funding in employee co-operatives or consumers being financiers in the case of consumer co-operatives – the situation fundamentally changes. Co-operative operators have learned to bring together the “schizophrenia” of the co-operative structure and these apparent contradictions among the business components and instead put them at the service of the co-operative project. This leads us to recommend that the Alliance invite, through its research committee, all researchers to broaden and diversify their descriptive models of enterprise in light of the co-operative model.

Before proceeding further, we must remember that, for us, a co-operative organisation is “a company comprising several people voluntarily brought together with a view to satisfying economic or social needs through their shared efforts and the implementation of the necessary means”¹.

1. Critical analysis of certain premises of financial capitalism

Reflecting on the place of capital in co-operative activity requires us to be aware of the vast footprint of ready-made capitalism theory, which is supposedly based on the neutrality of management science. We should not fail to examine these premises.

1.1 IS IT TRUE THAT COMPANIES CANNOT EXIST WITHOUT CAPITAL?

Domination of the agency theory leads us to assume that a company would not be able to exist without an initial capital input. Analysing history, however, demonstrates that the evidence for this premise is far from incontrovertible. Throughout the 19th century and until

¹ This legal definition of a co-operative is retained as the transposition of the international Co-operative Principles in a new version (dated 31 July 2014) of Article 1 of the French law of 1947 on co-operatives.

the turning point in the First World War, public limited companies were regarded with suspicion. A general partnership, guaranteed by the indefinite commitment of its members, was considered to be more reliable by third party creditors. It suffices to observe the fact that bankers now tend to require guarantees on their personal wealth from directors of capital companies to secure their loans.

In the 19th century, when the accumulation of wealth was much less than today, a company's strength particularly lay in the creators' commitment to supply the industry (in work or expertise). This is why a limited partnership – as a way of combining industrial supply, sponsorship, and financing from the sponsor – constitutes the creation of business in the form of an incorporated company.

These different ways of understanding the creation of businesses have also entered the world of German financial co-operatives from the 19th century: it is the difference in approach between Frédéric-Guillaume Raiffeisen and Hermann Schulze-Delitzsch.

The first, a creator of the eponymous rural credit co-operatives, had a key insight that the weakness in the assets of the farmers who launched the co-operative could be compensated by the unlimited commitment of each of the members to cover, if necessary, the commitment of their co-operative. On the other hand, members accepted that the co-operative would keep all of its profits, thus allowing capital to be accumulated over time. In order to avoid members' risk of bankruptcy in the event of a funding appeal, the system was strengthened thanks to federative mechanisms between co-operatives. In the insurance sector, this member guarantee mechanism translates into a call for contributions with members paying a supplementary contribution in the event of a loss at the end of the financial year.

The second was the creator of the “vorschussvereine”. These co-operative banks were made up of small retailers and artisans with more property than farmers. They applied for an initial down payment in the form of an establishment fund. From this perspective, the differences in terminology convey the differences in co-operative vision from that of the capitalist sector. Since the contributions made by members could not be speculative, members could not access capital gains in the event of withdrawal from the co-operative.

It is very interesting to recall the strong opposition at that time between these two eminent co-operative pioneers. This historical experience demonstrates that different types of co-operatives – those formed with initial capital and those formed without – have experienced successes as well as difficulties. This leads us to wonder what the founding energy of the co-operatives is. Is it the initial provision of funds from the creators, or their desire to work together – even without any initial fund contribution – by making a commitment through energy and a sense of responsibility? History helps us understand that the “capital” of a business, co-operative or otherwise, cannot be limited to the subscription of shares.

1.2 THE BIASES AND INADEQUACIES OF ACCOUNTING SCIENCE

Too often in recent times, the concept of capital has been reduced to the accounting definition of share capital. Accepting this kind of reductionism in our vision weakens thoughtful reflection. Capital is a concept emerging from several areas of analysis:² economics, finance, accounting, management, sociology, philosophy. It is important to note the role played by rich and philanthropic investors during the 19th century, which was the glorious era for the emergence of co-operatives. One simply needs to glance at the portrait galleries of the major co-operators to realise the prominent role played by socially established

“This leads us to wonder what the founding energy of the co-operatives is. Is it the initial provision of funds from the creators, or their desire to work together – even without any initial fund contribution – by making a commitment through energy and a sense of responsibility?”

² <https://fr.wikipedia.org/wiki/Capital>

“It is essential that the co-operative movement does not allow itself to be confined to a strictly accounting-focussed definition of capital, which is also strongly biased by questionable premises.”

and wealthy persons who also cared about human progress and other forms of knowledge and not simply about their financial capital.

The variety of analyses demonstrates the richness of the concept of “capital” and reinforces the argument that it is essential that the co-operative movement does not allow itself to be confined to a strictly accounting-focussed definition of capital,³ which is also strongly biased by questionable premises. Like Galileo, who was condemned by the Inquisition for having supported the principle of heliocentrism having said “e pure se muove”⁴, we cannot accept the judgement of contemporary inquisitors in limiting co-operatives to an accounting definition that is unsuited to co-operative capital. We hope that the co-operative movement will encourage its managers and researchers to work on the concepts of immaterial capital, cultural capital, and natural capital, which are all areas in which the potential and vitality of co-operatives can be demonstrated. Co-operatives must also find a way, through effective communication, to highlight their ability to enhance other types of capital, not just the accountancy concept of capital.

Two analytical biases illustrate the limits of accounting science regarding co-operative capital.

Firstly, the qualification of the equity nature of co-operative shares by some accountants who classify co-operative shares as debt on the grounds that they are redeemable by the company when the member leaves. This analysis is biased on several levels. First of all, it forgets the fact that the value of shares may be reduced to absorb potential losses on the part of the co-operative. This is radically different from the situation of traditional bond or debt that receives fixed income and is mostly indifferent to business results. In addition, it would be deluded to suppose for a capital company that its capital is constantly fixed. Recent times have demonstrated to us how frequently shareholder-owned, capital intensive businesses have used the redemption of their shares or the distribution of reserves to boost their share prices on the stock market. It can be deduced from this that the legal aspect of redeemability is not enough to constitute a sufficient basis for the accountants’ qualification of co-operative shares.

Moreover, it is equally important to highlight the bias of the Basel Committee – the authority responsible for co-ordinating national bank regulators – in its definition of equity capital. Following the global financial crisis in 2008, the G20 mandated the Committee to strengthen the financial solvency of the banks, particularly as regards core equity (Tier 1 equity). To do so, the Basel Committee published a document in December 2010,⁵ intended to standardise the definition of banking capital among national authorities. It is important to analyse the wording of paragraph 52 of this document to see how this example has not included the specific nature of co-operative banking into its analysis. First of all we must note,⁶ a footnote on page 12 of the document,⁷ which indicates that the criteria used by the capitalist banks apply to co-operative and mutualist structures. Then, an analysis of the 14 criteria used for the definition of capital indicates that two criteria may

3 It is important at this point to note the recent contribution of the study by Christopher Nobes: “Accounting for capital: the evolution of an idea”, in *accounting and business research*, 45, p. 413–4441 which shows through international comparative analysis that capital is far from being a universal feature of accounting.

4 This means, “and even as it moves”.

5 A global regulatory framework for resilient banks and banking systems: <http://www.bis.org/publ/bcbs189.pdf>

6 We wish to stress here that the quoted argument of neutrality is considered by the regulators as more important than the duty to pay respect to the legal differences. In short, it is a kind of “one size fits all” view.

7 The criteria also apply to non joint stock companies such as mutuals, co-operatives, or savings institutions taking into account their specific constitution and legal structure. The application of the criteria should preserve the quality of the instruments by requiring that they are deemed fully equivalent to common shares in terms of their capital quality as regards loss absorption and do not possess features that could cause the condition of the bank to be weakened as a concern during periods of market stress.



Indonesian farmers explore New Zealand systems at Massey University as part of the Fonterra Dairy Scholarship (Indonesia) Programme. Photo: Massey University.

create difficulties for co-operative banks. First of all, criterion number 3,⁸ which dictates that the titles are perpetual and non-reimbursable except in the case of the company liquidation. This brings us back to the aforementioned point regarding the redemption of shares. Secondly and most importantly, criterion number 5,⁹ which reveals the lack of comprehension regarding the co-operative model – it is written that capital remuneration cannot be contractually limited. This premise is in direct contradiction with the non-speculatory character and the provisions for limitation on the remuneration of co-operative shares. It supports the questionable premise that all capital investment is for the personal enrichment of the shareholder. This approach forgets the fact that, in the co-operative sector, based on the membership's twin aspect of investors and clients, one can choose to be a capital subscriber mainly to obtain goods or services at a fair price in return for the investment and not to receive dividends or capital gain.

8 3. Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).

9 5. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a bank is unable to pay distributions that exceed the level of distributable items).

1.3 HOW DO WE DEMONSTRATE THAT SHAREHOLDERS ARE NOT THE EXCLUSIVE OWNERS OF THE BUSINESS?¹⁰

The extension of the agency theory has led to the dissemination of the concept of share value as a key criterion of judgement in corporate governance.

Nowadays, we are not surprised to hear that shareholders primarily concerned with the return on their investment in a company can compel a company to make decisions that are contrary to the interests of employees or other stakeholders. This is the result of the strict application of the principle of shareholder value.

On this basis, the business should only be judged on the immediate or future financial effects generated in favour of the owners: the shareholders. From this perspective, the owners should not worry about the impact of their strategy creating negative externalities (for example, pollution generated by business activity).

Realising the negative effects generated by this short-term vision and increasingly conscious of the damage caused by the financial crisis of 2008, some people are calling for the restructuring of capitalism by rejecting the supremacy of the share value concept. That is why the G20 in Washington – at a time when the leaders of the world's key countries wanted to turn the page on unrestrained and dangerous financial capitalism – called for better regulation, as well as greater corporate social responsibility.

This rediscovery of the virtues of temperance and balance may also bode well for the rediscovery of the virtues of the co-operative model.

“The membership's double nature of a provider of finance and co-operative user leads us to find a point of balance that avoids (self-) exploitation.”

First of all, the membership's double nature of a provider of finance and co-operative user leads us to find a point of balance that avoids (self-)exploitation. This is why it is worth employing caution when considering the approach of disassociating the elements of the double quality within co-operatives. If, however, it is considered useful and necessary by the general meeting of members, such a disassociation should only be implemented together with mechanisms that guarantee that the interests of co-operative members are respected in relation to the investors.

In addition, the co-operative mechanism for democratic decision making – “one member, one vote” – allows us to avoid the majority abuse that the capitalist model can sometimes lead to, which is “one share one voice”.

Finally, respecting the 7th Co-operative Principle “Concern for Community” is also a way of avoiding selfishness so as allow the co-operative to develop harmoniously.

2. Usefulness of capital provided that it remains a tool at the service of the co-operative

Even as we remember that the co-operative sector was able to build successful and sustainable businesses without any initial capital outlay on the part of the co-operative members, we are not refuting the useful role of capital for the co-operatives insofar as it is examined in the light of the Co-operative Principles as interpreted by the International Co-operative Alliance.

¹⁰ In this context, it is interesting to note that even the Executive Director and Chief Economist of the Bank of England believes that this assumption has to be reviewed. Conclusion of his speech at Edinburgh University on 22 May 2015: http://www.bis.org/review/r150811a.pdf?utm_source=BIS+-+All+categories+-+daily&utm_campaign=e99d1f60ea-RSS_EMAIL_CAMPAIGN_RSS_ALL_CATEGORIES&utm_medium=email&utm_term=0_9691579743-e99d1f60ea-93527521

2.1 WHO AND WHAT IS BUSINESS CAPITAL USED FOR?

Capital allows a business to enjoy longevity. This quality leads us to think more deeply about its usefulness to co-operatives.

It is important to note that share capital does not have the same function across all countries because of legal or sociological traditions that take different approaches to the various business stakeholders. We have already covered the point about the mistrust that has long prevailed against stock companies and the preference for partnership companies where the guarantees and commitments of the associates underlying their assets are more clearly identifiable.

This is the basis of the continental European approach – that the share capital of a business is the substitute for the personal guarantee of the associates and the final guarantee for third-party creditors (be they employees, suppliers, or financial backers). This is why, in the continental European tradition, the standard-setters have imposed accounting rules such as the principle of prudence, historical cost accounting (to avoid passing on to the financial backers the negative effects of currency volatility and market values), as well as the obligation to account for depreciation in such a way that the productive value of the working tools can be preserved through their reconstitution.

The Anglo-American approach is different. In this case, accounting must reflect the fair value of the investment made by the shareholder. It is important to give the shareholder the ability to be able to dispose of his investment by selling it at any time. This results in a perspective that is often relatively short-term, lasting only for the duration of the current financial year, and which uses market value as the sole basis on the premise that the market is supposed to have incorporated every piece of information that is useful to a rational investor. It was indeed the deregulation of this system that led to the financial crisis in 2008. This is why the leaders of the G20 invited the International Accounting Standards Board (IASB) managers to develop their conceptual framework to avoid a short-term view, which had been a source of volatility when used widely to evaluate companies. Reading the final publications of the IASB, however, leads us to conclude that its conceptual framework has not really changed and that its original biases still stand.

These differences in approach also often translate into business liquidation procedures that are very different from one country to another, particularly with regard to the compensation of creditors.¹¹

For example, the principle of prudence leads us to discard non-tangible items in accounting valuation. These include intangible assets that are difficult to evaluate because they are interrelated with their creation and use by the company, such as human capital, in-house expertise, or consumer brand loyalty.

Generally speaking, this leads us to note that the value of a business should not be reduced to its accounting image. We must note the discrepancy between the “real” accounting figures and the value of the transactions related to the business. This demonstrates that simply reading the accounts, by far, will not give us the right picture of the true wealth of a company.

It is the same, *mutatis mutandis*, for co-operatives. This is why the international co-operative movement is interested in actively working on matters such as the review or creation of

¹¹ To illustrate this, when Europe sought to standardise the liquidation procedure for insurance companies by way of a directive, it recognised two different procedures: those of continental Europe and those of the United Kingdom. The first legally guaranteed the interests of policyholders better than the second.

complementary reports in addition to stand-alone accounting data, for example, a social and environmental responsibility report.

2.2 CO-OPERATIVE CAPITAL, A TOOL OF TRANSGENERATIONAL DEVELOPMENT

“Capital is worthwhile for co-operatives because it allows them to execute their mission under the control of members of the co-operative.”

Capital finances the sustainable acquisition of goods required for business development while guaranteeing the firm autonomy in relation to third parties such as suppliers or bankers. Capital is worthwhile for co-operatives because it allows them to execute their mission under the control of members of the co-operative.

This is why the authors and commentators of the Alliance's Co-operative Principles have always been cautious about turning to outside sources of capital beyond the co-operative membership. The introduction of outside sources of capital constitutes a breach in the balance of the double quality of the co-operative. This double quality strengthens the co-operative through the necessary convergence of interests, because it is difficult to imagine that co-operative members would intend to exploit themselves. However, for practical reasons, co-operatives have never banned external sources of capital as long as this capital remains under the control of the members and does not contradict their interests.

From experience, unfortunately in several instances, we have demonstrated that the excessive use of external capital can be a prelude to demutualisation. In such cases, the interests of the members of the co-operative will be damaged. These damaging precedents must remain in our memories and serve as a guardrail.

Co-operatives have a considerable ability to gradually build capital, through the accumulation of profit in the form of indivisible reserves. This is the result of accepting a ceiling on the remuneration of shares coupled with the refusal to allow individual appropriation of capital gains. Residual assets are not distributed to members redeeming shares; upon liquidation, they are also usually not distributed to the latest co-operative members but are transferred to another co-operative. In certain countries, legislation further mandates individual responsibility on the part of the co-operative members through measures that require them to use their personal wealth to cover the co-operative's losses. These measures convey the principles of solidarity, including financial solidarity, which are substantial with the co-operative approach.

All of these co-operative measures have one virtue: they limit the phenomenon of the “free rider” passenger¹², which is a well-known subject of economic analysis. From this perspective, the co-operative approach is more virtuous, not only from a moral standpoint but also in that it guarantees the functioning of the market.

“Indivisible reserves are a superb tool to transfer co-operative capital between generations, and this, in principle, improves the sustainability of the co-operative form of business.”

Finally and above all, indivisible reserves are a superb tool to transfer co-operative capital between generations, and this, in principle, improves the sustainability of the co-operative form of business. From this perspective, we must note that we are the beneficiaries of the reserves established by previous generations of co-operative members, and we have a duty to make them flourish for future generations.

Other approaches, already recognised in some countries, must be investigated at the international level:

1. Inter-cooperation between co-operatives, either by creating shared tools that deliver capital savings (shared resources), mutual contributions of financial means, or common tools¹³ for financial capacity building.

¹² This refers to a person or body that obtains and profits from an advantage to the detriment of other business partners.

¹³ In this area the Italian experience of co-operative development funds financed by sharing part of the co-operatives' annual surplus is very inspiring.

2. Growth in the number of investors with patient capital, or capital with a social or philanthropic purpose. This could be a way of renewing ties among all stakeholders within a company.

Conclusion

Beyond its own self-reflection, the international co-operative movement must – in its on-going reflection on the future of humanity – contribute a vision of the future for subsequent generations.

Consequently, with our vision made possible by the fertility and innovativeness of the human mind, we must facilitate more human and more economically efficient business and economic development in all its forms: using financial capital, human capital, and natural capital. From this perspective, it is important to consider how co-operatives can better manage common goods.

Having started this paper with the title of a piece by Rabelais,¹⁴ I would like to finish by applying an expression to the co-operative movement from another great humanist of the Renaissance: Jean Bodin – the affirmation that the wealth of the co-operatives resides in the men and women who work to bring them to life.¹⁵

“The wealth of the co-operatives resides in the men and women who work to bring them to life.”

14 Highly critical of the Sorbonne education of his time, Rabelais stated with regard to the education of the Gargantua: “Science without conscience is but the ruin of the soul”.

15 In his work entitled the Six Books of the Commonwealth, Jean Bodin wrote: “But one should never be afraid of having too many subjects or too many citizens, for the strength of the commonwealth consists in men. Moreover the greater the multitude of citizens, the greater check there is on factious seditions. For there will be many in an intermediate position between the rich and the poor, the good and the bad, the wise and the foolish. There is nothing more dangerous to the commonwealth than that its subjects should be divided into two factions, with none to mediate between them. This is the normal situation in a small commonwealth of few citizens.”

6

New capital instruments for
financial mutuals:

Ideas for co-operatives
from the UK experience

PETER HUNT

6. New capital instruments for financial mutuals: Ideas for co-operatives from the UK experience

PETER HUNT

Introduction

In March 2015, the UK Parliament approved landmark legislation for friendly societies and mutual insurers to permit them to issue “Mutual Deferred Shares” for the first time.

These financial services mutuals conduct insurance and savings business in the interest of their members, but they currently have no share capital.

The Mutuals’ Deferred Shares Act 2015 deals with the challenge of how to raise additional external capital in a co-operatively owned business whilst maintaining its core mutual purpose of providing the best service and quality for the member owners.

Mutuo¹ is currently working with HM Treasury and Regulators to help draft the regulations that will govern the first share issuance (expected in 2016).

This chapter explains the thinking behind the creation of these new shares and how they have been designed to sit comfortably within a co-operative ownership structure.

The need for new capital instruments

British friendly societies and mutual insurers can trace their origins back to the 1700s. Through savings and insurance products, they have provided collective security for large numbers of working people to protect against life events such as sickness, unemployment, and death.

These firms were established on a pure co-operative basis as they focus entirely on the provision of best value services to their members and customers. Legislation² was originally introduced to register them as “friendly societies”. In later years, some registered as “companies limited by guarantee,” i.e., with no share capital.

With the introduction of government welfare programmes, these businesses adapted to provide insurance and savings to mass markets. Today, their products are often cheaper, consistently offer wider benefits and better service, and pay higher returns than their stock market listed competitors.³

Between them, these types of mutual insurers⁴ today manage the savings, pensions, protection, and healthcare needs of over 30 million people in the UK collecting annual premium income of £15.9 billion and employing nearly 38,000 employees.

Friendly societies and mutual insurers do not have share capital in the way that listed firms and many co-operatives do. Instead, the capital accumulated in these firms has been built up over many years from retained earnings and is collectively owned by customer members.

1 Mutuo works to grow and strengthen the co-operative and mutual sector in the UK by: communicating their priorities to decision makers, acting as an advocate with politicians and regulators, building links between mutual business leaders, and developing new mutual businesses.

2 Friendly Societies Act 1875

3 Association of Financial Mutuals <http://www.financialmutuals.org/files/files/key%20facts%20040615.pdf>

4 For the reader’s benefit, the term mutual insurer is used to mean friendly societies and mutual insurers.

Between the late 1980s and 2000, this sector was particularly affected by demutualisation and consolidation with many life firms merging and others seeking stock market listings. In many cases, the lack of access to additional capital was used as a prime reason for a mutual insurer to demutualise.

The need for mutual insurers to raise more capital is likely to increase in the future as Solvency II⁵ places additional demands on friendly societies and mutual insurers.

These factors exert strong negative pressures on these mutually owned firms; the slow growth of capital through retained earnings is a disadvantage in this environment contrasting with publicly listed firms, which have separate shareholder capital and therefore more options to raise new funds.

My contention in this chapter is that it is vital we allow friendly societies and mutual insurers to access new forms of capital that support their long-term business purpose.

This type of innovation addresses a number of important challenges facing these firms:

1. THEY MUST BE ABLE TO PLAY A FULL PART IN AN ECONOMY WITH DIVERSE CORPORATE OWNERSHIP

Friendly societies and mutual insurers do not have the ability to raise capital that public listed companies and some co-operatives and building societies do thus placing them at a disadvantage.

This both reduces competitive pressure from the operation of different business models in the same market and adds greater systemic risk to the financial services sector of the economy.

2. WITHOUT NEW CAPITAL MANY MUTUALS COULD BE DRIVEN INTO INAPPROPRIATE CORPORATE FORMS THROUGH DEMUTUALISATION

Mutual insurers in 1994 accounted for 50% of the UK insurance market; today it is closer to 7%. The key factor in this change has been demutualisation with lack of access to capital used as the key justification for this corporate change. The process of demutualisation has destroyed competition and member value in these businesses.⁶

Demutualisation means that consumers would no longer have non-listed, member-owned options in the financial services marketplace.

3. A LACK OF CAPITAL LIMITS MUTUALS' GROWTH AND THE ABILITY TO DEVELOP NEW PRODUCTS

Access to capital permits businesses to consider innovations into new business areas. The restricted nature of mutual ownership means that often the funds are not available for this type of development, so new products and services are more slowly developed in mutuals than in their listed competitors.

As a result, new products that require investment of working capital in order to develop are more difficult to fund in a mutual, which further limits their ability to offer consumers choice and competition in the market place.

⁵ Solvency II is a European Union (EU) legislative programme to be implemented in all Member States of the EU. It introduces a new, harmonized, EU-wide insurance regulatory regime with minimum capital requirements for insurance businesses.

⁶ See All Party Parliamentary Group for Mutuals <http://www.mutuo.co.uk/wp-content/uploads/2013/03/windfallsorshortfalls.pdf>

4. THE NEED FOR AN ALTERNATIVE TO RAISING DEBT

Large mutual insurers have successfully raised funds via bond issues in 2013 and 2014. These were significantly oversubscribed indicating that there is substantial institutional interest in investing in the sector.

However, debt is of lower quality than member funds for firms wishing to build their capital base. There is inevitably a limit on the amount of debt that can, or should, be raised.

5. FIRMS MUST BE ABLE TO MORE EASILY CONSIDER TACTICAL ACQUISITIONS

Mutuals often lack the capital to take advantage of immediate, tactical acquisitions. By helping to facilitate the growth of the business and integrate supply chains through acquisition, new capital can help mutuals to compete with proprietary counterparts.

6. MEMBERS' CONTRIBUTIONS TO CAPITAL CAN BUILD STABLE MUTUALS

There are a number of examples globally where members contribute to the capital base of co-operatives in the financial services industry. Examples from Canada and The Netherlands and across the European Union show how mutuals can enlist their members in raising capital through the issuance of co-operative shares.

This investment relationship with members builds stronger mutual ties between members and institutions.

Mutuals Deferred Shares: A new capital instrument in the UK

For friendly societies and mutual insurers, the concept of introducing share capital is a radical and potentially controversial change. Having existed, in many cases for centuries, on the basis of collective funds, the regulatory focus on capital quality (liquidity and loss absorbency) has created new challenges for these firms.

We should distinguish at the outset between the need for a strong capital base to underpin the conduct of insurance and savings business, on one hand, and access to working capital for the development of the firm on the other. Our focus has been on the latter, where mutuals are most at a disadvantage to their competitors. Their main capital base is generally strong⁷ and more than adequate for their day-to-day business reflecting their prudent attitude to business planning.

However, the way that their capital is organised (often in single funds) and how it is raised (through retained earnings) presents particular challenges to their ability to operate as flexibly as their listed competitors.

The compatibility of investor capital with the Co-operative Principles

Investment from participating members is commonplace in many co-operatives. It is less typical to see external investors whose main interest is in a financial return from their capital. For co-operative purists, any introduction of external capital is potentially problematic

⁷ See www.financialmutuals.org

INFORMATION BOX: MUTUALS' DEFERRED SHARES ACT 2015

The Mutuals' Deferred Shares Act received Royal Assent in March 2015. It is a short piece of legislation that created a legal framework for friendly societies and mutual insurers to issue new deferred shares, and empowered the Treasury to make regulations to govern a regime for these new shares.

THE ACT HAS JUST FOUR CLAUSES:

Clause 1 gives the power to The Secretary of State to permit the use of deferred shares in friendly societies and mutual insurers.

Such shares can be transferred but not withdrawn, but the Act prohibits repayment of principal other than on the solvent winding up or dissolution of the issuer or where the appropriate regulator has consented to the repayment.

This removes any risk of “carpet bagging” by those solely interested in demutualisation. Furthermore, no shares will be issued until the current members have approved it.

Clause 2 restricts the voting rights of holders of a deferred share as a further safeguard against the motivations for demutualisation.

Clause 3 sets out the proper legal definitions for the various types of mutuals affected by this legislation.

Clause 4 is the usual Short title, commencement, and extent.

PREPARING THE BILL

The policy idea for the Bill came from Mutuo, which had examined the way in which some co-operatives raised capital from their members and considered how this could be adapted to mutual insurers that had no such share capital in existence.

The process by which the Bill became law required over two years' of patient work. The barriers encountered along the way were not due to hostility to reform but rather because of misunderstandings about the nature, purpose, and scope of mutual and co-operative capital.

A critical element to the success of the Bill was the attitude of the authorities. It was essential to bring policy makers and regulators along on a journey to understand the different ways that financial services co-operatives may raise capital in different countries, as well as to pose new questions in a UK context about how to grow capital whilst continuing to protect the Co-operative Principles.

Regulatory approval was critical. Shares issued under the Bill also needed to qualify for solvency purposes. Given that we were seeking to create perpetual shares in these mutuals, the logic followed that they should be treated in the same way as ordinary shares in a company – for accounting purposes. For the future, this new capital would be part of the firms' highest quality assets and help towards creating a level playing field with listed competitors.

The Prudential Regulatory Authority (PRA) took the lead, as it was the critical decision maker over the qualification of shares for solvency purposes and the supervision of firms that intend to issue them. Only once the PRA was satisfied that the shares could qualify as restricted tier one capital was HM Treasury able to support the Bill.

as it introduces new stakeholders with different motives to the existing membership of the business.

It is easy to see how the interests of investors – which we can expect to want to maximise the return on their investment – can potentially skew the longer-term purpose of a co-operative organisation serving its members. This can happen if investors receive a greater

“Care must be taken to ensure that the core purpose of the co-operative is not “dominated” by the need to pay dividends to shareholders, or worse, provide a back door to demutualisation.”

say than the individual members or a larger share of the operating profits. It is sometimes argued that this risk makes investor capital fundamentally incompatible with co-operative philosophy and business models. But this does not need to be so.

The second and third Co-operative Principles: “Democratic Member Control” and “Member Economic Participation” are the guide here.⁸ Care must be taken to ensure that the core purpose of the co-operative is not “dominated” by the need to pay dividends to shareholders, or worse, provide a back door to demutualisation.

In producing this new share, we have ensured that these Principles are respected. The features of the mutuals’ deferred shares govern the relationship between investors and the co-operative, and we believe that investor capital may be welcomed if these Principles are respected in any measure enacted.

INFORMATION BOX: KEY FEATURES OF THE NEW MUTUAL DEFERRED SHARES

- New deferred shares are permanent
- They confer membership on the holders
- They could be owned by individuals or institutions
- Yet no member would have more than one vote as a result of holding the shares
- Investing members that did not trade with the business would be excluded from any member votes related to mergers or dissolution
- Members will vote on the compensation level paid to investors

Does this challenge the existing Co-operative Principles? The fact that member investment is common in many co-operatives suggests that there should be room for innovation in this area.

For example, co-operative banks in Germany (*Volksbanken*) raise capital from member investments. Desjardins Group in Canada, one of the most successful credit union groups in the world, routinely offers co-operative shares to its members.

I would argue that the key point is that we must apply the Principles in a way that ensures we do not unduly constrain a modern mutual business. We can respect the Principles whilst making sure that our businesses have the flexibility to compete in a fast changing environment.

In the UK, and certainly elsewhere too, there is great opportunity to grow the co-operative and mutual sector. Yet this may be on the basis of new models of co-operation with hybrid capital structures rather than “pure” co-operatives, with only trading member capital.

A thornier issue is the validity of membership being conferred when the only engagement with the co-operative is as an investor, and particularly when that investor is an institution, and therefore, unlikely to participate as a consumer member.

The key definition of a co-operative, or any business for that matter, is related to the purpose of the organisation. For whom does it exist and whom does it serve? Clearly, any co-operative business that exists to serve capital investors is no co-operative at all. A purist view would both exclude new structural innovations and inhibit the co-operative’s capacity to grow and compete. Yet there is a way for external capital to co-exist with existing co-operative stakeholders.

“Clearly, any co-operative business that exists to serve capital investors is no co-operative at all. A purist view would both exclude new structural innovations and inhibit the co-operative’s capacity to grow and compete. Yet there is a way for external capital to co-exist with existing co-operative stakeholders.”

8 www.ica.coop



Board members of Co-operative Business New Zealand in discussion.
Photo: CBNZ.

We can look at a number of examples of co-operatives sharing ownership for part of their business with investors, such as *Crédit Agricole*⁹ where part of the business is listed on the stock market. Clearly, the introduction of deferred shares in mutuals is less radical than that alternative.

A co-operative must also conform to the second Principle of Democratic Member Control. In this context, control, to me, infers an ultimate say. It is about creating a structure that maintains proper control for members and preserves the co-operative purpose of the business. It suggests a member ownership “lock”, rather than some kind of purity where there may only be one type of member stakeholder. This is what we have tried to achieve with this legislation and the rights associated with the mutuals’ deferred shares.

So different stakeholder types may coexist in a co-operative so long as the principal members – for whom the original business purpose was designed – retain ultimate control.

In practice, this is the day-to-day reality in most co-operative businesses, where corporate debt finance means that banks and bond holders will be important stakeholders each capable of influencing the business in order to protect their interests.¹⁰ In such cases, new levels of sophistication are developed by co-operative businesses in order to manage any potential conflicts while remaining true to the purpose of the business.

In the UK, Mutuo believes that a permanent majority control of 50.1%+ is necessary to ensure that the second Principle is met. Permanence is a key part of this with measures required to ensure that the minimum threshold of control is always met.

“The second Principle of Democratic Member Control. Infers an ultimate say. It is about creating a structure that maintains proper control for members and preserves the co-operative purpose of the business. It suggests a member ownership “lock”, rather than some kind of purity where there may only be one type of member stakeholder.”

9 <http://www.theguardian.com/social-enterprise-network/2014/mar/18/can-coops-compete-capital-investors>
10 <http://www.co-operativebank.co.uk/aboutus/governance>

Co-operatives can develop rules to ensure that this is the case in perpetuity, for example requiring new members to sign charitable assignments in the case of a demutualisation (thus removing the motive to join in order to cash out), but there is no substitute for legislation that locks in member ownership.

So far, such legislation does not exist in the UK, and Mutuo is looking at adapting the concept of “disinterested distribution”¹¹ that is common in EU states.

Meeting the challenge of raising capital in financial services co-operatives

“Co-operatives do not operate to separate regulatory rules, despite the many distinguishing features that temper their behaviours. This means that co-operatives will come under the same capital pressures yet with fewer opportunities to access new capital. In a stress environment this can place co-operatives at a distinct disadvantage to their proprietary competitors. The founders of these mutually owned firms did not envisage this situation. It is a product of a changing business environment, and so co-operatives need to find ways to adapt.”

The justification for taking the step of permitting investor membership therefore requires one to take a pragmatic view of co-operative ownership that recognises the challenges faced by businesses that have used a corporate model that is largely unchanged for over 100 years.

Financial services co-operatives operate in regional and global markets that are highly regulated. Their competitors are often complex, multi-layered businesses. This means that the manner in which financial services businesses are regulated overall will reflect the need to control behaviours in all types of firms.

Co-operatives do not operate to separate regulatory rules, despite the many distinguishing features that temper their behaviours. This means that co-operatives will come under the same capital pressures as all other financial services businesses – with minimum solvency levels and capital requirements in common with the industry yet with fewer opportunities to access new capital. In a stress environment this can place co-operatives at a distinct disadvantage to their proprietary competitors.

The founders of these mutually owned firms did not envisage this situation. It is a product of a changing business environment, and so co-operatives need to find ways to adapt.

We can see that the lack of access to investor capital makes it very difficult for new co-operative or mutual financial services businesses to be established. It is likely that none but the smallest of niche operators will be able to enter these markets as long as this is the case.

Many co-operative banks have member capital which complements retained earnings so that they are less affected by expectations of greater capital requirements. However, co-operatively owned insurers do not have such member shares and so have less flexibility in raising capital whilst maintaining their co-operative status.

Their response has to be pragmatic and recognise the new challenges that they face. In responding to this, friendly societies and mutual insurers are considering how to re-cast the role of their members as investors and providers of capital.

In this chapter, I hope I have managed to explain how we have sought to resolve this “capital conundrum” in the UK for one part of our mutual sector. I have simultaneously attempted to demonstrate how we have benefitted from an active, engaged, and collaborative relationship with government and regulators. I hope our example of close engagement will provide a useful example to those attempting similar reforms in other countries.

¹¹ For a description, see Ownership Commission www.mutuo.co.uk

7

Co-operative Principles and the Capital Needs of the African Co-operative Sector

GEORGE OMBADO

7. Co-operative Principles and the Capital Needs of the African Co-operative Sector

GEORGE OMBADO

Introduction

The financial sector is an integral part of any economy given the sector's ability to facilitate income generation and production of goods and services. At the same time, the co-operative organization has emerged as a distinct contributor to a nation's economic development. By seeking to increase their membership level across all levels of society, co-operatives hope to enable a broad spectrum of members to derive economic empowerment from their co-operative organizations. Financial co-operatives in developing countries, therefore, potentially have a special role to play in national socio-economic development by uplifting lives through the provision of services in a way that meets the needs of the vast majority of population.

To do this, a financial co-operative must address its capitalization challenges. Achieving financial strength and sustainability requires a co-operative to enhance access to capital, while the Co-operative Principles require that it meet its members' needs and ensure member control by members and preserve its autonomy and independence. This chapter discusses the financing and capitalization needs of African co-operatives, especially financial institutions, and how this interacts with the Co-operative Principles.

Co-operatives and Africa's socio-economic development

The World Bank is forecasting that Africa's GDP growth in 2015-2016 will remain steady at 5.6% making it one of the world's fastest growing economic regions. This performance can be attributed to many factors including an improved business environment, diversification of trade, and, in sub-Saharan Africa, the democratization and improved management of discovered natural resources.

From the perspective of national socio-economic development, the co-operative business model stands out given its multidisciplinary nature. In Africa, the co-operative sector has the potential to be one of the most important sectors, because it is able to support almost all spheres of the economy. Its capacity to support both large-scale and small-scale trading enterprises is enormous. However, the co-operative sector is yet to be acknowledged in the national, economic, development agenda of most countries – possibly with the exception of Kenya and Ghana, which have made significant progress with the adoption of the co-operative model in their economic reforms. The majority of markets in Africa are in a grim situation with enterprises that are supposedly meant to promote economic growth in the worst state. Quite a significant number of central governments across Africa are grappling to economically empower the masses. To facilitate meaningful economic growth that would empower people, enable business activities, foster entrepreneurship, and help address shortfalls relative to the United Nations Millennium Development Goals, a greater role for the co-operative sector is required.

Numerous studies have illustrated that developed and sound financial structures can accelerate economic growth especially when they recognize the role played by other

financial intermediaries such as co-operative organizations.¹ Although most of these studies have been conducted in the developed world, the key takeaway that is relevant for Africa is that economic growth relies hugely on the effective mobilization of scarce capital and its effective transformation into productive and sustainable investments. Reflecting on the past decade, while Africa's economy has seen relatively strong growth, the situation remains fragile and vulnerable due to multidimensional factors that negatively affect capital formation. Due to limited capital availability or the makeshift nature of capital structures, we have not been able to make productive and sustainable investments that significantly improve the economic well being of the majority of the population.

Given this, it is important and necessary that African co-operative organizations, particularly financial co-operatives, be well capitalized so that the co-operative sector as a whole can play a larger role in national and regional socio-economic development. This calls for the establishment of a structure to enable capital formation in Africa in a format that draws in available savings in the economy while being consistent with the co-operative business model.

Co-operatives in Africa's existing financial system

Corporate funding in Africa is currently dominated by large multinational or regional commercial banks whose aim is to make as much profit as possible for their shareholders. In the area of personal finance, the majority of the population seeks financial services from commercial banking services rather than from the co-operative sector. Even those who are members of co-operatives seek the services of commercial banks despite their high interest on lending and low interest on saving.

Why is this so? One argument is that commercial banks have operated in a more financially sustainable way, given that they are profit centres focused on shareholder return. The comparatively elevated level of debt in a bank's capital structure disciplines managers' risk-taking, forcing them to ensure that they provide profitable financial services after undertaking due diligence.

In some African financial co-operatives, however, the emphasis on meeting members' needs has sometimes been misinterpreted by managers to mean lending without regard to credit risks.

A number of co-operative organizations have even borrowed money from commercial banks at higher interest rates for onward lending to members at lower rates. This is worrisome, because while the organization is meeting members' financial needs in the short term, it has put its very financial viability into question. This concern can apply to all forms of co-operative organizations, and part of the problem has to do with the false perception that co-operatives are merely social welfare organizations that serve the poor.

While it is true that co-operatives can contribute towards poverty alleviation, they are first and foremost aimed at empowering members, not giving out charity.

Beyond management issues, a key disadvantage faced by financial co-operatives vis-à-vis commercial banks is their relatively weak capital and financial position. Currently in most African countries, the financial demands of current and potential members of co-operative banking institutions exceed the available supply of funds. This inhibits co-operative organizations' ability to meet their members' financial needs.

“In some African financial co-operatives, however, the emphasis on meeting members' needs has sometimes been misinterpreted by managers to mean lending without regard to credit risks.”

“While it is true that co-operatives can contribute towards poverty alleviation, they are first and foremost aimed at empowering members, not giving out charity.”

¹ As an example, see “Key Drivers for soundness of the Banking Sector: Lessons from Developing Countries” by Vaithilingam, Santha, Nair Mahendhiran, and Samundram Muthi (2006) *Journal of Global Business and Technology*, Vol. 2.



Cacao bean fermentation at Kuapa Kokoo farming co-operative, Ghana.
Photo: Divine Chocolate.

The problem of capital in African financial co-operatives is either due to a lack of sufficient savings among members or the inability to access available funds from potential non-member stakeholders that are deemed to have a different agenda from that of the co-operative – or both. The result is the same: members join co-operatives with the expectation that they will be able to access cheaper financial services, but the credit facility extended is often inadequate or enough to meet only consumption needs and not production needs.

Perhaps this weakness is a result of the sector's inability to meet capital demands through the mobilization of members alone, especially in countries with less robust financial systems and less developed co-operative sectors. This leads us to consider if there is room for other stakeholders who are not necessarily members, but financiers or investors, to be involved in the capitalization of co-operatives. However, questions arise about governance: in particular, can we expect members to be in control of their affairs without influence from non-member financiers?

Capital issues and the Co-operative Principles

Co-operatives have a unique approach, which is guided by the international Co-operative Principles. However, one cannot help but question if some of the Principles would require a little flexibility and contextualization in order to yield meaningful impact.

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For Africa, there is a need for co-operatives to evolve further to shift their primary focus from helping the poor to supporting entrepreneurs in becoming change agents within their economies. While this evolution has already started, the number of people utilizing co-operatives is far below par (based on membership levels).

In some cases, concerns have been raised with regard to the unique attributes of the Co-operative Principles. One should not be shy away from decisively evaluating the impact of the Co-operative Principles on the development and growth of the co-operative sector at large. Below, I discuss Principle 2: Democratic Member Control and Principle 4: Autonomy and Independence of the Alliance's Statement on the Co-operative Identity (which includes the Co-operative Values and Principles) especially as they apply to financial co-operatives.

On Democratic Member Control – This principle is based on the belief that every member within the society is equal. This gives members of a community an opportunity to take control of their own economic path through co-operation. Each member of a financial co-operative, therefore, has one vote irrespective of the amount of resources the individual member places into the co-operative. Members' authority in the co-operative is not pegged to the amount of money saved or deposited. This could deny co-operative organizations much needed capital from investors (including institutions) that, while not members, appreciate the co-operative model sufficiently to invest in them. A strict "one member, one vote" system could thus be subjected to a tough test in an environment where a large population is excluded from accessing the financing system, where social inequality is rampant, where higher savings/deposits naturally command great influence, and where professionalism is not yet fully embraced. Having voting control but being unable to make a meaningful positive impact could also be self-defeating for members. Members need resources to make an impact, and this is what investors bring to the table. Therefore, a more balanced interaction between the members and non-member investors may be needed.

Given that the core objective of the Co-operative Values and Principles are to guide co-operative organizations in meeting members' need, my view is that we should be open to factors that would contribute towards this ultimate goal. In fact, for African financial co-operatives, it can be argued that capital is the most important factor in fulfilling member's economic needs. While caution is required when welcoming non-member investors to inject funds into co-operatives, such capital adds value to our members in empowering them economically – something that we cannot do if we have limited capital. Though one can question the intent of investors, our focus should be the usage of funds and the development of safeguards such that we can tolerate external capital that enables us to boost overall member's returns (while meeting investors' return). In some geographical jurisdictions in Africa, co-operative institutions have established co-operative investment groups sharing the same body of members. In these cases, the investors engage with the co-operative closely.

Besides, co-operative financial institutions, also known as credit unions or savings and credit co-operative organizations (SACCOS), have also grown to supply financial services to other co-operative entities. It is important therefore to appreciate that while co-operatives are not driven solely to seek profit, they should not be restricted from making a surplus to enhance their financial strength and stability for the sake of members and that of the co-operative community.

On Autonomy and Independence – A related question is whether investor capital will adversely affect the autonomy of the co-operative.

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Taking a step back, the concept of “control” in a co-operative model is a complicated matter. This model, which “provides for members’ control”, implies that the members determine the direction that they want the organization to take. Yet there are instances in which members misconstrue the Principle to imply that they should be involved in micro-management of the co-operative. Practice has shown that what co-operative institutions need to succeed is a combination of robust financial capacity and highly skilled human capital to oversee management.

It is the expectation of co-operative members – and rightly so – that their institution will put their interests before the interests of main financial contributors. In my view, however, an overly strict and narrow interpretation of Co-operative Principles would be counterproductive where the involvement of other stakeholders is necessary for the success of co-operative organizations and the achievement of co-operative objectives. In regions with a relatively mature co-operative sector, we find that it is often possible to obtain support from other stakeholders and other stronger co-operative bodies in establishing a capital base. My view is that governance structures should recognize such other key stakeholders that are supporting co-operatives. This does not in any way give them an opportunity to promote their agenda, which is distinct to those of the members, if the co-operative is sufficiently mature.

For African co-operatives, one scenario that needs to be considered in the context of the “Autonomy and Independence” Principle is when the government becomes a potential contributor of capital to the co-operative. In my opinion, government support for co-operatives can be effective when policies geared towards supporting specific communities are already in place, and where these policies are in harmony with the co-operative’s objectives. In Kenya and Ghana, for example, some co-operative organizations have used youth or women enterprise funds established by the government to develop their members, and this ultimately promotes the growth of co-operatives. Interestingly, these funds are targeted only at co-operatives that have met certain thresholds stipulated by the regulatory framework. Such a policy encourages professionalism and growth in co-operatives and serves to improve public confidence in the sector. The same cannot be said of cases in which the government used co-operatives to gain political mileage during an election year. The probability of success as a result of external support from the government diminishes where proper systems are not in place, where the co-operative sector is relatively weak, and where governmental authorities do not understand or appreciate the uniqueness of the co-operative model.

Establishing a successful Africa Co-operative Bank

In the recent past, there has been some discussion about the potential formation of an Africa Co-operative Bank, to provide financial support to entrepreneurs operating in Africa. The idea behind this is to fill existing gaps in the financial system that hinder the growth of entrepreneurial activities.

There have previously been attempts to establish co-operative banks in some African countries namely: Benin, Cameroon, Kenya, Nigeria, Rwanda, South Africa, and Uganda. Among them, only the Co-operative Bank of Kenya has stood the test of time and is able to compete with other multinational banks. Other co-operative banks across the continent either took off on wrong footing or were sold off due to factors such as limited capital to support adequate business operations and a lack of professionalism (and sometimes as a result of government interference).

A robust co-operative bank requires that the country's co-operative strategies constitute an integral part of the financial system and services being provided to the masses. Recognition of the co-operative model in the national development agenda has a multiplier effect. In the case of the Co-operative Bank of Kenya, the bank initially focused on supporting agricultural activities (in line with the profile of the majority of Kenyan co-operatives). Being able to support this sector, which was shunned by other financial institutions, gave the bank a strategic boost. In contrast, the other national co-operative banks were founded on robust business activities but became part of a government initiative to help the poorer segment of the population – one considered unlikely to pay for the service. Their success and lifespan were limited.

Conclusion

Developing structures to enable capitalization of co-operatives in Africa is necessary for the sector to remain relevant. Establishing this requires a roadmap at the national level to support policies and regulations that work for co-operatives such as in the development of products and services that would increase membership levels. Co-operatives must be able to successfully advocate a model in which co-operatives have a sufficient capacity and role in the financial structures and systems of their countries.

Achieving this calls for flexibility or rethinking of some of the current Co-operative Principles. While the co-operative model cuts across sectors in economy, its ability to meet members' needs and aspirations is often determined by its financial muscle. Given this, there are huge challenges to be faced by co-operative organizations that need external sources of capital but are unable to access them. The Co-operative Principles are not cast in stone; let's look at our *raison d'être*. Our ultimate concern should be our members, and we need to exercise an appropriate degree of flexibility especially where our members are struggling to raise enough capital to engage in meaningful co-operative business to improve their lives.

“A robust co-operative bank requires that the country's co-operative strategies constitute an integral part of the financial system and services being provided to the masses. Recognition of the co-operative model in the national development agenda has a multiplier effect.”

8

Perspectives from the Ground: Fonterra Co-operative Case Study

PROFESSOR NICOLA M SHADBOLT AND ALEX DUNCAN

8. Perspectives from the Ground: Fonterra Co-operative Case Study

PROFESSOR NICOLA M SHADBOLT AND ALEX DUNCAN¹

Introduction

New Zealand accounts for 2%-3% of global milk production yet is the largest trader of milk across borders. In stark contrast to other milk producing countries, less than 5% of New Zealand milk is consumed within the country. Also, over the years, the number of providers of dairy products to New Zealand consumers has diminished as co-operatives have merged and the focus has been on developing export strength.

As co-operatives merge, maintaining the mutuality of the relationship among members, the heart of co-operatives, and their strength and adaptability (Boardman & Shadbolt, 2005), is a challenge. The literature on co-operatives is replete with discussion of the causes of co-operatives' formation and continued durability and growth. But the ground in which they grow shapes their evolution and means that context matters in critically assessing their diversity of form.

In New Zealand there are two pieces of legislation of specific relevance to co-operatives (Evans & Meade, 2005): the Co-operative Companies Act 1996, which serves as a companion act to New Zealand's general Companies Act 1993; and the Industrial and Provident Societies Act 1908. In addition, in 2001, the Dairy Industry Restructuring Act 2001 (DIRA) was passed, which enabled the establishment of Fonterra.

Fonterra is a dairy, farmer-owned co-operative. All of its shareholders are New Zealand farmer suppliers, with a requirement for shareholders to hold a minimum of one share for every kilogramme of milk solids supplied. The co-operative commits to collect the milk and pays for it according to a calculation that takes into account the percentage of milk fat and milk protein and the volume of the milk. There is one average farm gate price set for the whole season's supply of milk. This final price evolves over the season as market demand and exchange rates vary, so it is not determined and paid in full to the farmers until after the end of the season.

The co-operative processes the milk it collects in New Zealand (18 billion litres) into a range of products the majority being dried milk powder for export. The co-operative produces some 2.5 million tonnes of dairy ingredients annually, as well as food service and consumer products and exports to more than 100 markets. These products deliver a return to the co-operative that is retained for growth or paid out in dividends to shareholders. Fonterra also owns processing plants and collects milk from non-co-operative members in other milk pools such as Chile (500 million litres) and Australia (1.5 billion litres), and has access to milk in Europe and China through a variety of joint venture and wholly owned companies. Profits and losses from all geographies are reflected in the dividends paid to shareholders.

Fonterra is governed by a board of directors comprising nine directors elected from the shareholder base and four appointed directors. Voting for directors and constitutional amendments is based on milk production that is backed by shares held. Representation from the membership base is enabled through a 35-person shareholders council that is elected on the basis of one farm, one vote – more akin to traditional co-operative voting.

¹ Professor Shadbolt and Mr. Duncan are respectively a farmer elected Director and a former employee of Fonterra Co-operative Ltd. The views of the authors are not necessarily those of Fonterra Co-operative Limited.

Fonterra was established in 2001 from the merger of two dairy co-operatives (Kiwi Co-operative Dairies Limited, the New Zealand Co-operative Dairy Company Limited) and the New Zealand Dairy Board. The merger was enabled by DIRA. To address concerns about the possible competitive effects of the merger – particularly in relation to local consumers but also the acquisition of milk from farmers – DIRA provided for significant on-going constraints on Fonterra’s behaviour. One of the primary constraints placed on Fonterra by DIRA was the requirement of “open entry and exit”, which provides that in New Zealand Fonterra must:

- Accept all milk supply offered by dairy farmers in New Zealand willing to hold shares in proportion to their milk supply.
- Allow any farmer that wishes to cease supplying Fonterra to exit on notice at the end each season (subject to any long term contractual arrangements in place with the relevant supplier). Fonterra is also constrained as to how much milk it can collect under long term contracts.
- Enable an exiting farmer to realise the value of their investment in Fonterra without unreasonable delay.
- Ensure that new entrants and exiting suppliers (or those increasing and reducing their milk production and hence shareholding) in the same circumstances are treated on identical terms.

DIRA also imposed a range of other restrictions on Fonterra: in particular that Fonterra must make up to 5% of its milk production available to independent processors at a regulated milk price that references Fonterra’s farm gate price. This was to ensure that New Zealand consumers could be served by a variety of providers, not all of whom needed to have the capability to pick up milk. A key rationale for the open entry and exit regime outlined above was to keep barriers to entry for new competitors sufficiently low in order to promote a competitive price for milk at the farm gate including through Fonterra remaining efficient and innovative in the future. The latter aspects of dynamic economic efficiency were apparent as a key policy motivation in commentary and disclosures at the time. Fonterra’s institutional form as a co-operative is relevant in this context, since it faces a strong incentive to pay the highest milk price to its owner-suppliers on a long-term sustainable basis.

The pro-competitive regulatory regime that facilitated Fonterra’s formation in 2001 was complemented by the provisions of Fonterra’s Constitution.

A feature of the two major dairy co-operatives that merged to form Fonterra was to set shares at a nominal value. However, shareholders of both co-operatives voted to establish Fonterra on terms under which shares were issued and surrendered at their “Fair Value”. The motivation for this change stems from “free-rider” tensions within the co-operatives during the phase of rapid industry expansion in the last half of the 1990s. This required substantial investment in new processing capacity. A new capital instrument to better enable new entrants to bear the full cost of incremental capacity to produce their milk (Bekkum, 2001) was introduced. Valuing shares on a “Fair Value” basis thereby found expression in the founding capital structure of Fonterra.² The share value – calculated each year by an external body – was based on the net present value of projected future streams of revenue and costs in the co-operative’s business plans. The tension created by valuing shares at market value in this regime is that if they are too high, they create a barrier of entry for new suppliers and attract exit – too low and they attract new suppliers at the expense of existing suppliers.

² As did the separate ‘Peak Note’ capital instrument adopted by New Zealand Co-operative Dairy Company, although this feature was removed when Fonterra’s capital structure was simplified in 2005.

As discussed further, Fonterra itself – rather than a regulator – has defined the precise rules by which it sets its milk price (which ultimately determines its share price) within the context of the above pro-competitive incentives.³

The form that Fonterra took was, therefore, determined in part by legislation and in part by changes to the constitution approved by co-operative members at Fonterra's inception.

This chapter documents how Fonterra evolved from this point to address the constraints created by legislation and capture opportunities created by global markets, with a focus on capital issues. Using secondary data collected from publically available documents and the experience of the two authors who were involved in the process (as governor and manager respectively), it details the rationale for the capital structure adopted by Fonterra ("Trading Among Farmers") and outlines the rigorous process by which Fonterra worked with its members to introduce it. Some reflection is also provided on the process that was followed and the time required for democracy to have its voice.

There is a significant body of literature on the "demise of the traditional co-operative" and the observation that they either cease to exist – or restructure to shift into different forms – as a result of the problems they face. However, little research exists into how the new forms perform and further adapt to both strengthen their business and stay true to the fundamentals of being a co-operative. This may be because – as noted by Nilsson, Svendsen and Svendsen (2012) – most co-operatives are still traditionally organised. This paper provides evidence from a co-operative that has (been) shifted from its traditional form and documents how it addressed and resolved a particular issue of redemption risk that its new form has created.

Progress of Fonterra post-2001

By 2014, Fonterra has become the world's largest milk processor (by volume of milk processed). It employs 17,300 staff globally, and in the 2013-2014 financial year, it generated revenues of NZ\$22.2 billion. As New Zealand's largest business, its success (measured in what it pays farmers for their milk and the profit it generates in doing so) has a large impact on the New Zealand economy.

As already noted, Fonterra is characterised by an export orientation unusual in dairying. The collective strength of Fonterra therefore is reflected in its ability to be competitive in global markets that are many, varied, and require a high degree of in-market knowledge; as well as finely tuned supply chains, logistics, and efficient processing and packaging.

THE CHALLENGES CREATED BY DIRA AND THE SOLUTIONS SUGGESTED

After a period of relative stability following its formation, Fonterra faced increasing challenges from 2007 onwards reflecting three inter-related factors:

- Greater volatility in milk prices. This led Fonterra to initiate an auction platform to discover prices for key commodities (initially whole milk powder but later extended to other products and sellers). This platform – known as 'Global Dairy Trade' or GDT – held its first auction in July 2008.
- Greater competition for milk, partly as a result of the regulatory regime. Fonterra's share of raw milk in New Zealand progressively fell from about 96% in 2001/02 to under 90% in 2012/13. Nonetheless, due to strong milk growth in New Zealand, while

³ For a fuller discussion of the incentive effects of open entry and exit at fair value, refer to Evans and Quigley; "(2001) and Evans, E., & G. Guthrie (2006).

Fonterra's share has fallen, the volume of milk it processes has significantly increased in the last 14 years.

- A nationwide drought in the 2007/08 season that resulted in a significant reduction in milk volumes. The impact of the drought coincided with a fall in Fonterra's share price in June 2008 and the onset of the Global Financial Crisis.

The above factors, together with a share standard that strictly linked shares held to production, resulted in farmers being required to surrender shares due to lower production and for Fonterra to purchase them during unfavourable conditions associated with the Global Financial Crisis. The result was a significant net payment by the co-operative to its shareholders. The co-operative was faced with undue redemption risk that was restricting its ability to capture growth opportunities in the market.

Of note was the loss of share in raw milk that reflected the regulatory obligation for Fonterra to make up to 5% of its milk production available to independent processors at a regulated milk price. This regulatory milk was supplied primarily to companies setting up to export milk rather than provide it to the domestic market, including to companies that existed before DIRA. There was no term limit on how long those companies could receive regulatory milk, and they could 'cherry pick' when they received milk to optimise seasonal plant utilisation. These outcomes were contrary to the underlying policy goal of reducing milk supply risks during the initial 'start-up' phase of new entrants, as well as businesses that supplied the domestic market. The cost to Fonterra was losing milk often at key times through droughts and at the beginning and end of the season. This resulted in reduced plant efficiencies as well as competition in overseas markets from companies using milk supplied by Fonterra's farmers at a price well below its opportunity cost. Most of the new companies set up since DIRA are now majority overseas owned.

These factors gave impetus to both a request for a change in DIRA and a change in its own capital structure. Removing the obligation for the co-operative to issue and redeem shares would require an alternative basis for liquidity the most obvious being trading of shares amongst farmer-members.

In advance of this, in 2009, the co-operative instigated a critical change that involved allowing members to hold more shares than required to back production and the unbundling of pay-out to farmers into a dividend on shares and a milk price on milk solids supplied. This was overwhelmingly supported by its shareholders. The user-control principle was not challenged as voting rights were not attached to these "dry shares". However, the changes resulted in residual rights (dividends) being linked to shares rather than supply and therefore departed from the user-benefit principle and Chaddad and Cook's (2002) defined patronage-based returns. However, the change strengthened incentives for farmers to retain dry shares when milk production fell since they would continue to attract a dividend. This reduced balance sheet risk while the share standard still retained a strong link between production and ownership (with dry shares as a total of all shares on issue being a small percentage of total shareholding). Dry shares did, though to only a limited extent, relieve the constraint on raising equity capital commonly associated with the residual rights of control criteria.

THE JOURNEY FROM IDEA TO FUNCTIONALITY

Advice from capital markets experts to Fonterra and the government was that trading of shares amongst farmer-members alone was unlikely to provide a market that was deep enough to provide adequate liquidity or avoid "one-sided trading" that results when a relatively homogenous group of security holders decide, simultaneously, to either sell or

“Removing the obligation for the co-operative to issue and redeem shares would require an alternative basis for liquidity the most obvious being trading of shares amongst farmer-members.”

“Trading of shares amongst farmer-members alone was unlikely to provide a market that was deep enough.”

INFORMATION BOX: KEY MILESTONES IN IMPLEMENTING FONTERRA'S NEW CAPITAL STRUCTURE

- **2007:** There was a failed attempt to change capital structure through the creation of a publicly-listed entity that would hold the operational assets of the co-operative and be 85% held by a 100% farmer-owned co-operative that linked ownership to supply. This was not implemented due to concerns that this would eventually lead to a loss of farmer control.
- **2008-2010:** The Global Dairy Trade (GDT) auction platform was implemented in July 2008 to provide a key objective reference point for the setting of Fonterra's Farmgate Milk Price and hence improve price transparency.

In the season ending in June 2010, additional flexibility in the share standard was introduced by: 1) allowing farmers to hold more shares ("dry shares") than required by the share standard tied to milk production, and 2) paying a dividend on shares separately from a milk price on milk supplied (previously, distributed earnings were "bundled" with the payment for milk).

After consultations with shareholders in March 2010, in June 2010 shareholders overwhelmingly approved changes to Fonterra's constitution to enable capital structure changes (78% voting participation with approval of 90% of votes cast). This new regime is referred to as "Trading Among Farmers" (TAF).

- **2012:** In June 2012, a second vote for TAF was held. Additional safeguards were incorporated into Fonterra's constitution.

In July 2012, after a six-month consultation process, amendments to DIRA were passed that enabled TAF and put in place Commerce Commission oversight of Milk Price. The Commission completed a "Dry Run" review of Milk Price with no material issues.

Prior to the listing of units, shareholders were invited to sell the economic rights of their shares to the Fonterra Shareholders' Fund, receiving in return a price equal to the initial NZ\$5.50 per share. However, only NZ\$30m was offered by shareholders. Fonterra therefore issued shares itself to the Fund to achieve a target listing amount of up to NZ\$525m.

In November 2012, TAF was launched and Fund units starting to trade on the stock market.

- **2013 onwards:** In June 2013, a second opportunity was given to Fonterra shareholders to sell economic rights to the Fund. The offer was oversubscribed, and acceptances were scaled back. As a result, the full NZ\$525m raised when the Fund was launched in late 2012 was returned to shareholders.

Since the launch in November 2012, Fonterra's unit and share prices have been closely aligned and supported by good liquidity (ranking among the top 10 equities on the New Zealand Stock Exchange). Liquidity is supported by both the unit market and the shares traded on the shareholder-only exchange.

purchase. Adequate liquidity was considered to be critical for both farmers (since they would be forgoing the ability to redeem or acquire shares from the co-operative) and the government, which was concerned that inadequate liquidity would weaken the open entry/exit regime to which Fonterra was subject.

Key events that led up to Fonterra changing its capital structure in 2012 shaped the form of those changes, as illustrated in the Box below.

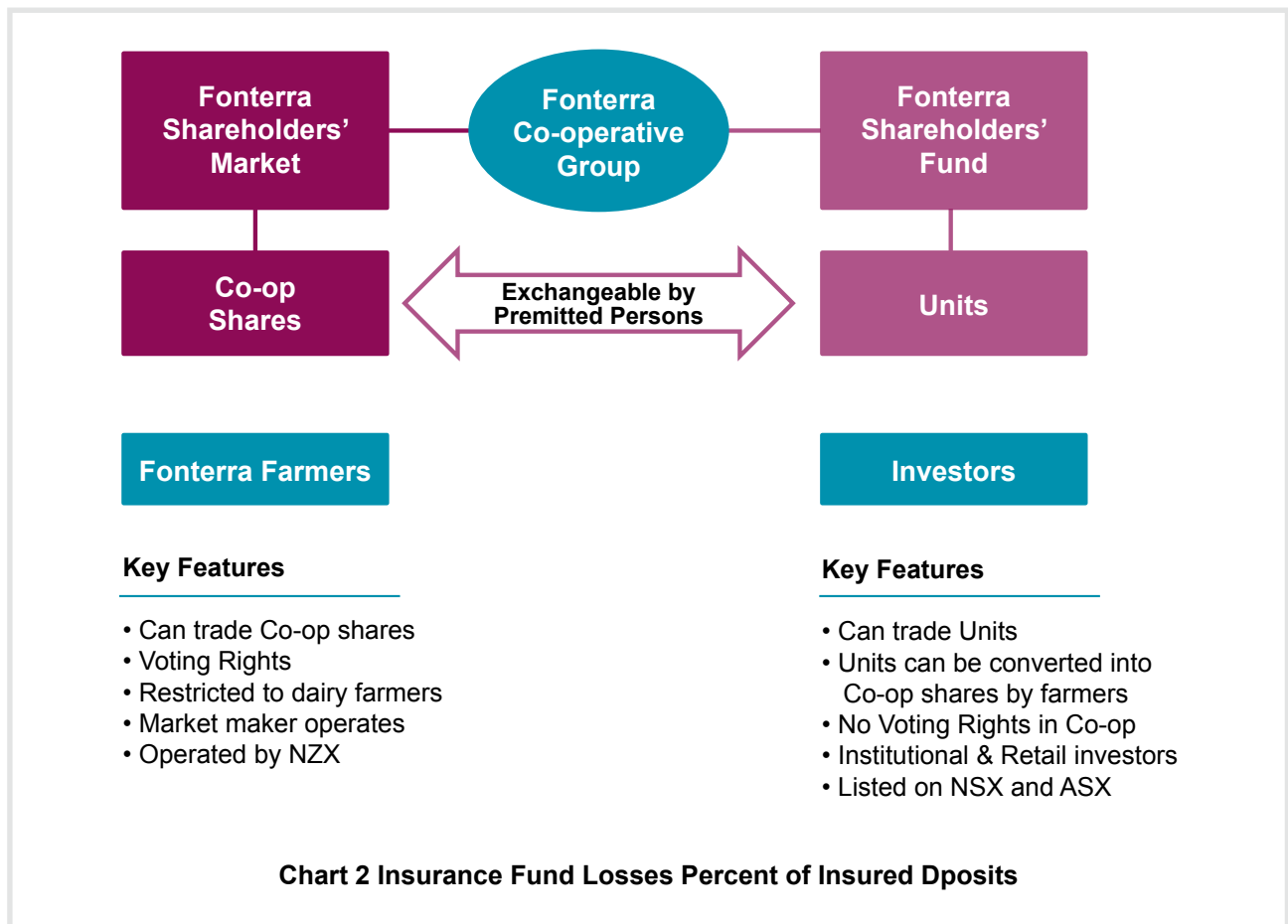
Fonterra's capital structure, Trading Among Farmers (TAF) implemented in November 2012 is outlined in Figure 2. It consists of two markets: one for shareholders only (for shares) and one for the public (for units) and resulted from the following developments:

- Creating a derivative equity instrument (a unit issued by a “Fonterra Shareholders’ Fund”) that can be held by the public with identical economic rights to a share;
- Relaxing the share standard to enable farmer shareholders to hold ‘dry shares’ up to double their production (within an overall cap of 20% of total shares) on the expectation that a small number of shareholders may provide a significant amount of liquidity; and
- Providing more flexibility in the timing of the purchase or sale of shares by changing the basis on which a farmer’s minimum share requirement is calculated to a rolling average of their production in the previous three seasons, not just the prior season as previously.

“Adequate liquidity was considered to be critical for both farmers (since they would be forgoing the ability to redeem or acquire shares from the co-operative) and the government, which was concerned that inadequate liquidity would weaken the open entry/exit regime to which Fonterra was subject.”

Shareholders are able to sell the “economic rights” of their shares to these public investors through the Fund, subject to limits imposed by Fonterra. If those shares back the milk production of the farmer, the transaction does not reduce his or her voting rights. The farmer continues to exercise voting rights in respect of that production by the recording of a “voucher” in Fonterra’s register. The Fund issues a unit to the public for each share for which economic rights are purchased. The unit is then listed, and the proceeds from issuing the unit are paid to the farmer.

After a significant period of review and consultation that spanned nearly two years, the New Zealand government enacted changes to DIRA in July 2012 that facilitated the trading of Fonterra’s shares and created a role for the Commerce Commission (New Zealand competition regulator) to provide oversight of the annual process by which Fonterra sets its milk price for a season.



In broad terms, the legislation required Fonterra to ensure the shareholder-exchange is a 'registered' market under equity-market regulations (thereby importing requirements related to market rules, oversight, and conduct), and provide certain key rights and protections for the holders of units in respect of the management of the Fund (but, importantly, not in relation to Fonterra).

DIRA also imposed certain other disclosure and process obligations on Fonterra in respect of the setting of its milk price and, importantly, removed Fonterra's obligation to provide milk to competitors who had their own milk supply and altered the conditions under which competitors could source milk through the season.

In parallel with this process, the detailed design of new structures and processes to give effect to Fonterra's new capital structure proceeded under the oversight of the board, including a due diligence committee of the Board created solely to focus on these changes.

Key features of the design reflected the objectives of changes to the capital structure. The primary objective was to remove the obligation of the co-operative to issue and redeem its shares, which had posed significant balance sheet risk. Importantly, the objective was not to raise capital – any proceeds from the issue of units to the public would be paid to shareholders, and not Fonterra. Equity would continue to be raised by retentions from earnings or conventional equity raising approaches.⁴

The Fonterra Board, the Shareholders' Council, and shareholders generally were also mindful of risks to the stability of the co-operative if patronage-linked equity fell significantly over time as a proportion of all equity. The board received advice that a material divergence would make agency and other issues increasingly acute (Cook, 2012). Accordingly, particular attention was paid to the design of policies and processes to limit the extent to which the Shareholders Fund could grow as a proportion of shares on issue (with a threshold of 20% at which point significant action would be required). Likewise, the proportion of shares on issue in excess of the aggregate that shareholders are required to hold (dry shares) is subject to similar thresholds and oversight.

Units in the Fonterra Shareholders' Fund were listed on the New Zealand and Australian stock exchanges in November 2012. The listing followed a book build among institutional investors that resulted in an issue price at listing of NZ\$5.50 per unit (which was the upper end of the NZ\$4.60-NZ\$5.50 range disclosed at the start of the book build process). Fonterra issued NZ\$525 million of units at this price. The NZ\$525m was subsequently fully paid to shareholders through a second offer to sell economic rights in June 2013, as noted in the Information Box. These are the only vouchers that have been issued to-date, with all other transactions being trades and transfers of dry shares. The price of the units (and Fonterra shares by connection) altered significantly over subsequent months as the market familiarised itself with the co-operative business model and extreme volatility of the milk market (milk prices doubling and then halving in a matter of years). This, coupled with the realisation that growth is funded primarily by retained earnings, has resulted in a more cautious approach now used to value the units and the appearance of a risk beta not dissimilar in size to the one used when shares were valued before TAF was created.

Discussion & Conclusions

The evolution of Fonterra from its original form, albeit already a shift from the traditional co-operative form, has involved lengthy and considerable consultation with its various stakeholders, notably government and its member shareholders. It also involved some

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⁴ Fonterra Prospectus (2012), Fonterra Co-operative Group, p.114

experimentation akin to that described by Fairbain (2004) when the board made its first attempt to introduce capital structure change in 2007. This first attempt challenged the user-owner principle (Barton, 1989) and Chaddad and Cook's (2004) residual rights of control criteria and was rejected by members.

Interestingly, the next "experiment" in 2009 that involved allowing members to hold more shares than required, and the unbundling of pay-out to farmers into a dividend on shares and a milk price on milk solids supplied, was overwhelmingly supported. The final change to address redemption risk created by DIRA was more contentious as it involved the introduction of outside equity: not to purchase shares and become owners in the co-operative, but to purchase "economic rights" from members and trade them in a separate listed exchange. Residual return rights (dividends and share value) claimants now included non-members. If the defining characteristic of a co-operative is that its members are the residual claimants, as stated by Chaddad and Iliopoulos (2013), then this change posed a challenge.

It was recognised that this last step could put the Co-operative Principles at risk so various steps were included to address this. Firstly the voting rights, being the residual rights of control, were retained with members even after the sale of the economic rights to their shares. Residual return rights do not change apart from the fact that shares are now valued by the farmer market and unit market rather than through a predetermined valuation process. A collateral benefit of the unit market being publically tradable is that the co-operative is now subject to external control mechanisms provided by financial analysts scrutinizing investments. This was identified by both Holmstrom (1999) and Coque (2008, cited by Arcas-Lario et al, 2014) as being necessary for optimal and efficient investment portfolios. The co-operative is arguably better analysed and the issue of information asymmetry better resolved under the new structure than previously. Nonetheless, the language of financial markets is unfamiliar to many farmer members so on-going education is necessary to increase participation in, and understanding of, the trading platforms.

Setting a limit on the percentage of shares whose economic rights could sit within the unit market and the percentage of dry shares of total shares issued were both safeguards addressing the user-owner principle (residual rights of control) and patronage-based returns. While widespread support was gained for the introduction of dry shares in 2009, even though this departed from the user-benefit principle (patronage-based returns), the agency and other problems associated with passing returns to non-members were faced more starkly with capital structure changes implemented in 2012. Tight control of the size of the unit fund as a proportion of shares on issue was the response.

While the full spectrum of factors relating to member satisfaction were challenged throughout the process, including leadership changes, a key focus was to ensure members understood the changes and had the opportunity to be involved. Participation rates were high: 78% of shares at the June 2010 vote and 85% at the June 2012 vote. Of concern was a misunderstanding from within and from external commentators that this change was for the purpose of raising capital. This created tension within the co-operative as it was likened to the first failed experiment and a potential loss of residual rights of control to non-members – the slippery slope to corporate status.

In conclusion, the capital structure innovation put in place by Fonterra has delivered to its aim of enhancing the stability of its capital base, while enabling farmer shareholders to buy and sell shares through their own closed market and for a parallel unit market to supplement liquidity in the farmer-only market to facilitate 'fair' market values being realised, as required under DIRA. The determination to be a co-operative, the recognition of mutuality and its benefits, the power of the membership base to respond to and accept change after

“Voting rights, being the residual rights of control, were retained with members even after the sale of the economic rights to their shares. Residual return rights do not change apart from the fact that shares are now valued by the farmer market and unit market rather than through a predetermined valuation process. A collateral benefit of the unit market being publically tradable is that the co-operative is now subject to external control mechanisms provided by financial analysts scrutinizing investments.”

“The co-operative is arguably better analysed and the issue of information asymmetry better resolved under the new structure than previously.”

rigorous debate were all observed in this journey from idea to functionality. The focus now is to further stabilise the co-operative and, to paraphrase Arcas-Lario et al (2014), to enhance farmer member satisfaction through delivering quality services in order to help them achieve their goals and demonstrate that their co-operative is reliable and competent.

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The Statement on the Co-operative Identity

The Statement on the Co-operative Identity

Definition

A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social, and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise.

Values

Co-operatives are based on the values of **self-help, self-responsibility, democracy, equality, equity and solidarity**. In the tradition of their founders, co-operative members believe in the ethical values of honesty, openness, social responsibility and caring for others.

Principles

The co-operative principles are guidelines by which co-operatives put their values into practice.

1. VOLUNTARY AND OPEN MEMBERSHIP

Co-operatives are voluntary organisations, open to all persons able to use their services and willing to accept the responsibilities of membership, without gender, social, racial, political or religious discrimination.

2. DEMOCRATIC MEMBER CONTROL

Co-operatives are democratic organisations controlled by their members, who actively participate in setting their policies and making decisions. Men and women serving as elected representatives are accountable to the membership. In primary co-operatives members have equal voting rights (one member, one vote) and co-operatives at other levels are also organised in a democratic manner.

3. MEMBER ECONOMIC PARTICIPATION

Members contribute equitably to, and democratically control, the capital of their co-operative. At least part of that capital is usually the common property of the co-operative. Members usually receive limited compensation, if any, on capital subscribed as a condition of membership. Members allocate surpluses for any or all of the following purposes: developing their co-operative, possibly by setting up reserves, part of which at least would be indivisible; benefiting members in proportion to their transactions with the co-operative; and supporting other activities approved by the membership.

4. AUTONOMY AND INDEPENDENCE

Co-operatives are autonomous, self-help organisations controlled by their members. If they enter into agreements with other organisations, including governments, or raise capital from external sources, they do so on terms that ensure democratic control by their members and maintain their co-operative autonomy.

5. EDUCATION, TRAINING AND INFORMATION

Co-operatives provide education and training for their members, elected representatives, managers, and employees so they can contribute effectively to the development of their co-operatives. They inform the general public - particularly young people and opinion leaders - about the nature and benefits of co-operation.

6. CO-OPERATION AMONG CO-OPERATIVES

Co-operatives serve their members most effectively and strengthen the co-operative movement by working together through local, national, regional and international structures.

7. CONCERN FOR COMMUNITY

Co-operatives work for the sustainable development of their communities through policies approved by their members.

The Alliance's Blue Ribbon Commission on Co-operative Capital

The Blue Ribbon Commission on Co-operative Capital is a thought leadership group of individuals with particular expertise and experience in co-operative financial capital issues. Its mandate is to frame and guide the Capital strategy of the *Blueprint for a Co-operative Decade*, which is the global strategy for co-operative growth adopted by the members of the International Co-operative Alliance. We wish to recognize and acknowledge the significant contributions and support of the members of the Commission:

- Chair: Ms. Kathy Bardswick – CEO, The Co-operators Group, Ltd. (Canada)
- Mr. Evandro Kotz – Executive Director, Superintendent, Sicredi (Brazil)
- Ms. Monique Leroux – Chair of the Board, President, and CEO, Desjardins Group (Canada)
- Mr. Arnold Kuijpers – Director, Corporate Affairs, Rabobank (The Netherlands)
- Mr. TAN Suee Chieh – Group CEO, NTUC Enterprise (Singapore)
- Mr. Bill Cheney – President and CEO, SchoolsFirst Federal Credit Union (USA)

Author Biographies

Author Biographies

TAN SUEE CHIEH

Tan Suee Chieh is the Group Chief Executive of NTUC Enterprise, the holding entity of the group of NTUC social enterprises in Singapore. He serves as Deputy Chairman on the Boards of NTUC First Campus, NTUC Foodfare, NTUC Health, NTUC LearningHub, NTUC Link and Mercatus, and is director of NTUC Income and NTUC FairPrice.

He was previously the Chief Executive of NTUC Income from 2007 to 2013. Prior to that, he was President, Asia Pacific Region, of the SHL Group PLC. From 1981 to 2001, he was with Prudential PLC and held several senior positions including Chief Executive of Prudential Singapore and Managing Director, Established Markets of Prudential Corporation Asia.

He is an Advisory Board Member of the Sim Kee Boon Institute for Financial Economics at SMU as well as UniSIM College. He is a Trustee of the Singapore LSE Trust, the Vice Chairman of the Singapore Children's Society, a Fellow of the Royal Statistical Society and Institute of Actuaries, and a Past President of the Life Insurance Association of Singapore.

Suee Chieh is an alumnus of the London School of Economics and has a Master's in Social Organisational Psychology from Columbia University. He is a Fellow of the Royal Statistical Society and Institute of Actuaries, and was a Past President of the Life Insurance Association of Singapore and the Actuarial Society of Malaysia.

He received the "Outstanding CEO of the Year" award from the Singapore Business Awards (2013).

CHUIN TING WEBER

Chuin Ting is currently Senior Vice President, Corporate Office/ Cluster Development at NTUC Enterprise Co-operative Limited, the holding co-operative for the Singapore Labour Movement's Group of social enterprises. Over the past three years, she has played a key role in advancing various Group strategic initiatives in the areas of capital restructuring and capital management, as well as in the engagement of key stakeholders on Co-operative Principles and structure. Chuin Ting is also the Cluster Head for the Group's financial services cluster, in which role she supports the holding co-operative's engagement with its insurance subsidiary on strategic issues.

Before NTUC Enterprise, Chuin Ting was an investment professional at Lion Global Investors Limited, one of Singapore's largest local asset management firms. During a five-year tenure that encompassed the Global Financial Crisis of 2008-2009, Chuin Ting was first a fixed income analyst and thereafter a macro strategist. Prior to investment, Chuin Ting served the Singapore Ministry of Defence for nine years in a variety of positions in its Defence Policy Office, including as its Deputy Director, advising the Minister and Permanent Secretary for Defence on policy responses to international strategic issues.

Chuin Ting read Modern History at Oxford University, from which she has Masters of Arts and Bachelor of Arts (Honours) degrees. She also holds a Bachelor of Arts in Chinese Language and Culture from the Beijing Language and Culture University, the Chartered Financial Analyst (CFA), designation and the Chartered Alternative Investment Analyst (CAIA) designation.

BRUNO ROELANTS

Bruno Roelants has a Master's in labour studies. He is Secretary General of CICOPA, the sectoral organization of the International Co-operative Alliance for industrial and service co-operatives, and of its regional organization CECOP CICOPA-Europe. He worked on development projects in China, India, and Eastern Europe, and coordinated the co-operative negotiating group on ILO *Recommendation 193 on the Promotion of Cooperatives*. He has lectured on co-operatives in Italy and is a co-author of *Capital and the Debt Trap – Learning from Cooperatives in the Global Crisis* (second edition 2013) and of *Cooperatives and Employment – a Global Report* (2014).

FRANK LOWERY

Frank has been a long-time employee of The Co-operators having worked there in positions of increasing responsibility for the last 28 years. He is currently the senior legal officer of the company and corporate secretary. He oversees the legal, compliance, records and corporate secretarial functions of the company. He has also had past involvements on the public policy committee of the Canadian Cooperative Association, as Chair of the Government Relations Committee of the Ontario Cooperative Association, and as a director of AIESEC and of HOA. He was formerly a candidate for election to the House of Commons and to the Legislative Assembly of Ontario. He was one of the first group of legislative interns for the Legislative Assembly of Ontario in 1975.

WAYNE SCHATZ

Wayne has been with The Co-operators and its subsidiaries for nearly 20 years in various, progressively responsible legal and business roles. He is currently Vice President and General Counsel (P&C Operations) and Assistant Secretary. Wayne completed his legal education and training in the Provinces of Saskatchewan and Ontario, Canada. In 1996, after five years in private legal practice, he joined The CUMIS Group Limited, an insurance provider focussed on Canadian credit unions. Following a successful 26-year joint venture, in 2010 The Co-operators acquired CUMIS. In his current role, Wayne supports the corporate, commercial, and regulatory legal needs of The Co-operators property and casualty insurance businesses. He is also a second year student in the Masters of Management (Co-operatives and Credit Unions) program through Saint Mary's University in Halifax, Nova Scotia. Wayne and his wife, Clara, have three daughters and live in Ancaster, Ontario, Canada.

ARNOLD KUIJPERS

Arnold Kuijpers has been working with the Rabobank Group since 1981. At Rabobank Nederland and Rabobank International he had positions in various divisions including economic research, treasury, retail banking, and corporate banking. Arnold Kuijpers has been Managing Director for Rabobank Ireland Limited, as well as Director, Group Strategy. Currently Arnold Kuijpers is Director, European Affairs of Rabobank and is based in Brussels.

He has vast experience serving as chairman or member of non-executive boards of banks and other financial institutions in various countries.

He is a member of the Executive Committee of UNICO Banking Group and the Executive Committee of the European Association of Cooperative Banks. He is also a member of the Banking Stakeholders Group of the European Banking Authority in London.

Arnold holds a master degree in economic sciences from Tilburg University in the Netherlands.

HANS GROENEVELD

Hans Groeneveld is SVP of Co-operative & Governance Affairs at Rabobank Nederland, as well as Professor, 'Financial Services Co-operatives' at TIAS School for Business and Society, Tilburg University in The Netherlands. His responsibilities at Rabobank comprise initiating and managing strategic projects, as well as representing the bank in the national and international co-operative world on behalf of the Executive Board as speaker, consultant, or member of working groups/task forces. Previously, he held various senior and managerial positions in staff divisions and business directorates. He has been Deputy Chief Economist as well as Director, 'International Services'. Before joining Rabobank Group, he worked as manager at the Dutch Central Bank in the monetary and supervisory department, respectively. He holds a PhD in financial and banking economics. He is Board member of the International Raiffeisen Union (IRU) in Germany, Chairman of the Think Tank on European Co-operative Banks, and member of the Co-operative Business Education Consortium. He has published extensively on economic and financial topics, co-operative banks, and strategic organizational issues in academic and policy journals. As Professor, he teaches the co-operative organisational form and focuses particularly on financial co-operatives worldwide. Moreover, he is program director of research projects on co-operatives for third parties.

BILL HAMPEL

Bill Hampel is Chief Economist and Chief Policy Officer of the Credit Union National Association (CUNA), the largest and most influential national trade association advocating for America's credit unions, with over 100 million memberships and \$1 trillion in assets.

Bill is one of the longest tenured executives of CUNA having joined the association as economist in 1978. He was promoted to Chief Economist in 1985, and to Senior Vice President of Research and Policy Analysis in 1992. He transferred from CUNA's Madison office in 1997, and since then has been a senior member of CUNA's advocacy team. He served as Interim President/CEO of the association from June to September 2014.

Bill is an expert on the economy and credit union issues, and is regularly interviewed by the media for stories appearing on major national television, radio, and print outlets. He has also testified before Congress about a number of key credit union issues. Bill served as a staff member at Navy Federal Credit Union in Virginia during a one-year sabbatical in 1989.

He was on the board of directors for CUNA Credit Union (now Summit Credit Union) from 1991 to 2003 serving as board chair from 1999 to 2001. From 2004 to 2011 he served on the board of the National Cooperative Bank.

Hampel holds a doctorate in economics from Iowa State University. He and his wife Diane live in Alexandria, Virginia and have two children: Alan, a credit union loan officer; and Vonnice, a Congressional staffer.

JEAN-LOUIS BANCEL

Jean-Louis Bancel is member of the Board of the International Co-operative Alliance and Chair of its Principles Committee (the body in charge of keeping alive the Co-operative Principles). He is also President of the International Cooperative Banking

Association (since 2006) and was President of the International Cooperative and Mutual Insurance Federation (2001 – 2005), both Alliance sectoral organisations. He is a former civil servant of the French Ministry of Finance in various senior positions. He worked as secretary general of the Groupement des Entreprises Mutuelles d'Assurances (trade body of the non life mutual insurance sector, 1997 – 2004). He joined Crédit Coopératif in 2005 as Vice President and became Chairman in 2009.

PETER HUNT

Peter founded Mutuo in 2001 as the first cross mutual sector body to promote co-operative and mutual business to opinion formers and decision-makers. He has twenty years' experience in the mutual sector working with co-operatives, mutuals, and employee-owned businesses. For ten years, he was General Secretary of the Co-operative Party.

In 1999, he was a co-founder and secretary of Supporters Direct, the football supporters' initiative, which has gone on to establish over 100 supporters' trusts at professional football clubs.

He led the Parliamentary teams which piloted five private members bills through the UK Parliament, working with all parties to update co-operative and mutual law.

He led the Mutuo teams in major constitutional and governance reviews by the Co-operative Group and Nominet. He is a founder member of the management board of the Oxford Centre for Mutual and Employee-Owned Business, based at Kellogg College, Oxford University.

Since 2004, he has worked closely on a number of public sector structural reforms – including NHS Foundation Trusts advising both Government and Trust Boards on the adoption of new membership structures. In 2011, he advised the Coalition Government on its plans to mutualise Post Office Ltd and in 2012 published the report of the Ownership Commission, a two-year study into corporate diversity.

In 2015, Peter published an independent review into public policy affecting mutuals and completed work on the Mutuals Deferred Shares Act, which permits mutual insurers to issue cooperative share capital.

GEORGE OMBADO

George Ombado is a development economist with a significant amount of exposure in strategic management within the financial sector. He has undertaken assignments in government agencies, development agencies, and in the financial sector. He holds a B.Com. (with Honours), an M.A. in Economics of Development from Erasmus University in The Netherlands, and a MSc in Management from Strathclyde Business School, UK. George is the current Chief Executive Officer of the African Confederation of Co-operative Saving and Credit Association (ACCOSCA) having joined ACCOSCA as the Head of Research and consultancy; he played a key role in developing the five-year strategic plan for ACCOSCA presently under midway stream. He has worked with three leading financial institution in FTSE 100 (UK) and international development agencies. Mr. Ombado holds the I – CUDE designation. He is currently the Convener of the Alliance for Africa Banking Group.

NICOLA M SHADBOLT

Nicola M Shadbolt is elected director of Fonterra Cooperative, a dairy co-operative with approximately 10,000 members; \$22b turnover; 16800 staff globally; ingredients to over 100 countries; and branded products to Asia, Australia, China, Latin America, the Middle

East, and New Zealand. She is also Massey University Professor of Farm & AgriBusiness Management delivering research and education. Her research interests include co-operatives – their management and strategies, farm business analysis and performance indicators, ownership structures in dairying, investment and risk analysis, and overall strategic management by farmers. She is also DairyNZ Chair in Farm Business Management; Director of the International Food & Agribusiness Management Association; Director of Hopkins Farming Group, Ltd.; Editor of International Food and Agribusiness Management Review and International Journal of Agricultural Management; and represents New Zealand in the International Farm Comparison Network (IFCN) in Dairying. Nicola has a depth and breadth of understanding of farming and has been a farmer for over 30 years. She is shareholder and Director of five farming and forestry equity partnerships that include two dairy farms. The farming venture boasts a turnover of \$3m with assets of \$20m and complex arrangement of share farming arrangements within equity partnerships to leverage resources. In 2006 the farm won the Ballance Supreme Farm Environment Award for the Horizon's region. Nicola is a Fellow of the New Zealand Institute of Primary Industry Management and the Australian Institute of Company Directors.

ALEX DUNCAN

Alex's time in Fonterra commenced in early 2002 and ended amicably in July 2015. During most of that time, Alex led the Corporate Finance function of the Office of the CFO and played a key role in many significant changes made by the Co-operative. The most recent was leading the design and implementation of Fonterra's capital structure changes that took effect in December 2012. This included engagement with government agencies on refinements to the regulatory regime to which Fonterra is subject. In May 2007, Alex initiated the development of GlobalDairyTrade (GDT) through which Fonterra now sells around a third of its production. Alex was also a key advisor to the Board subcommittee that oversaw the development of the basis upon which Fonterra has set its Milk Price since 2008/09, of which GDT was a key foundation. Prior to joining Fonterra in 2002, Alex led the New Zealand Corporate Finance function of Arthur Andersen (and in that capacity was an advisor to the CEO's of the two co-operatives involved in the formation of Fonterra) and was earlier an official with the New Zealand Treasury for a decade from 1986. He commenced his career in the fishing industry during a period of significant reform in the early 1980s.



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